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Remarks of J. L. Robertson
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The Foreign Credit Restraint Program of the Federal Reserve - Past, Present, Future

When I accepted the invitation to address this group I had no idea that we were going to be gathering at such an interesting time. After what we have been through in recent weeks, I can appreciate why the ancient Chinese cursed their enemies by saying, "May your children live in interesting times." I hope that we can keep things from becoming any more interesting.

Of course, if we are to achieve greater tranquility in financial markets, we are going to have to maintain confidence. All of you as bankers know how important confidence is. I once asked a local banker in my home town, Broken Bow, Nebraska, how one got started in banking. He said, "It's all a matter of confidence, son. When I started, way back yonder, we didn't have a bank here so I just hung up a sign reading 'Bank'. Pretty soon a feller came along and deposited a hundred dollars, and then one of the ranchers put in five hundred. That gave me so much confidence that I put in ten of my own."

There is no doubt that the bolstering of confidence in the dollar is necessarily commanding top priority attention these days. It is common knowledge that international confidence in the dollar will be difficult to maintain unless we are successful in correcting our balance of payments deficit. Our huge gold reserves gave us many years to bring about a solution to that problem, but, perhaps because of an excess of confidence, we did not act as soon or with as much vigor and resolution as prudence might have dictated. As a result, the actions we have taken and are now being forced to take are more drastic than would have been necessary if the job had been firmly tackled earlier.

For several years now the free world economy has been confronted with two related but separable problems. Both are of great concern to the United States; the solution to both requires action by us; but neither can be resolved solely by action on our part. I refer, of course, to the deficit in the U. S. balance of payments and to the role of gold in the international monetary system.

Two weeks ago we took a step toward the resolution of the second problem by terminating the "gold pool" arrangement and separating the gold markets of the world into two - an official and a private market. A step long advocated by some, but feared and abhorred by others, was finally made necessary by events. From my point of view, it will prove a desirable and useful step. We can now proceed - rapidly, I hope - to the development of a new international reserve asset capable of human management; capable of being expanded at a rate which the nations of the world collectively can determine, rather than a rate determined by the vagaries of hoarding demand and the profitability of gold mining.

But it would be a mistake to believe that progress in this direction has reduced in the slightest the need for achieving a greater degree of equilibrium in our country's international accounts. True, here too, we need international cooperation; our own policy actions, while necessary, may not be sufficient. It has become a trite observation that if some countries run deficits in their balance of payments, others are bound to be running surpluses. Appropriate remedial actions by both kinds of countries are necessary for the restoration of international financial equilibrium. One of the heartening developments is the growing and public acknowledgment of this simple fact of life in the capitals of Europe.

But neither does that absolve us from the necessity of managing our own affairs with a proper eye to external as well as internal balance. In the present state of the domestic economy, with its inflationary bias, we need more fiscal rectitude. To be specific, we need a far closer balance between federal income and outgo than we have seen recently or are likely to see this year or next in the absence of both a tax increase and a reduction in expenditures. We can have guns and butter, but not unlimited amounts of both at the same time. And, of course, monetary policy must make its proper contribution to the balancing of demands for goods and services with our ability to produce them. The recent more restrictive stance of credit policy is well known to this audience.

But these general policies - which operate on overall demand in the economy - affect only slowly the major elements

in the balance of payments, especially the all-important trade account. In the meantime, it is regrettably necessary to continue and even to intensify the programs we have adopted to bring the external balance under better control. And it is our common interest in one of these programs - restraint on bank lending - that has brought us together today, which may be the happiest accomplishment of the program to date.

Let me say again what I have often said before, that while I question whether these restraints are beneficial either to the balance of payments position or the U. S. economy in the long run, I am persuaded that for the short run they are essential and are preferable to any other quick alternatives in sight. They are far better than resort to a system of government licensing of individual transactions - a system that has been discarded by most of the nations that have tried it.

