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CAPITAL FLOWS IN THE U.S. BALANCE OF PAYMENTS
SINCE 1965

A Paper Presented By

Andrew F. Brimmer
Member
Board of Governors of the
Federal Reserve System

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Almost four years have passed since the United States in February, 1965, adopted programs aimed primarily at the improvement of the capital accounts in the U.S. balance of payments. More than five years have passed since the adoption of the Interest Equalization Tax (IET) in 1963, which was also focused on a segment of the capital account. Given this passage of time, one might naturally ask what effects -- if any -- have these programs had on capital flows as recorded in the balance of payments.

In this paper, I will review briefly the main developments since 1965 with respect to several key elements in our capital accounts. I will stress particularly the changes in those accounts with which the Federal Reserve portion of the President's program is concerned -- the flow of funds from commercial banks and other financial institutions. I will also discuss foreign borrowing in the United States through the sale of long-term bonds and securities (most of which are bought by U.S. nonbank financial institutions) and foreign investment in this country through the purchase of U.S. securities.

The general conclusions which emerge from this assessment of the impact of the balance of payments programs on capital flows can be summarized briefly:

- Commercial banks (which have not fully used the leeway available to them in any year since the voluntary foreign credit restraint program began)

* Member, Board of Governors of the Federal Reserve System. I am grateful to Mr. Gordon B. Grimwood of the Board's staff for assistance in the preparation of this paper.

by the end of September had reduced their foreign claims by over \$700 million below the amount outstanding at the end of last December, or by \$300 million more than had been requested for all of 1968.

- During the last 3-1/2 years, there has been a noticeable shift of bank funds to the developing countries, which has been matched almost entirely by a decline of bank lending in continental Western Europe.
- Foreign branches of U.S. banks have taken over a substantial part of the foreign lending formerly done by the head offices; the funds from which these loans are made are acquired mainly in the Eurodollar market.
- New issues of foreign securities in the U.S. still seem to be influenced to a considerable extent by the IET. Although such issues rose sharply last year and are continuing at a high level in 1968, the direction of this capital outflow shows clearly the impact of the IET.
- Foreign purchases of U.S. securities (which have become an increasingly important factor in the recent improvement in the capital account) may well exceed substantially the capital outflow related to U.S. acquisition of foreign issues during 1968.
- Finally, a basic improvement in our balance of payments must rest heavily on a sizable improvement in our trade surplus, which in turn will depend upon how successful we control inflation.

In stressing the role of the balance of payments programs on the flow of U.S. capital, I do not wish to imply that these programs were the only factors at work. Since 1965 many influences have affected these flows, and these other factors may well have been equally significant. I refer particularly to the restrictive monetary policy which was adopted in

the fourth quarter of 1965 and followed during most of 1966, and which was adopted again in the fourth quarter of last year. Other important developments were a slowdown in economic activity in the industrial countries of Western Europe during 1967 (which still may not have been completely reversed) and several major international financial disturbances.

Finally, the rapid development of the Eurodollar market, which was itself stimulated by our balance of payments measures, has provided alternative sources of financing, both through banks, including foreign branches of U.S. banks, and through the growth of the Eurobond market. These developments undoubtedly have tended to reduce the demand for capital from U.S. sources, particularly by foreign subsidiaries of U.S. corporations.

Flow of Commercial Bank Capital

Bank lending to foreigners was included in the balance of payments programs of 1965, in part at least, because of a very rapid increase in the foreign assets of banks during 1964. After increasing at an average annual rate slightly above \$1 billion in the previous five years (which was itself high from an historical standpoint and which was focused mainly on Japan), bank claims on foreigners went up by \$2.5 billion in 1964. Thirty per cent of the outflow in that year went to countries of Western Europe, excluding the U.K.; 25 per cent went to Latin American and other countries in the Western Hemisphere (excluding Canada); and 25 per cent went to Japan.

The principal objective of the 1965 program, then, was to reduce the rate of increase in bank lending to foreigners to a more manageable figure. At the same time, another main goal was to insure sufficient credit to finance our expanding exports and to meet the needs of the developing

countries. To achieve the latter objectives, the Federal Reserve requested the banks to give an absolute priority to bona fide export credits, and the highest priority in the nonexport category to credits to meet the needs of developing countries. Banks also were asked to avoid action that might place an undue burden on the United Kingdom, Canada, or Japan. Term loans to these nations as well as to other developed countries were inhibited in any event by the extension of the IET to bank credits with maturities of one year or longer.

