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Statement by

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before the

Permanent Subcommittee on Investigations

Committee on Government Operations

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Mr. Chairman and Members of the Subcommittee:

I am happy to respond to your request for comments on the wide range of issues involved in dealing with the inflated cost of oil. Your questions established a broad framework for this discussion and I will generally follow their order in responding. I intend to concentrate, however, on those aspects of the problem that fall most clearly within my knowledge, and the responsibilities of the Federal Reserve.

Your first set of questions relates to the financial and economic consequences of importing oil at current OPEC prices. Much has already been said about the severe direct economic impacts of the enormous sudden jump in oil prices imposed by the OPEC countries. These consequences would be severe at any time, but they are especially disruptive now because they add very significantly to the inflationary pressures generated by the worldwide boom that got started in 1972. Moreover, the need to adjust to these higher payments increases the possibility of recessionary tendencies in particular countries, and because of the disruption of balance of payments and threats of currency instability, interferes with progress toward a better basis for the world's monetary system.

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The dangers of escalating inflation are still present in many parts of the world. The OECD has recently reported that consumer prices in OECD countries were 13-1/2 per cent higher this August than a year ago. In the June-August period there was some slowing -- to an annual rate of 12 per cent -- but with food prices rising again, and new wage contracts likely to reflect past high rates of inflation, it will take the strongest determination to deal firmly with this problem. After having already had a massive upward thrust to inflation rates from the rising cost of oil, it is additionally harmful to be confronted with the constant threat that oil prices might be pushed up even further. There is absolutely no justification for the increases of last year, much less for further increases, either in terms of rising costs of production in OPEC countries or in terms of the rise that has occurred in the cost of OPEC imports. The prices of other goods have not risen even over several years in a manner to justify the 1973-74 increases in oil prices. Moreover, a very considerable part of the increases in prices in the past year, and of the increases that may come in the year ahead, in the over-all price level for food, industrial materials, and other goods produced in the oil-consuming countries, is a direct consequence of the boost in their cost of oil. The OPEC countries themselves are a principal driving force in the inflationary spiral. If there is a single action that could dramatically improve the world's economic outlook, it would be a substantial cut in the price of oil. Without such a cut, the outlook remains very disquieting.

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Apart from the serious inflationary effects of the jump in oil prices, it has had a depressing effect on economic activity, as consumers use more of their current incomes and savings to pay for oil and oil-related products and services. This could be offset by an increase in investment. A shift in the use of aggregate national output toward investment, including especially investment to develop our energy resources, would have been desirable in any event. But it is very costly to have to make this shift under the pressures of an abrupt rise in energy costs. Finally, as I shall discuss later, some of the consuming countries will have very serious problems of adjustment because of the strain on their over-all balance of payments.

I turn now to the international trade aspects of the problem. In the short-run, the higher revenues of the oil producers go mainly into financial assets. This is because imports of these countries start from a relatively small base, and even very rapid expansion still leaves a substantial trade surplus for them. We understand that the Treasury will be supplying some estimates of the magnitudes of these transactions. We might note that imports of these countries totaled under $25 billion in 1973; indications are that they are growing by 50 per cent this year, and may well grow as rapidly next year. Even so, if their annual revenues from oil exports are sustained at something like a $100 billion level, OPEC countries would still have a trade surplus of some $40-50 billion in 1975.

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Oil-exporting countries will now be able to buy much more of the equipment and technology needed to diversify their economies, and should also be able to raise the standards of living of their populations by bringing in more consumer goods of all kinds. It is reasonable for these developments to be going forward in areas where there is abundant energy, and I certainly hope they will be successful. At the same time the additional demand on the rest of the world for capital equipment and technical skills, while it may seem marginal in the aggregate, would not be easy to accommodate when capacity is already strained in these critical areas.

For particular oil-importing countries, the need to pay much more for oil, and also for food and other commodities, is already forcing a choice between seeking unprecedented amounts of external financing or somehow reducing their trade deficits and limiting or even cutting back their real consumption levels. This immediate impact on some countries, and the inflationary consequences everywhere, are the main economic issues that need to be dealt with for the short run.

