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Statement of
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before the
Subcommittee on International Exchange and Payments
of the
Joint Economic Committee

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Mr. Chairman, I welcome the opportunity to respond to the invitation to testify at these hearings with respect to the voluntary foreign credit restraint program administered by the Board of Governors of the Federal Reserve System.

Since the guidelines for banks and nonbank financial institutions have been in force for about four years and have been revised several times, I have had prepared a report in some detail describing the evolution of the program together with statistical material. With your permission, I would like to submit that report for the record as an Appendix to this statement.

Present Structure of the Program for Financial Institutions

The present program is based on guidelines revised on December 23, 1968. These guidelines continued the program from the previous year without any major change. The program may be considered in two categories, a bank program and a nonbank program. Essentially, they are as follow.

1. The Bank Program. The revised guidelines for banks issued by the Federal Reserve Board on December 23, 1968, continue the program, initiated in February 1965, to restrain the rate of growth in credits extended from the United States by U.S. banks to foreigners. This is done by requesting each bank, individually, to hold the level of assets covered by the program to a given percentage of the amount of such assets it held on December 31, 1964. The target ceiling for 1969 generally is 103 per cent of the 1964 base figure or a ceiling related to a specific percentage of total assets, whichever is larger.

Each bank, while staying within its ceiling, is to give an absolute priority to extending credits for financing U.S. exports and to providing credits to developing countries.

Banks are requested to refrain from making new term loans -- that is, new loans of more than one year maturity -- to the developed countries of continental Western Europe, except for the purpose of financing U.S. exports. Furthermore, they are to reduce their ceilings on each reporting date by the amount of repayments in the preceding month of loans to such countries outstanding on December 30, 1967. Short-term loans to developed countries of continental Western Europe are to be held to 60 per cent of the level existing at the end of 1967.

Credits to Canadians are exempt from the guidelines.

2. The Program for Nonbank Financial Institutions. The objectives of the nonbank program are the same as those for the bank program. The guidelines for nonbank financial institutions have been conformed as closely as possible to those for the banks, with allowances for differences in methods of operation.

About 90 per cent of the total loans and related foreign assets of nonbank financial institutions are excluded from the guideline ceiling. The bulk of this exclusion, roughly \$10 billion, is accounted for by investments in Canada; the remaining \$2 billion of the exclusion is accounted for by bonds of international institutions and long-term investments in the developing countries and in Japan. The 1969 guidelines

request that the nonbank institutions hold the level of assets covered by the guidelines to 95 per cent of the amount of covered assets held on December 31, 1967.

The nonbank guidelines follow the bank guidelines with respect to priorities and with respect to restrictions on loans to developed countries of continental Western Europe and exemptions for Canadians.

Principal Changes in Programs Since 1965.

The objectives of the program for financial institutions and the means of achieving them have remained unchanged since it was established in 1965. In each year, as it became apparent that the programs would have to be continued, the financial institutions could count on operating under a program structured about the same as the earlier ones.

This has been possible largely because the program has been based, not on detailed regulations, but on guiding principles. Under the "guidelines," the management of each financial institution can operate with a minimum of governmental supervision or interference in decisions of management.

Another important fact is that the program remains voluntary. In Executive Order 11387, issued on January 1, 1968, the President authorized the Department of Commerce to issue regulations governing the foreign direct investment of non-financial firms. The Executive Order gave discretionary authority to the Board to regulate the

international transactions of financial institutions. When revised foreign credit restraint guidelines were issued on January 1, 1968, the Board announced that, in view of the strong cooperation received from the financial institutions throughout the life of the program, it did not intend to invoke the mandatory provision of the Executive Order. It has had no reason to change its position in this respect.

Those changes that have been made in the foreign credit restraint programs over the last four years were designed to assure that priority credit requirements could be met and to maximize the flexibility open to the institutions within the overall ceilings.

Several changes have been aimed at reducing the inequities inherent in a program of restraints. I will say more about them in a moment. The guidelines for 1966 and 1967 permitted banks with small base figures to add flat dollar amounts to their bases in calculating their ceilings. In most cases this alternative formula resulted in a ceiling higher than the formula based on the stated percentage of outstanding credits on the base dates. The initial guidelines for 1968 provided that reporting banks whose target ceilings (109 per cent of the 1964 base) were less than 2 per cent of their total assets as of December 31, 1966, could use the latter figure as their ceilings. The "2 per cent" formula had to be modified when a more restrictive program was announced on January 1, 1968, but the principle of providing an alternative based on total assets remained.