The program announced in 1965 has been extended three times because the deficit in our balance of payments has persisted. The form of the bank program remained essentially unchanged until January 1, 1968. For the first time on that date the banks were requested to achieve a net inflow of funds during the year through a reduction in outstanding loans. The more restrictive program (which was focused especially on those countries whose surpluses mainly reflected our deficit) requested the banks to make no new nonexport credits to developed countries of continental Western Europe. Finally, due to an extremely difficult financial situation in Canada early this year, that country was exempted completely from all U.S. balance of payments programs on February 29, 1968.

The Federal Reserve Board constantly monitors progress under the programs for financial institutions to assure that the objectives are being achieved. My purpose here is not to give a progress report on the Federal Reserve program (for which I have administrative responsibility on delegation from the Board). Rather, my objective is to look at U.S.

capital flows over the last 3-1/2 years as influenced by the balance of payments programs and by the other factors mentioned above.

An Over-all View

Foreign assets held by commercial banks that are covered by the Federal Reserve program increased during 1965 by about \$170 million, compared with a permissible increase of almost \$500 million under the ceiling for that year. In 1966, despite an increase in the aggregate ceiling, covered assets fell by \$160 million, leaving the banks almost at their base date position of December 31, 1964. During 1967, covered assets increased by \$370 million, but the banks at the end of that year still had an aggregate leeway of \$1.2 billion.

The program announced last New Years Day in effect requested that banks reduce their covered foreign assets by at least \$400 million during 1968. By last September 30, as I mentioned above, the banks had reduced their claims by over \$700 million, or by \$300 million more than had been requested for all of 1968. At the end of September, the banks were \$328 million below the December, 1964, base figure, and they had an aggregate leeway for the remainder of the year of \$629 million. (Table 1 attached.) However, I do not expect that all of that leeway will be used. Moreover, I am confident that the banks will more than achieve the objective of a net inflow of \$400 million -- even if we experience in the fourth quarter the seasonal outflow of funds that usually occurs during the closing months of the year.

Geographical Distribution of Bank Capital Flows

As I stated at the outset, a striking change has occurred in the last 3-1/2 years in the geographic pattern of bank lending abroad. The data on which we must rely to trace the regional flows of bank capital are not exactly comparable with the aggregate figures given above. For this purpose, the analysis must be based on data supplied on Treasury Foreign Exchange forms from which the balance of payments statistics are derived. In general, the coverage of foreign assets reported on the Treasury forms is broader than that of the foreign credit restraint program because the former include collections and other claims held for account of customers, and also include claims held by the U.S. agencies and branches of foreign banks.

The Treasury data show that on December 31, 1964 (the base date), the developing countries accounted for 38 per cent of all bank claims on foreigners; Japan for 26 per cent; developed countries of continental Western Europe for 18 per cent; Canada for 11 per cent, and the United Kingdom for only 3 per cent. Broken down between short and long-term claims, Canada and Japan accounted for higher percentages of short-term claims, while the percentages of long-term claims on the developing countries and the developed countries of continental Western Europe were higher than the relative positions of those areas with respect to total bank claims.

Developing Countries

In the period December 31, 1964, to August 31, 1968 (the latest date for which data are available), over-all banks claims on foreigners

declined by 3.3 per cent. On the other hand, bank claims on the developing countries increased by 28 per cent. The shift in the direction of flow of bank credit was most marked with respect to long-term loans, which are most important to economic development. Long-term claims on developing countries rose by 33 per cent, and by the end of last August they accounted for 63 per cent of a total that itself had declined by 16 per cent over the same period.

Developed Countries of Continental Western Europe

The shift of funds to the developing countries was made almost entirely at the expense of the developed countries of continental Western Europe. Bank claims on these countries declined almost dollar-for-dollar by the amount that claims on developing countries increased. The major part of this shift was in the long-term area, where claims on developing countries increased by \$568 million while claims on Western Europe (mainly because they became subject to the IET in February, 1965) went down by \$1.1 billion.

