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Statement by

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of the

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I am pleased to be able to testify before this Subcommittee on international financial conditions. The wide range of issues on which you asked me to comment can be grouped under four headings: (1) the functioning of foreign exchange markets, (2) the Federal Reserve's role in encouraging U.S. exports, (3) developments affecting the international financial system, and (4) the financial implications of higher oil prices. I have organized my testimony accordingly.

1. Foreign Exchange Markets

On behalf of the Senate Committee on Banking, Housing and Urban Affairs, the Federal Reserve conducted, in the spring of this year, a survey of major U.S. banks' foreign exchange activity during the period of exchange market turbulence from September 15 to November 15, 1978. The survey sought information on banks' daily positions, daily trading volume, and profits and on banks' internal monitoring of their traders' positions. The survey covered, on a consolidated basis, the 15 U.S. banks that do the largest amount of foreign currency business. It also covered the U.S. agencies and branches of five leading foreign banks.

The staff of the Federal Reserve Board analyzed the results of the survey, and I am submitting the staff report for the record. I will briefly summarize its main conclusions:

(1) The daily data for the two-month period present a picture of bank position-taking that is consistent with that presented by the regular Treasury Foreign Currency Reports on bank positions as

of the close-of-business each Wednesday.

(2) Banks' net positions and daily changes in those net positions were generally small when compared with their gross foreign currency positions, with their outstanding exchange contracts, and with their overall volume of exchange market transactions.

(3) Statistical tests show essentially no correlation between banks' positions and dollar exchange rates during the period.

(4) The volume of exchange market transactions by this group of banks, both with banks and with non-banks, was fairly stable over the period. There is no statistical evidence of a relationship between the volume of transactions and decreases in the value of the dollar.

(5) There is a significant positive correlation between the variability of dollar exchange rates and the volume of trading. However, statistical tests were generally unable to provide evidence that higher volume "caused" greater exchange rate variability.

(6) About half of the respondent banks reported that they had no formal limits on positions taken during the day (so-called daylight limits). Of those banks that did have daylight limits, none reported a change in those limits during the period.

(7) Quarterly foreign exchange trading profits of the banks generally rose over the period 1976-1978. This appears to have been related to the increase in variability of exchange rates over that period.

The reason why banks appear to be able to make greater foreign exchange profits when markets are volatile than when markets are calm seems to lie in the nature of these banks' role in the exchange markets.

These banks are all active dealers. As dealers, their role is to stand ready to take short-term positions or "make a market" in foreign currencies in order to accommodate quickly temporary imbalances between supply and demand by other market participants -- exporters, importers, international investors. To make a profit from taking a position, a dealer has to buy at a price lower than that at which he sells. The better a dealer can anticipate future price movements, the more favorably can he position himself to take advantage of those movements. And the more rapidly he can turn over a position of given profitability, the greater his total profits.

Bank dealers in the foreign exchange market make profits by taking small positions and turning them over frequently. Since volume, or turnover, seems to be positively correlated with exchange-rate volatility, and since dealers are better able to anticipate short-run price movements than are other market participants, it is perhaps not surprising that greater profits tend to be associated with periods of greater exchange-rate volatility.

The Subcommittee has asked about foreign exchange reporting requirements abroad. The banking authorities of all major countries require commercial banks in their countries to report at some regular interval on their foreign currency positions. Many countries impose some formal limits on banks' foreign currency positions, either for prudential (bank safety) reasons or for exchange control or balance-of-payments reasons. The United States and Canada have no such limits, and in October of this year the United Kingdom abolished its remaining exchange controls, including limits on bank positions. In most countries, commercial banks are required to report their positions at least on a monthly basis; in a few countries, reports are filed weekly, and in Switzerland any transaction in Swiss francs that exceeds $5 million equivalent must be reported daily. Details in the required reports vary considerably: some countries require data on each bank's combined spot and forward position in the home currency against all foreign currencies taken together (France); others require spot and forward positions to be reported separately, and identification currency by currency (Belgium, Germany, Switzerland, the United Kingdom, Japan, Canada and the United States). In countries with strict exchange controls, banks may be required to identify whether forward foreign exchange sales are with residents or non-residents (Belgium).