Another change was an upward revision in the target ceiling in 1966. This 1966 ceiling was maintained in 1967. This 1966 change was made because the Board was satisfied that the financial institutions were making every effort to reduce their foreign activities, and because the Board wanted to make absolutely certain that there was ample room within the ceiling to meet requirements for priority credits.

A major change was made in the guidelines issued on January 1, 1968. For the first time, they requested an outright reduction in the target ceilings of banks and other financial institutions. The reduction requested during 1968 amounted to \$400 million for the banks and \$100 million for the nonbank financial institutions below the level of covered assets outstanding on December 31, 1967. Additional emphasis was also given to priority credits to the less developed countries in order to prevent these reductions from bearing unduly on them.

Finally, as a result of a difficult financial situation that developed in Canada early in 1968, the U.S. Government agreed to exempt that country from the Federal Reserve, as well as the Department of Commerce, balance-of-payments programs after February 29, 1968. Canada was therefore effectively exempted from the guidelines. This exemption had a larger impact on the operations of nonbank financial institutions than on those of the banks.

Impact of the Programs on the Balance of Payments

The Committee will recall that the present programs were introduced in early 1965, after the increase of bank lending to foreigners rose to \$2.5 billion in 1964, more than double the average annual increase during the immediately preceding three years. This surge of bank lending abroad was due to several factors. The

imposition of the Interest Equalization Tax, effective in mid-1963, led to the subsequent substitution of bank financing for financing that had been done in the U.S. capital market. But there is also some evidence which suggests that a large amount of anticipatory borrowing occurred to avoid governmental controls which were generally expected by the financial community as the balance of payments situation worsened in 1964.

In the ten months following the announcement of the foreign credit restraint program, covered assets of banks increased by only \$170 million. Although this figure is not exactly comparable to changes in bank claims as reported for balance of payments statistics this sharp decline in the rate of increase, compared with 1964, more than accounted for the total improvement in the balance of payments in 1965.

Nonbank financial institutions reduced their covered assets by \$200 million during 1965. The reduction included a 50-per cent decline in holdings of liquid funds abroad.

In this instance, we are fairly sure that the program had a major impact on movements of bank capital. Many banks found themselves over the target when the program was announced, and many had binding commitments that had to be honored. Their efforts to get within the target ceiling under these circumstances, including in some cases the selling of foreign assets abroad, undoubtedly was the major reason for the reduction in the rate of growth in bank lending.

Beginning about the fourth quarter of 1965, monetary conditions in the United States began to tighten and remained tight during 1966. The limited availability of funds to meet domestic loan requirements reduced the interest of the banks in making foreign loans; indeed, during 1966, the banks, through their foreign branches, pulled in a sizeable amount of Euro-dollars for use in the domestic market. At the same time, a rise in interest rates in the United States relative to rates abroad reduced the attractiveness of the U.S. capital market for foreign borrowers. A reduced level of economic activity in Western Europe also had an impact on foreign demand for credit here.

Covered assets of the banks declined by about \$150 million in 1966; this swing from an increase to a decline in assets improved the U.S. payments balance by approximately \$300 million. Market forces were predominant during this period although the foreign credit restraint program undoubtedly had some effect in individual instances.

Monetary conditions eased in 1967. In that year, the banks recorded an outflow of about \$370 million. This swing from an inflow in 1966 to an outflow in 1967 contributed \$500 million to the deterioration of the balance of payments. On the other hand, banks in the aggregate maintained a substantial leeway under their ceilings during the year, so we cannot say with certainty that the foreign credit restraint program exercised a severe check on lending abroad.

From the start, the programs have taken care to avoid adverse effects on export financing and the extension of loans to the developing countries. Both are "priority areas" in the guidelines. I will comment briefly at this point on the experience of the developing countries under the program.

Helping the developing countries meet their capital needs has been an important national objective for many years. It was recognized early in our formulation of U.S. balance-of-payments measures that there would be no point in reducing the outflow of capital in the private sector if that cutback merely resulted in a larger outflow from the U.S. through the public sector. This is the reason for the high priority accorded in the guidelines to credits to the less developed countries. It was also the reason, as I mentioned earlier, for designing the restrictive program for 1968 in such a way as to minimize the impact on the developing countries.

The banks are observing the priority. In almost four years since the inauguration of the restraint program (through October 1968), the foreign claims of banks have been reduced by \$170 million. But over the same period, claims on the developing countries have increased by \$1.4 billion, almost half of which consisted of long-term loans which are so important to economic development.