We are now well into the fourth year of this program, in which we have received the thorough - I suppose you would not want me to say wholehearted - cooperation of the banking community. But I am proud of that cooperation, and I know it has not been given grudgingly but rather in the knowledge that the maintenance of a sound and stable dollar is in the interest of all Americans as well as the banking community. All of us know that our balance of payments deficit is not an inconsequential tail wagging a dog, but a serious disease of a crucial nerve center - a disease that unchecked would threaten not only to cripple this particular dog but to infect the entire kennel. Without reasonable equilibrium in our payments balance, we cannot keep our economy prosperous and growing, and without growth and prosperity in the United States there cannot be continued growth and prosperity elsewhere in the free world.

In 1965 and 1966 we did manage, with the help of the voluntary foreign credit restraint program, to reduce our payments deficit to about \$1.3 billion each year, but in 1967 we came up with another whopping deficit - \$3.6 billion on the so-called liquidity basis. It was \$800 million greater than the liquidity deficit for 1964, and you may recall that

it was the size of the deficit in that year that led to the imposition of the program and other balance-of-payments measures in early 1965.

Not only did the overall deficit turn out worse last year than it was back in 1964, but our trade balance, which is an important measure of our competitive strength, suffered a serious deterioration. In 1964 we took considerable comfort from the fact that we had a \$7 billion surplus on trade account, and nearly \$8.5 billion on our current account as a whole, including military expenditures abroad. After allowing for our net government grants and credits abroad, we still had a \$4 billion surplus in that year out of which to finance private capital outflows. We reasoned that if we could keep private capital outflows down to about \$4 billion, we might solve our payments problem.

Thanks to the large reduction in the outflow of bank credit in 1965 and 1966, compared with 1964, we did succeed in sharply reducing the private capital outflow in those two years to around the \$4 billion level. And, as I said, we did reduce our overall deficit. Unfortunately, however, we began to encounter trouble in another area. Our imports grew much faster than our exports. Between 1964 and 1967 our imports rose about 45 per cent while our exports increased only 20 per cent. This cut our 1967 trade surplus to barely \$3 billion. This was not enough to cover even our official grants and credits, much less private capital outflow.

It is little wonder, therefore, that the President found it imperative to announce more stringent balance-of-payments measures on January 1 - including much tighter restraints on foreign lending and investing by banks and other financial institutions. This tightening in no sense reflected any disappointment with the way these particular programs had worked. On the contrary, with the magnificent cooperation of these institutions, we had achieved all that we had hoped for under the voluntary foreign credit restraint program. The tighter control was necessitated simply by the fact that we had lost on current account more than we had gained on capital account. Therefore, still more had to be done.

Recognizing that some results could be achieved faster than others, the decision was made to turn the screw a little

tighter on the capital account while at the same time trying to get Congress to pass legislation that would help improve the picture on the current account. Unfortunately, as the weeks slipped by, confidence that the required fiscal measures would be adopted ebbed away, and the prospect of another heavy deficit in the U. S. balance of payments was a major factor in provoking the rush to gold last month. This abated when the gold pool countries decided to let the price of gold in the private market find its own level, but we must not think that the problem has been solved merely because this decision halted the hemorrhage of gold from the world's monetary stock.

Furthermore, we ought not to deceive ourselves with the pleasant fiction that the whole problem is merely a statistical matter that can be solved by readjusting our payments statistics. As bankers, you know as well as I do that statistical manipulation of financial statements - window-dressing, if you please - will not transform a weak bank into a strong one.

The U. S. balance of payments will continue to be a disturbing factor in the international monetary system as long as we continue to run a large deficit - sending more dollars abroad than foreigners are willing to hold. It is imperative that we move quickly to implement the President's program, since movement in this direction is an essential element in the basic solution of our problem.