The U.S. information on banks' foreign exchange positions is as comprehensive as that of any country. Weekly data are collected from all U.S. banks that have over $10 million in outstanding foreign exchange contracts, as well as from U.S. agencies and branches of foreign banks. Assets and liabilities, as well as exchange contracts bought and sold, in eight foreign currencies are covered by the survey, and both home offices and foreign branches of U.S. banks must report. The United States is the only country with extensive and timely reporting on overseas branch activity. In addition, on a monthly basis, U.S. banks must provide data on the maturity structure of their foreign exchange positions.

Switzerland and the United Kingdom are the only major countries that regularly collect information on the volume of individual bank's transactions. The Federal Reserve has conducted periodic surveys of turnover (1966, 1969, 1977) in the U.S. market and will conduct another survey in March 1980. These surveys provide concrete information on the magnitude of the market and the importance of various types of transactions. All major central banks, however, have reasonably good current impressions of the "condition of the market" and the relative volume of trading based on frequent discussions between commercial banks and the operating desks of the respective central banks. The New York Trading Desk, for example, has direct phone links with more than 40 banks in the United States, and it talks with traders in a number of other banks.

The Subcommittee has asked about the impact on exchange markets of Rule no. 8 of the Financial Accounting Standards Board. This rule requires U.S. corporations to value, for public reporting purposes, their net monetary assets or liabilities denominated in foreign currencies at current market rates and to identify so-called translation gains or losses as a separate part of net income.

When first promulgated, FASB-8 was the source of considerable controversy -- it was alleged to have caused corporations to engage in forward exchange market contracts to cover liabilities denominated in certain currencies, particularly Swiss francs, which had appreciated substantially against the dollar. It was alleged that corporations engaged heavily in such transactions, resulting in downward pressure on the dollar, in order to avoid large foreign exchange translation losses, even if the covering transactions did not make sense from an economic view.

Whatever the merits of the rule -- it has some in my view upon which I will be glad to elaborate -- it remains controversial and is currently being restudied by the Standards Board. However, the rule is no longer a major source of concern in the exchange market, in part, apparently because the market has become accustomed to it and, in part, because many corporations appear to be less concerned about reporting translation losses. Hence, corporations reportedly are undertaking fewer foreign exchange transactions solely to cover their "accounting exposure."

2. <u>The Federal Reserve and U.S. Exports</u>

U.S. exports have increased at a rapid pace this year, reflecting, in part, the improved U.S. competitive position arising from the depreciation of the dollar in 1977 and 1978 and from the expansion of economic activity abroad. From the fourth quarter of 1978 to the fourth quarter of this year we expect an increase of 25 percent in exports of manufactures and other nonagricultural goods. The increase has in part reflected higher prices for exports, but volume has increased at least 10 percent. Agricultural exports have also risen. The strength of our export industries this past year, and the prospect of further growth next year, do not suggest that they have been at a disadvantage in their access to credit from U.S. financial institutions.

Federal Reserve policies are not designed to channel funds to the financing of U.S. export industries or other particular sectors of the economy -- a philosophy that is not universally held abroad. Federal Reserve policy is designed to promote financial stability externally and internally. Such policies can help to avoid the wide gyrations in exchange rates that may disrupt international trade and finance and can provide an environment for sound long-term financial planning by all U.S. companies, including exporters.

With respect to measures to facilitate bank financing of U.S. trade, the Federal Reserve in June revised its regulations for Edge Corporations to increase the ability of these corporations to provide international banking services more effectively, in accordance with the Congressional mandate of the International Banking Act.

One change permits Edge Corporations to finance the production of goods for export, whereas previously Edges were restricted to financing only the transportation, storage and actual exporting of goods sold abroad.

A second change permits Edge Corporations to establish domestic branches. By providing an alternative organizational form through which banks can conduct multi-state Edge Act business, the Board sought to increase the flexibility of banks -- especially regional banks and smaller banks that might have limited amounts of capital to invest in Edge Corporations -- to provide international banking services. Only recently have banks begun to apply for Board approval of domestic branches of Edge Corporations, so that it will be some time before the impact of this change can be properly assessed.