Impact of the Program in 1968 and Prospects for 1969

We have now reached a point where we can begin to assess the performance of the financial institutions under the revised program announced in the President's New Year's Day Message of 1968 --although we have data on the banks only through November, 1968, and on the nonbank financial institutions through the third quarter of 1968.

You will recall that the program was designed to secure a reduction in holdings of banks' covered assets by \$400 million during that year. As of November 30, 1968, they had reduced their covered assets by \$673 million, or by \$273 million more than the objective for the year. If this proves to be the position at the end of the year, the change in bank lending between 1967 and 1968 will have contributed about \$1 billion to the year-to-year improvement in the U.S. over-all U.S. payments position.

By September 30, 1968, the nonbank financial institutions had reduced their holdings of covered assets by \$192 million; this compared with a suggested reduction of \$100 million. The actual reduction was achieved despite the exclusion of Canadian assets from the target ceiling on February 29, 1968. Canadian assets are by far the largest part of the foreign portfolio of the lending institutions; they account for about 70 per cent of total foreign assets and about 80 per cent of assets not covered by the guidelines.

What are the prospects under the guidelines for 1969? The banks on November 30, 1968, had a leeway under the ceiling effective on that date of about \$580 million. From this we may subtract \$55 million representing the last increment of a reduction in the ceiling related to

short-term credits in developed countries of continental Western Europe and perhaps \$10 million reflecting repayments of term loans to those countries during December. (The ceiling had been reduced by a total of \$370 million through November by these provisions of the guidelines.)

Again assuming no major changes occurred during December, we are left with a leeway at the beginning of 1969 of about \$525 million. We estimate that the ceiling may be reduced during 1969 by a further \$100 to \$200 million. This would leave a potential further expansion within the guidelines of roughly \$300 to \$400 million. This is not an exceptionally large amount in comparison with leeways which have existed in the past. Whether it would be significant depends upon developments in other areas of the balance of payments and upon the course of our domestic economy.

Balance of Payments Developments in the Absence of Program

And now, Mr. Chairman, I have reached a subject on which I cannot be so specific. You have asked what would have happened to the balance of payments in the absence of the foreign credit restraint program. While I can express my opinion, I must stress that it rests more on logic than on hard statistical evidence.

From what I have already said, it may be concluded that the major impact of the program occurred in 1965, when the outflow of bank capital was reduced sharply. The changes in bank credits to foreigners in the period 1966-1968 to a large degree, appeared to be responses to market forces

operating on the banks. However, it is undoubtedly true that, in individual cases, banks would have undertaken a greater volume of foreign loans in the absence of the program, and therefore the balance of payments would have been worse. Moreover, the reduction in credit outstanding to continental Europe in 1968 -- the area that has had a persistent balance of payments surplus -- is certainly attributable to the program. Also, the shift in credits toward developing countries since 1964, at least in part, must be related to the program.

In a broader sense, world trade has continued to grow since the beginning of the program, and the international monetary system, despite some rough spots along the way, has been successful in financing the increase in trade. We know that confidence, upon which the international monetary system ultimately depends, can be easily shaken. The Federal Reserve's foreign credit restraint program, by providing some insurance against sudden large capital outflows from U.S. financial institutions, has contributed to the stability of the international monetary system.

Problems and Issues Relating to the Programs

The Board has been increasingly concerned about the incidental impact of this program upon the competitive position of the banks. Basing the program upon a situation prevailing at a particular date tended to "freeze" the competitive situation. While this was not desirable, it was not easily avoidable and was acceptable for a temporary program. However, as the program has been carried forward, possible distortions in competitive positions and, more basically, in the allocation of resources become more and more important.

There were 16 banks in the United States on the base date with foreign assets of \$100 million or more; these banks held 82 per cent of assets covered by the program. By June 30, 1966, the proportion had increased to 84 per cent; presently it is back down to 82 per cent. The program has not increased the concentration of foreign assets in these banks; however, it is probable that in the absence of the program the concentration would have been reduced.

In this connection, we must take into account the fact that most of the larger banks have branches abroad. Insofar as these banks were constrained by the program from making loans at the head offices, they were in a position to make such loans at the branches. Loans by foreign branches are exempted from the program. All but one of the group of 16 banks to which I referred above have branches abroad.

As we might expect, U.S. banks that have been willing and able to establish branches abroad generally have gained some competitive advantage in the international field over those U.S. banks that have not done so. This advantage may, in some cases, have been enhanced by the ability of those overseas branches, consistently with the guidelines, to make loans to foreigners.