As my previous remarks have suggested, the changes taking place in the size and composition of our payments deficit during the past three years have altered the role of the Federal Reserve's foreign credit restraint program. You will recall that in 1964 credits granted by banks in the United States to foreigners expanded by \$2-1/2 billion - an amount nearly equal to the entire payments deficit. Consequently, we could hope that a significant cutback in this outflow alone would make an important contribution to the elimination of our payments deficit; in fact, the complete cessation of the outflow of bank credit that was achieved in 1965 more than accounted for the entire improvement in the payments balance from 1964 to 1965.

In 1967 bank credit to foreigners expanded again, by slightly less than \$400 million. Our program for 1968 is

designed to convert that outflow into a reflux of about the same magnitude. The resulting improvement of nearly \$1 billion would be little more than one-fifth of the sum needed to eliminate our payments deficit completely. But at the risk of being considered petty, I believe that in our present payments situation every billion counts. Hence, while our bank credit program can make only a partial contribution to the solution of today's payments problem, I trust you will understand why the Federal Reserve has felt compelled not only to continue its program but to make it even more stringent.

But the comparison between the improvement to be expected from our foreign credit restraint program and the total needed for a correction of our payments deficit also explains why all of us at the Federal Reserve are convinced that our best efforts will be in vain if they are not accompanied by other drastic measures, covering the entire field of private and public expenditures at home and abroad. The rise in our imports alone should be sufficient proof of the overheating of our economy, and therefore of the need for more restrictive domestic policies. And we have learned at our cost that monetary measures alone are unable to correct the overheating if they have to work unaided by fiscal restraint.

From 1961 to 1965 we could hope that a temporary excess of domestic spending over domestic production could be considered a form of investment. Our economy was badly underemployed; and as the excess spending brought idle labor and idle plants back into production, total output and income were raised. We had reason to hope that the rise would be large enough to close the gap between expenditures and receipts, and thus do away with the deficits, both in the federal budget and in our total international accounts.

Today, our economy is close to full employment. We must continue to encourage further growth, both by bringing the hard-core unemployed into the production process and by raising the productivity of our industries. But we must realize that the possibilities for rapid growth are far more limited than they were prior to 1965. In those years, we could hope to achieve good results by merely diverting investment from foreign countries to the United States - in

other words, by cutting down the outflow of credit and capital rather than by reducing the total of public and private credit and capital expenditures at home and abroad. Today, such switching alone would be insufficient. For this reason we must consider our foreign credit restraint program as only a part of an endeavor to bring total expenditures back into line with our production. And clearly this effort cannot be restricted only to the private sector if we want to keep our economy at a stage of maximum productivity.

Under our Constitution, the Congress and the President decide what portion of our national product should be devoted to public rather than private expenditures. We have to accept their decision even if we consider the portion too high or too low, and even if we disagree with the purposes for which the funds are spent. But neither the President nor the Congress can alter the fact that the sum of private and public spending cannot exceed the total produced in our economy without resulting in price rises that will undermine our economic and social structure, and further diminish the competitiveness of our products in world markets.

These considerations bear on the rationale of the recent changes in the Federal Reserve guidelines, designed to help the banking community make its appropriate contribution to the needed correction of the payments deficit.

In order to produce a reflux of bank credit in 1968, it was necessary to reduce the ceiling to a level below the currently outstanding amount of foreign credits. This was accomplished in two steps. First, the leeway existing on January 1 was substantially reduced by lowering the ceiling from 109 per cent of the 1964 base to 103 per cent. Secondly, as you know, the ceilings for individual banks will be further reduced during the year as their credits to Western Europe are reduced in accordance with the provisions of the guidelines.

It appeared to us that this method of achieving the needed further reduction in the ceiling would be in harmony with the basic purposes of the program and would not cause unnecessary hardships or inequities, even though those banks

that have large amounts of outstanding credit to Continental Europe are being asked to bear a larger share of the necessary cutback.