The Board is still studying a third change that was proposed for public comment: the establishment of a special class of customers (Qualified Business Entities) all of whose transactions could be presumed to be international, or incidental to their international activities, and hence not subject to the transaction-by-transaction screening that has been applied to operations of Edge Corporations. Most of the concerns about this concept have centered on the possibility that it would unduly expand the domestic banking activities of Edge Corporations. Data are needed on the number and characteristics of companies that might be qualified under various types of guidelines, and judgments will be required on the operational problems that might be encountered under various definitions. The Federal Reserve is currently studying this concept in light of the substantial number of comments received on the proposal.

There is, frankly, very little the Federal Reserve can do to promote the establishment of Edge Corporations. The procedures are relatively simple. Nevertheless, there are statutory standards to be met and, as in all chartering functions of a banking nature, the Board must satisfy itself about the reputation, expertise, and integrity of the organizers and owners. As of now, all Edge Corporations are owned by banks. There are no legal impediments to their ownership by non-banking interests. Nor has much interest been expressed by such groups in the past. Of course, ownership of an Edge Corporation by a non-banking firm would raise some of the same kinds of policy issues present when such firms own commercial banks.

3. International Financial System Developments

One aspect of the international financial system that has received increased attention from policy makers over the past year has been the Eurocurrency, or Xenocurrency, markets. While the Eurocurrency markets are linked to domestic financial markets and are subject to the influences of monetary policy through the impact of policy on interest rates, they do pose some problems for monetary policy. My judgment is that these problems have been of only moderate significance to date, but their significance is increasing.

Let me identify some of the ways in which the Eurocurrency markets complicate the execution of monetary policy. The existence of the Eurocurrency markets lessens the precision of domestic monetary control. Monetary authorities could, in principle, act in such a way as to provide for the desired growth of bank liquidity, taking account of both the domestic and the Eurocurrency markets. One problem that the Federal Reserve would encounter in following such an approach is that we cannot gauge well the extent to which growth in the Eurocurrency markets affects spending in the United States. Dollars held or borrowed by nonbanks (U.S. or foreign) in the Eurodollar market could be spent anywhere in the world, not just in the United States. On the other hand, it is likely that growth in the non-dollar portions of the Eurocurrency markets could stimulate spending in the United States, at least marginally. Other monetary authorities, in Germany in particular, face similar uncertainties.

Perhaps an even more serious problem in carrying out a monetary policy that takes explicit account of the Eurocurrency markets would arise because of the uneven effects of a restrictive policy on the domestic and the Eurocurrency markets. Those smaller domestic banks and their customers that have less access to the Eurocurrency markets than have the large international banks and their U.S. and foreign customers would absorb a disproportionate share of the burden of a restrictive policy. This inequity, in turn, could undermine support for an appropriate counter-inflationary monetary policy. This was one of the reasons why in its October 6 actions, the Board included Eurodollar borrowings as subject to the 8 percent marginal reserve requirement on increases in managed liabilities.

Moreover, if monetary authorities focus exclusively on the growth of domestic monetary aggregates, ignoring the effects of the more rapid growth of liabilities to nonbanks that is occuring in the Eurocurrency markets, they may facilitate more expansionary and more inflationary conditions than they intend, or may be aware of. Indeed, there is a risk that, over time, as the Eurocurrency markets expand relative to domestic markets, control over the aggregate volume of money may increasingly slip from the hands of central banks. Consequently, the Federal Reserve in its examination of redefinition of the U.S. monetary aggregates has considered the possibility of including some portion of Eurocurrency liabilities to nonbanks. It would also be prudent to have available additional instruments for controlling the Eurocurrency markets such as we have for controlling domestic monetary aggregates. This is one of the principal reasons for seriously considering the need for reserve requirements against Eurocurrency deposits on an international basis.