United Kingdom, Canada, and Japan

Bank claims on these countries -- which were especially mentioned in the guidelines after export credits and credits to developing countries -- fluctuated during the period under review but changed only moderately overall. (Canada, as has been noted, was exempted from the program on February 29, 1968.) Total claims on the United Kingdom and Canada declined 22 per cent and 32 per cent, respectively, while over-all claims on Japan, after declining slightly in the last half of 1966, increased again by the end of 1967 to a level slightly above December 31, 1964.

Within these over-all totals both short and long-term claims on the United Kingdom declined, the short-term relatively more. Short-term claims on Canada were reduced by one half but were partially offset by an increase in long-term claims. A slight increase in short-term claims on Japan, which account for about 95 per cent of total claims on that country, was offset by a relatively sharp drop in long-term claims outstanding.

(Tables 2, 2-a, and 2-b.)

Impact of Restraint Program on Operations of U.S. Banks with Foreign Branches

When the foreign credit restraint program was announced in 1965, foreign branches of U.S. banks were exempted from the program provided that "the funds utilized (by the branches) are derived from foreign sources and do not add to the outflow of capital from the United States." This exemption was made because the operations of the branches are not reflected in the balance of payments statistics of the United States. It also avoided placing the branches in a less advantageous competitive position in the countries in which they operated.

Nevertheless, it was recognized that branch operations might have some effects on our balance of payments. Foreign branches of U.S. banks have taken over a substantial part of the foreign lending formerly done by the head offices. The funds from which these loans are made are acquired mainly in the Eurodollar market. To the extent that these funds represent a shift of dollar liabilities to foreigners from head offices to branches -- or to the extent that dollars are deposited at foreign branches which otherwise might have come to the head offices -- it is possible that there will be

an adverse effect on our balance of payments as measured on the official settlements basis.

Whether the adverse effect occurs depends upon the use made by the branches of these funds. If they are used for the purpose of making advances to the head office, there is no effect on our balance of payments whether measured on the liquidity or the official settlements basis. However, if the funds are used to make loans to foreigners that otherwise would have been made by the head offices, the official settlements balance may be affected. The borrowers may use the dollars acquired to purchase local currencies, or they may use the dollars in lieu of dollars that otherwise would have been acquired from foreign official reserves. In either case, our liquid liabilities to foreign official institutions would be higher than they otherwise would have been.

The business of the foreign branches expanded very rapidly after the announcement of the foreign credit restraint program. Dollar loans to foreign nonbank customers increased by almost 60 per cent between the end of February, 1965 (the first date for which such data are available) and the end of that year. To a considerable extent, this increase reflected the "sale" of foreign assets to the branches by the head offices of some banks that were substantially over the target ceiling when that ceiling was announced.

Bank loans to foreigners increased by 20 per cent in 1966. This more moderate gain partly reflected the adjustment of head offices to the program ceiling. But it may also have been the result of tightening monetary

conditions in the United States. Eurodollar funds acquired by the branches were advanced to the head offices to meet domestic requirements rather than used to increase branch loans to foreigners.

The increase in loans to foreign nonbank customers by the branches was 40 per cent in 1967, and in the first eight months of 1968 the rise was 30 per cent. As of the end of August, U.S. dollar loans outstanding to foreign nonbank customers at foreign branches of U.S. banks (at \$2.4 billion) were more than three times the amount of such loans outstanding on February 28, 1965.

It is difficult to measure the extent to which the branch lending activities may have resulted in the "substitution" or "shift" of U.S. head office liabilities to foreigners described above. One problem is that our data do not go back far enough and in sufficient detail. However, we may draw some tentative conclusions from an examination of changes in head offices deposit liabilities to foreigners in the years preceding and in the years since the announcement of the foreign credit restraint program.

If we look at U.S. bank deposit liabilities to foreign bank and nonbank customers, adjusted to exclude accounts that are affected by other than market forces (see Table 3), we find that the total of such liabilities increased by an average of 7 per cent per annum between the end of 1964 and 1967. Liabilities to foreign

banks increased by almost a 2 per cent annual average, while liabilities to foreign nonbank customers went up by over 10 per cent per annum.