We could have sought to achieve a net inflow simply by reducing the ceiling for all banks by several additional percentage points. But since one of the essential purposes of the program was to reduce outstanding credits to the surplus countries of Western Europe, we could find no logic in requesting banks which had few or no credits to that area to cut back their loans to other areas in order to achieve the \$400 million targeted inflow.

Let me emphasize that neither these cutback provisions nor any other parts of the guidelines justify refusal to extend bona fide export credits to residents of Continental Europe or to anybody else. The best way to correct a payments deficit is to expand exports; and the Federal Reserve will never intentionally do anything that might jeopardize export expansion. Clearly, however, a credit will expand exports only if without the credit the exports would not take place. Hence, a credit does not lead to export expansion if it either replaces what otherwise would have been a cash transaction or if it substitutes U. S. bank financing for financing available outside the United States. It is not always easy to draw the line between necessary and unnecessary export credits, and banks can hardly be blamed for being inclined to give a credit-worthy customer the benefit of the doubt. But the principle is clear enough; and if every bank tries to abide by that principle we cannot go far wrong.

Incidentally, as you know, the Board has recently made a change in its Regulation K, relating to Edge Act Corporations, that is connected with our foreign credit restraint program. The Board has suspended its "general consent" for the acquisition by those corporations of equity investments abroad. By requiring the Board's specific consent for all such investments, it will be possible to implement more fully the policy that banks should refrain from placing funds (even indirectly) in Continental Europe for any purpose other than to provide needed financing for our exports.

Canada has now been exempted from the program. In a sense, this is a logical extension of the Interest Equalization Tax exemption which Canada has enjoyed from the beginning, and I agree that a sound Canadian dollar is in our national interest. But this exemption makes it necessary to be sure that Canada is not used, directly or indirectly, as a "pass through" whereby U. S. dollars loaned or invested in Canada result in an increase of Canadian lending or investing in third countries. This exemption must not result in giving Canadian banks more advantages in competing with U. S. banks in third country markets than they otherwise would have. I have been assured that any steps that are necessary to prevent this from happening will be taken.

It seems unlikely that there will be a large outflow of credit to Canada by U. S. banks in 1968. Such outflow has not been significant in recent years, and I see no reason for believing it will expand this year.

Whenever I am privileged to discuss the Board's guidelines with the banking community, I am asked whether, despite its professed intent, the restraint program does not in fact hamper exports because export credits, like all other credits to foreigners, are subjected to the credit ceilings. I regularly answer that I know of no export transaction that has been prevented by the guidelines - and I have no doubt whatsoever that any such transaction would have been brought to my attention.

But today I want to say something about the adequacy of funds for export credits. We should not forget that banks in the U. S. are not the only source of dollar funds available for credits to foreigners. There is also the Euro-dollar market. As I understand the role played by that market in the U. S. payments problem, it helps mobilize dollar funds without increasing the net amount of dollars loaned to foreigners by U. S. residents. If a foreigner needs dollars to make a payment, either to a U. S. resident or to another foreigner, he can choose between asking for a dollar credit from a bank in the United States or from a bank located abroad and participating in the Euro-dollar market. If he chooses the second

alternative, he can draw on the pool of dollars already in the hands of foreigners, and especially of banks abroad - including the foreign branches of U. S. banks. In this way, the credit he receives only leads to a change in the ownership of a foreign-held dollar balance and does not add to our balance of payments deficit.

Those U. S. banks that have foreign branches have an opportunity to reduce the outflow of dollar funds by using Euro-dollars for purposes that would otherwise require an expansion of credits to foreigners by the home offices.

In order not to restrict the opportunities for Euro-dollar financing to those banks that already have established branches in Europe, the Board has decided that the use of bank funds for the establishment of new branches, even in Continental Europe, would not be inconsistent with the guidelines, as long as the funds involved are small and, in effect, constitute current expenditures rather than capital outflows. This exemption seems justified by the potential use of such branches to attract funds already in the hands of foreigners and to utilize those funds for transactions that otherwise would require the outflow of funds from the United States.