Turning to problems of the financial flows themselves, there are questions of immediate adjustments to be dealt with by financial markets and banking institutions, as well as the pressures that will mount over time if this new set of asset holders becomes a major force in international and national capital markets.

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It is difficult to foresee the ways in which the OPEC countries will dispose of their funds over the next few years. It will probably also be difficult to keep track of these funds as they move through various market channels. Some of the current accruals are placed directly in the domestic capital markets of the United States and the United Kingdom, or into such visible channels as bilateral loans to governments in consuming countries or the regional or multilateral lending institutions. The greater part, so far, has been going into the Euro-currency market, where it is available to any creditworthy borrowers. Yet another channel is the flow of funds through the multinational petroleum companies that still handle the purchase and sale of most of the oil that is produced.

The Treasury has recently issued some estimates of the flows of funds by OPEC countries in the first eight months of the year that indicate the OPEC countries have placed about one-quarter of their reserve gains of $25-28 billion in U.S. liquid assets, a smaller amount in sterling assets in the United Kingdom, and the remainder in the international markets. This pattern could change in response to relative market yields, and to the diminishing ability of particular markets and institutions to absorb funds of this type, or because of certain preferences the individual OPEC countries may have.

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Regarding efforts to monitor these funds, both the United States and the United Kingdom have regular reporting mechanisms identifying the nationality of the holders of certain assets held by foreigners. Of course, we have full information on funds kept with the Federal Reserve banks. Commercial banks in the United States report monthly the deposit and other liabilities which they owe to foreigners, the financial assets that foreigners keep with them, and liabilities owed to foreigners by customers of the banks that the banks can report on. Until now most of the oil-exporting countries have not been separately identified in these monthly bank reports but good estimates can be made of the liabilities owed to the oil-exporting countries as a group. Beginning with the figures for September 30, the banks will report liabilities to each of the oil-exporting countries separately.

In addition to the bank-reported liabilities, there are monthly figures on foreign purchases and sales of U.S. corporate stocks and bonds and Treasury securities, and quarterly reports on the foreign liabilities of nonbanking concerns. Again, none of these show most of the oil-exporting countries separately, and in any case the reports show only the country from which the orders were placed.

The Bank of England has begun to publish monthly data on sterling liabilities to oil-exporting countries as a group. They show holdings of British Government bonds and money market instruments

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by central monetary institutions in those countries, and holdings of money market instruments by other types of holders.

For the Euro-currency market, the only published source of current information is the monthly country breakdown of foreign-currency deposits with banks in the United Kingdom, published quarterly by the Bank of England, which shows many of the oil exporters separately and the Middle East oil exporters as a group. The Bank for International Settlements collects data on the Euro-currency market as a whole which are published in the BIS Annual Report, and are available to governments more currently. These data do not provide a detailed country breakdown of funds from the oil-exporting countries.

There are, of course, a great many kinds of investments that would not be covered by these reporting systems directed mainly to commercial banks. We are pleased to see and support the efforts of the Commerce and Treasury departments to undertake comprehensive new studies that will improve our current and future information on foreign investments here as either controlling interests or portfolio investments in U.S. businesses, and in such assets as real property or mortgages.

Your next set of questions refers to the experience of private financial institutions in recycling funds. I might say that the term "recycling" is appropriate, if at all, only in the sense

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that the OPEC countries cannot avoid placing their surplus funds somewhere -- but it tends to obscure the fact that the financing of deficits of particular oil importers is far from automatic. The process will involve over time an accumulation of debts piled on debts that will be quite different from a simple intermediation process.

Up to the present the international banking system does not appear to have been overstrained by the process of receiving and lending surplus oil revenues. Although there have been a few banks abroad that have closed in recent months, this has reflected over-extended foreign-exchange dealings and poor management, or the stresses of policy-induced credit tightening, rather than the recycling process.

However, in a longer perspective there is room for doubt that banks will be able to handle so large a fraction of persistent flows of this type. Banks are limited in the volume of deposits they can safely accept by the need to maintain an appropriate relationship between their capital accounts and over-all liabilities or assets. Retained earnings are unlikely to supply capital funds sufficiently fast.