Partial data for U.S. banks that had foreign branches prior to December 31, 1964, (the last year-end before the inauguration of the VFCR) indicate that deposit liabilities of such banks to foreign nonbank customers increased by almost 40 per cent between end-1964 and end-1967.

Data for banks that have established foreign branches since December 31, 1964, show the same pattern. These banks (which accounted for only 6 per cent of total deposit liabilities to foreigners on December 31, 1964) more than doubled deposit liabilities to foreign nonbank customers in the following three years.

We must conclude, on the basis of the above statistics, that it is possible that the activity of foreign branches might have had some adverse effect on our official settlements balance. However, the data do not provide conclusive evidence that this has been the case.

Flows of Funds from Nonbank Financial Institutions

Total foreign assets of nonbank financial institutions reporting to the Federal Reserve under the foreign credit restraint

program (insurance companies, finance companies, trust departments of banks, pension funds, etc.) were about \$14 billion at the end of June, 1968. On the same date, total foreign assets of banks amounted to about \$12 billion. However, of the former amount, only \$1.5 billion is subject to the guidelines; \$10 billion is exempt as claims on Canada; \$1 billion represents claims on international institutions, which are exempt from the guidelines; and the remaining \$1.5 billion consists of claims on developing countries and a small amount of other foreign assets which are specifically exempted from the guidelines.

The nonbank financial institutions were asked on January 1, 1968, to reduce their adjusted base date holdings of "covered" foreign assets to 95 per cent of the amount outstanding on December 31, 1967. As of June 30, 1968 (the nonbank financial institutions report on a quarterly basis), covered assets of all reporting institutions had been reduced by \$175 million from the end-1967 figure. As of last June 30, total covered assets outstanding were 93 per cent of the adjusted base date holdings. (Table 4.)

Assets not subject to the guidelines increased by almost \$400 million in the first six months of 1968. Two-thirds of this amount represented increased loans and investments in Canada.

Transactions in Foreign Securities in the U.S.

During the five years ending in 1961, the capital outflow related to net U. S. transactions in foreign securities averaged \$760 million annually; in only one of the five years did the outflow substantially exceed the average. In 1962, the outflow increased to \$970 million, and in 1963 the figure jumped to \$1.1 billion, a factor which led to the proposal of the IET. Moreover, larger amounts of new issues of European countries began to appear in the market. (Table 5.)

The Interest Equalization Tax had features which tempered its effect on new issues of foreign securities in the U. S., including the exemption of newly issued Canadian securities as well as the securities of the developing countries. Nevertheless, the tax did reduce sharply the capital outflow related to these transactions -- at least until 1967. The outflows for 1964, 1965, and 1966 were \$677 million, \$759 million, and \$481 million, respectively. In 1967, the outflow increased to \$1.3 billion and was running at only a slightly lower annual rate in the first half of 1968.

The direction of foreign portfolio investment by Americans was influenced by the incidence of the IET and the foreign credit restraint program. The increase in 1967 was related entirely to issues exempted from the IET (Canada accounted for 62 per cent of the new issues in 1967). Further, while it is not possible to separate long-term bonds from long term credits in our data, it appears that nonbank financial institutions might have accounted for approximately 60 per cent of the total increase in

net purchase of securities of Canada, Japan, the developing countries, and international institutions. Investments in all of these areas are exempted from the guideline ceiling for nonbank financial institutions.

Preliminary data for the first half of 1968 indicate a continuation of these trends with the exception of the international agencies. Based on these data, the outflow related to net transactions with Canada and the developing countries might be somewhat higher than in 1967. There was a net inflow on account of the international agencies of \$35 million in the first half, primarily as a result of large redemptions in the second quarter. However, new issues of international agencies are running a little above the 1967 level.

Foreign Purchases of U.S. Securities

At this point, it would be well to look at the other side of this coin, since foreign purchases of U.S. corporate securities have become an increasingly important factor in the recent improvement in our balance of payments.

In the five years ending December 31, 1964, net foreign purchases of U.S. corporate securities averaged about \$190 million annually. In 1965, there were net sales of \$350 million; however, this amount is more than accounted for by the liquidation in that year of securities owned by the government of the United Kingdom. Discounting this transaction, net purchases were only slightly lower than the average of the preceding five years. In 1966, net purchases jumped to \$900 million, twice the amount in any