Such use of foreign branches not only will reduce demands for nonexport dollar credits to foreigners that otherwise might impinge on the amount available for the financing of U. S. exports; it may also be directly geared to the financing of those exports. Just as the development of the Euro-dollar bond market should reduce foreign demands on the U. S. capital market, so the use of Euro-dollar credits may reduce the short-term demands on our banks for dollar credits to foreigners.

The President's Executive Order of January 1, 1968, empowers the Board of Governors to invoke mandatory authority to implement the credit restraint program, but I see no reason for shifting from a voluntary to a mandatory program. Although in general voluntary restraints are more difficult to maintain the longer the restraints endure, I have so far seen no evidence of lessening of the heartening cooperation

of the banking community with the Federal Reserve program. I am confident that you will continue to support our common efforts as long as conditions make the continuation of the restraint program necessary.

I am also confident that with our present program, supplementing the more restrictive monetary and fiscal policies called for by prevailing domestic economic conditions, and with the cooperation of our free-world trading partners, we will succeed in correcting our imbalance of payments.

However, we must recognize the possibility that from time to time the capital flow from this country will tend to be excessive - that is, our capital outflow may, given the size of the current account surplus and government outflows, provide more dollars to foreigners than they are willing to hold. Consequently, we must have stand-by measures available for use in case of necessity. The kind of long-run measure I favor is a flexible Interest Equalization Tax applicable not only to all credits to foreigners but to direct investments as well - flexible geographically as well as with respect to export and nonexport credits. I much prefer this IET-type of restraint to any form of direct controls, such as specific licenses for foreign credits and investments, which I think should be avoided at all costs.

Taxes on capital flows may be compared to sales or excise taxes. If, for instance, there are excise taxes on some articles and not on others, any consumer can freely decide whether to spend his money for the taxed commodity in spite of its higher cost, or whether he prefers to shift his purchases in favor of untaxed items. Similarly, under an expanded IET, any banker could still freely decide which credit extensions to foreigners he would consider profitable in spite of the tax, and which ones he could profitably forego in favor of domestic uses of his funds. Hence, the credit market could still orient its transactions by the profit motive and would not be subject to inherently arbitrary government intervention in individual business decisions.

Incidentally, I suspect that the applicability of such a flexible IET to direct investments would be more palatable now to many businessmen who opposed the idea when I first

proposed it several years ago - they having had a taste of restraints under mandatory regulations.

I am sure that many objections can be raised to this approach. It is inevitably discriminatory; almost all specific taxes and selective controls are. There would undoubtedly be some erosion in the effectiveness of even the best designed system of taxes as schemes for evasion were developed. Political pressures might lead to enactment of a complex, and even more discriminatory, system of exemptions. It might be difficult to persuade the Congress to give the Administration the desired degree of flexibility to raise or lower the rate as needed to adjust the volume of capital outflow. But these problems must be viewed in perspective and not be magnified. If there were an easy solution, we would have adopted it long ago and would now be basking in the glow of a healthy balance of payments equilibrium.

I trust that a situation will not arise that will call for such a program - at least not if the fundamental measures which are needed both at home and abroad are quickly and effectively implemented - but our experience with the payments problem warns us not to take things for granted.

Under all eventualities, however, we must preserve the principle of closest cooperation between the Federal Reserve and the banking community. The success of our guidelines has been due to that principle - respected, I may say, on our part as well as yours. This principle flows from the logic of the situation. In the task of helping to restore the U. S. payments balance to reasonable equilibrium, there are no separate goals for the Administration and the public, for the Federal Reserve System and the commercial banks. There is only the common goal of supporting the dollar as a basic element of the international payments system - not for reasons of national prestige or individual gain but for the sake of maintaining the monetary framework that has made possible over the past twenty years - and will continue to make possible in the future, we hope - an unprecedented rise in economic welfare in the United States and in the free world as a whole.