The provisions of the "2-per cent" rule in the initial guidelines for 1968 was an attempt to ameliorate the situation of banks with relatively small international operations. The provision applied to about one-half of the reporting banks, mostly banks with small bases

(but many of which are quite large overall) located in the interior of the country. These banks are primarily interested in being able to handle the export business of their regular customers, some of which they complain they are losing to the banks which are big and well established in the international field. For this reason, the additions to the ceilings, about \$600 million in the aggregate, were earmarked for priority credits only.

This additional leeway for banks with smaller credits to foreigners had to be curtailed to \$200 million under the program announced on January 1, 1968. They did not in fact use this additional leeway

A major issue since the beginning of the program has been the treatment of export credits. Many people, both inside and outside Government, have argued that all export credits should be exempted from the guidelines on the grounds that otherwise the possible loss of exports would cost us on current account whatever we might gain on capital account. I do want to stress that we are speaking here of credits to foreigners for financing U.S. exports. The program does not affect credits to American producers and exporters to finance U.S. exports.

We have kept the matter of export credits to foreigners under continuing review. We are convinced that in every year since 1965 the target ceiling has provided room for any reasonable expansion in export financing by the banking system as a whole.

One indication that this is true has been the behavior of exports since the program was initiated. On an annual average basis, exports have increased at a rate of about 7 per cent per year since 1964. In 1964, when foreign lending by U.S. banks increased by \$2.5 billion, exports increased by \$3.2 billion. On the other hand, exports went up by \$3.0 billion in 1966 while bank foreign lending declined by \$250 million. There does not seem to be an obvious link between exports and foreign lending by banks.

Further, the banking system over the life of the program consistently has remained substantially below the suggested target ceiling. There may have been some cases in which individual banks were hampered in granting export credits, but it seems obvious that sufficient financing has been available within the banking system.

A Treasury survey of export financing availability conducted in 1966 produced only 20 out of 758 respondents who said that the credit restraint program was an obstacle to their efforts to secure export financing. A more recent survey by the Office of Foreign Direct Investment, dealing with a somewhat narrower matter, showed that only a minor amount of additional ceiling would be requested by U.S. firms to finance exports to foreign affiliates.

There are also reasons for believing an exemption would be disadvantageous. Indeed, it might jeopardize the program and give no clear benefit to the balance of payments.

First, it is very difficult to determine whether a credit is essential to an export -- that is, whether the export would be lost in the absence of the credit. If the export would be made in any event, the granting of the credit merely deprives us of the advantage of a "cash sale" and, in the short run, worsens the balance of payments.

Secondly, an exemption of any type of credit creates an incentive to conform foreign credits to the definition of the credit exempted. We see a danger that the exempted export credits would rise at a much faster rate than would exports, with adverse effects on the balance of payments.

Finally, a flat exemption would leave the program "open ended." We could no longer be sure that total bank foreign lending would remain within the specified limits.

For these reasons, the Board has not been convinced that there should be a complete or otherwise broad exemption for export credits to foreigners.

Projected Review of Program

In the press release accompanying the announcement of the revised guidelines on December 23, 1968, the Board stated its intention to review the program early in 1969 to determine whether additional flexibility for financing U.S. exports might be provided in the guidelines.

Accordingly, I have scheduled meetings over the next month or so at the Federal Reserve Banks of New York, Atlanta, Chicago, Dallas, and San Francisco, to which have been invited representatives of other

Federal Reserve Banks and of the reporting commercial banks and other financial institutions in these areas. I hope that these meetings will provide information that will be helpful to the Board in evaluating the effectiveness of the guidelines, particularly with respect to the financing of U.S. exports of goods and services.

To focus the discussions, each reporting institution has been given a list of questions dealing primarily with its experience in financing exports under the guidelines for the past four years. The questions are specific. They deal with matters such as the extent and manner that the guidelines may have affected export financing, bank procedures in processing export loans, problems in identifying bona fide export loans, and the importance of export loans in the total foreign asset portfolio of the reporting institutions.

Specific information, based on experience of individual institutions, is what we need in evaluating the guidelines. Since some bankers and other participants may be reluctant to discuss matters in detail among competitors, we are suggesting that they may supply answers in writing if they care to do so.

At this moment, Mr. Chairman, I would prefer not to comment as to whether the foreign credit restraint program should be modified. While the regional discussions I am planning to have will be directed primarily to the question of export financing, they will not be restricted to that. I want to complete these discussions and study the information gained very carefully before I make any recommendations to the Board as to whether the program should be continued in its present form or modified in some way.