Apart from maintaining the adequacy of banks' capital, over-all stability of the banking system requires avoiding severe mismatching of maturities of banks' liabilities and assets.

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Recycling of surplus oil funds has so far meant that the banks have issued liquid liabilities to oil-exporting countries while granting longer-term credits to oil importers. As balance-sheet totals grow, so does the potential for a large absolute gap between a bank's short-term liabilities and its longer-term assets. While the extension of credit on the basis of deposits of shorter maturity is the essence of banking, a cause for concern about the liquidity of a bank arises if the deposit base consists too largely of short-term interest-sensitive funds, or of funds belonging to only a few large depositors, or of funds that may move quickly in response to potential exchange rate movements. For some time the Federal Reserve has been stressing the need for banks to review their capital adequacy and we have been concerned that domestically banks should hold down their reliance on a potentially unstable base of borrowed funds -- so-called liability management. Clearly the question of banking stability is sharpened for individual banks, and for the whole system, if banks continue to be a major factor in intermediating the international flows of oil funds.

I should note, however, that while we have a general concern about undue dependence on unreliable sources of funds, the fears sometimes expressed that the banking system could be threatened by a sudden withdrawal of OPEC funds from some banks are exaggerated.

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Current practices in international commercial banking provide a measure of liquidity to individual banks facing an abrupt withdrawal of short-term petro-dollar deposits. For example, were the beneficial owners of petro-dollar deposits to elect to withdraw their funds from some American banks and place them with banks of other nationalities, the American banks would be faced with a need to finance their asset portfolios. At the same time as the American banks were experiencing an outflow, banks of other nationalities would be confronted with an inflow of funds since the owners of these funds would have to deposit them somewhere, or would have to purchase other assets whose sellers would then make deposits. The banks which had lost the petro-dollar deposits would be able to bid for funds from the banks which had received the large and relatively sudden inflow of petro-dollar deposits in excess of the financing requirements of their loan portfolios. As long as the outflows do not seriously affect confidence in the ability of the banks in question, there could be a relatively smooth process as banks receiving the petro-dollar deposits redeposit them with those banks losing deposits. But the possibility of such deposit withdrawals can pose serious management problems, especially for all but the largest banks.

A second and related source of liquidity to banks that experience withdrawal of deposits is the sale of assets. A bank which experienced a withdrawal of its deposits could sell some of its asset portfolio to those banks which are experiencing the deposit inflow. For the foreign branches of U.S. banks, and most

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major banks that participate in the Eurocurrency markets, a large proportion of the assets consist of claims on other banks of less than one year maturity. In the event of liquidity pressures the foreign branches of the banks losing deposits should be able to liquidate these assets within a short period of time.

Apart from their ability to refinance in the market, commercial banks can turn to central banks in the event of liquidity difficulties resulting from any abrupt withdrawal of funds. The great bulk of the recycling involving U.S. banks has occurred through U.S. head offices or foreign branches; the role of foreign subsidiaries or consortia in which U.S. banks participate has been minor. For instance, the assets of the foreign branches of U.S. banks are more than ten times as large as those of subsidiaries and consortia banks. Almost all of these foreign branches belong to U.S. banks which are members of the Federal Reserve System. The Federal Reserve is prepared, as a lender of last resort, to advance sufficient funds, suitably collateralized, to assure the continued operation of any solvent and soundly managed member bank which may be experiencing temporary liquidity difficulties associated with the abrupt withdrawal of petro-dollar -- or any other -- deposits.

Similarly, central bankers who meet at Basle issued a statement on September 9 including the following comment:

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"The Governors also had an exchange of views on the problem of the lender of last resort in the Euro-markets. They recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary."

I shall return to questions of emergency assistance later.

You have asked about the supervision of the foreign activities, including the foreign branches, of U.S. banks. The primary means by which the overseas activities of U.S. banks are evaluated are through examinations and required reporting. The examination process, which entails a scrutiny of bank assets and operational procedures, seeks to assure that practices are being followed which minimize risks to depositors' funds and insure that the institution is a viable one, prudently managed. The concern here is primarily with solvency and liquidity, both of which relate primarily to the type and quality of a bank's assets. The examination process also seeks to verify that applicable U.S. laws and regulations are being observed. Examination responsibilities for the overseas branches at the federal level are divided between the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC. In addition to examinations, banks are required to file periodic financial statements on their overseas branch offices and soon the U.S. Treasury will be requiring weekly and monthly foreign exchange reports which will be collected via the Federal Reserve banks.

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Surveillance of foreign-exchange transactions by individual American banks and their branches is part of the bank examination process. A bank examination verifies a bank's foreign-exchange records, checks internal controls, and seeks to determine whether the institution's senior management is keeping informed of the bank's foreign-exchange activities.

There are no U.S. regulations specifically governing the maximum size of any foreign currency positions banks may take, either over-all or with respect to individual currencies. However, examiners will warn a bank if positions that are excessive by ordinary banking standards are found or if potential risks exist because of poor internal controls. In judging the prudence of a bank's foreign-exchange position, examiners consider size of the bank, volume of international business in the country concerned, currency involved, purpose of the position, and competency of the trading and executive officers. I should add that we are in the process of reviewing this system of surveillance to be sure that it is as comprehensive and rigorous as today's circumstances require.

Some of what I have already said relates to your question -- "For what period can the private banking sector, unassisted, meet the credit demands of oil-consuming nations within the limits of prudent risk exposure?"

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So far this year, the private sector has made large loans to oil-importing countries, but these credits have in a number of instances been supplemented by sizable official bilateral credits (the recent loan by Germany to Italy is an example) and also by sizable use by some oil-importing countries of multilateral credit facilities -- notably the resources of the International Monetary Fund (including the newly created oil facility).

I would think that a good part of the financing required by oil-consuming countries can be provided through private credit markets for some time, including not only bank financing but also the sale of financial instruments to the public. For banks, there is a risk boundary, differing for each bank, which should not be exceeded. I would not want to speculate on the period of time we are dealing with, but it is clear that the piling up of extraordinary loan exposure by any bank is simply not consistent with sound banking practice. We would expect the banking system itself to take steps to protect its viability. However, if the regulatory authorities see the bounds of sound banking being exceeded, it should be incumbent upon them to step into the picture. But there is no international counterpart to the FDIC, which through its regulatory and insurance functions can clearly protect depositors against insolvency risk.

On the more general question of the relationship of the flows of oil funds to the conduct of monetary and fiscal policy, I do not foresee any likelihood that the flows will affect our ability

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to meet the needs of our economy. Even massive increases in foreign-owned assets in the United States should not materially affect the over-all level of the monetary aggregates, since what happens is essentially that existing financial assets are transferred from domestic to foreign owernship, or among foreign owners. Appropriate fiscal and monetary policies should be able to maintain a high level of economic activity, regardless of whether foreigners acquire assets in our country or not. There may be shifts in yields on particular types of instruments, insofar as the asset preferences of foreigners may differ from domestic preferences. In particular, we have noted that placements of OPEC funds into very liquid assets have tended to reduce yields on such assets relative to other market yields both in the United States and in the Euro-markets.

Your letter raised a number of aspects of the provision of emergency assistance. In addition to its role as lender of last resort to member banks that I have already mentioned, the Federal Reserve has legal authority to lend to solvent institutions other than member banks to meet short-term liquidity drains when the national interest requires. Such emergency loans could be made under the Federal Reserve Act, subject to the procedures set forth therein; in either case the Federal Reserve would require adequate collateral.

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U.S. banks that own foreign subsidiaries, or that are shareholders in multinational consortia, have in the past carefully monitored the liquidity needs of their affiliates and provide assistance when appropriate. As I have noted, assets of these organizations are small in the aggregate relative to those of foreign branches, and we would expect that management would be watchful in supervising these operations. The Federal Reserve may, of course, provide emergency assistance to solvent member banks whether or not they are parents of foreign affiliates.

There are dangers in trying to define and publicize specific rules for emergency assistance to troubled banks, notably the possibility of causing undue reliance on such facilities and possible relaxation of needed caution on the part of all market participants. Therefore, the Federal Reserve has always avoided comprehensive statements of conditions for its assistance to member banks. Emergency assistance is inherently a process of negotiation and judgment, with a range of possible actions varying with circumstances and need. Therefore, a predetermined set of conditions for emergency lending would be inappropriate.

Extensive discussions of the role of host and home country central banks for extensions of emergency assistance to subsidiary and multinational financial institutions have produced a common understanding of the problem. In some countries abroad where there is no official

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lender of last resort, authorities have recently taken steps to strengthen the institutional framework for providing liquidity assistance to banks -- in some cases by establishing new institutions and in others by arrangements involving the commercial banking community. Thus new arrangements to provide liquidity to banks, when appropriate, have recently been announced in Germany and Luxembourg.

The rapid expansion of foreign operations by U.S. banks does not appear to have caused serious difficulties for the majority of the banks that have been active in this expansion. International banking activities continue to be highly concentrated among a very small number of the nation's largest banks that have considerable experience in this area. For example, at mid-1974, nine of the largest banks accounted for about two-thirds of the total foreign activity of all U.S. banks. I believe that the overwhelming majority of our banks have conducted their foreign operations in a reasonable and prudent manner.

Another set of questions in your request for comments relates to the provision of assistance to consumer nations unable to secure funds in private money markets. We have not developed any independent estimates of the needs of individual countries, or of the aggregate non-market assistance that might be required. I believe the Treasury will respond to these questions in some detail. However, I would like to offer a few general observations.

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As I noted above, private market institutions cannot be expected to go beyond the bounds of prudent risk management. This means that if the price of oil stays high a growing list of countries will meet serious difficulties as they pile up debts to pay for oil. The obvious remedy for this is the restoration of a reasonable price for oil. Far less satisfactory, and perhaps ultimately ineffective, is the provision of financing on terms that private markets could not possibly consider.

For the moment, the new oil facility at the IMF is the primary vehicle for financing the most needy countries, supplemented by some bilateral credits by OPEC countries. One of the initiatives taken at the recent meetings of the IMF was the creation of a Joint Ministerial Committee on the Transfer of Real Resources charged with the task of discussing ways of assisting the most seriously affected developing countries. There are also calls for mechanisms to help other countries as the need arises. I would like to note, however, that there is considerable need for caution in creating new credit-supplying facilities. We could find that adjustments that oil-importing countries should be making will be postponed if access to credit becomes easy and automatic. I have in mind especially the need to cut down on energy use, to intensify investment efforts to create substitute sources, and to remove as rapidly as possible balance of trade deficits unrelated to the higher price of oil.

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On the other hand, there is a responsibility to consider the problem of countries already operating at a very low level of real income as they now confront adjustment to higher energy and food costs. This is the principal subject of your last group of questions. There is a danger that individual consuming countries, in trying to be prudent and avoid a buildup of debt, will take measures that can only succeed if they force other consuming countries to accept undesired trade deficits and foreign debt. There is not much evidence yet that such behavior is being followed, but it is a real and present threat to the free cooperative framework for world trade and payments that we have been trying to strengthen and extend.

I remain hopeful that the oil-producing countries will become aware of their own long-run interests, recognizing that as their actions weaken world productivity and welfare they generate a determination in other countries to resist the arbitrary use of economic power and the piling up of unneeded assets. At the very least, I should think, the oil-producing countries with surpluses far beyond their ability to spend -- even in the very long run -- ought to provide the funds that the poorer countries need to cover their essential needs for oil. Moreover, these funds should be provided on highly concessionary terms and without calling on other consuming countries to accept any burden of default. When other countries bear the potential risk of default, it is they, and not the oil producers, who are the real creditors.

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Having said that, I would conclude by noting that with good will it should be possible to find solutions that will avoid threats to the social order and confrontations. The poorer countries surely should not bear any great part of the real burden that will be involved in improving living standards in oil-producing countries. And the major industrial countries that are oil consumers should be able to depend on a reliable supply of energy consistent with economic growth over the years ahead, and at a reasonable price.

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