With regard to international discussions of the Eurocurrency markets and what might be done to control their growth, I believe that there has been some progress. It is now more generally recognized that these markets potentially present not only prudential problems but also monetary policy problems. Countries have been studying different techniques for coping with the markets but are not yet agreed on the need for, or the nature of, effective measures.

Another aspect of the international financial system that has received increased attention over the past year has been the phenomenon of diversification of official reserves. We do not believe that such a process has accelerated during 1979. However, some tendency toward a multi-currency reserve system is obvious. Against this background, attention is being given to the possible role of an IMF Substitution Account in encouraging the evolution of an SDR-based system.

4. Financial Implications of Higher Oil Prices

The average price of imported oil is now more than 70 percent higher than it was at the end of last year. It appears likely that the price of OPEC oil will increase further in 1980. Recent events in Iran and other Middle Eastern oil-producing countries have underscored once again the vulnerability not only of the U.S. economy but also of the economies of other oil-importing countries to supply disruptions and to the adverse economic effects of higher oil prices.

The higher oil prices already experienced in 1979 are causing great difficulties. They have contributed to the global acceleration of inflation this year and to the slowdown of real economic growth of the economies of the developed countries now expected in 1980. They are undermining the current account positions of oil-importing countries and forcing some of these countries to incur rapidly rising debts.

Additional price increases in 1980 would compound the pressures on developing countries and industrial countries alike. The combined current account deficit for the non-OPEC developing countries in 1979 is likely to be about $10 billion larger than in 1978 and could increase substantially further in 1980. The size of the increase in 1980 will depend to a large extent on OPEC pricing decisions.

As the OPEC surplus rises to new heights, it is appropriate to ask oil producers whether they fully realize the impacts on developing countries of their pricing decisions. Some non-oil developing countries will be able to increase their international borrowings or their exports and thus sustain a continuing flow of both oil and non-oil imports, but many countries will be forced to curtail imports in order to make ends meet. Lower-income developing countries, in general, must rely on official sources of finance -- multilateral and bilateral -- and may obtain bank credit only as part of co-financing arrangements. However, it is the developing countries with higher income levels that will account for the bulk of the enlarged deficits.

As a general principle, I believe that many countries will have to place greater emphasis than in the past on adjustment of their economies to the higher oil bills rather than on financing enlarged deficits. It will probably be necessary, and also highly desirable, to have the IMF play a greater role in assisting countries to make the necessary policy adjustments. It would be desirable if banks encouraged countries to turn to the IMF and if countries went to the IMF before the deterioration in their external financial condition became extreme.

If the IMF is to play this role, it must have adequate financial resources. The Congress now has before it legislation that would lead to an increase in the size of the U.S. quota in the IMF by 50 percent; quotas of most other members would increase by a similar percentage. These increases were negotiated prior to the 1979 increases in oil prices. Although the IMF now is in a fairly comfortable position to increase the scale of its lending, it would be highly desirable for Congress to act promptly to increase the U.S. quota so that the IMF can play the more active role that will be required over the next several years.

There will, of course, be a major role for the commercial banks in financing the increased current account deficits of oil-importing countries, but it is not clear just what the size of that role will be nor how lending will be shared among banks. In recent years some developing countries have been able to add to their reserve asset holdings, and it may be that they will draw on these assets to help pay for needed imports. Alternatively, if bank credits are readily available, oil-importing countries may step up their borrowing from banks.

In the year and a half ending last June, a great surge occurred in international lending by non-U.S. banks, which increased their outstanding loans to non-oil developing countries by $30 billion, while U.S. banks were adding only $5 billion of such loans to their portfolios. U.S. banks' share of the total loans outstanding to these countries fell from about one-half of the total to less than 40 percent. This shift in the composition of international lending is clear evidence that large foreign banks have become increasingly competitive with the major American banks in the provision of international financial services. Whereas in the early 1970s it was unusual to see a major syndicated Eurodollar bank credit that did not have a U.S. bank participating in the management group, today it is not uncommon for syndicated credits to be arranged without any U.S. bank participation.

The strong competition from European and Japanese banks has resulted in borrowers paying reduced interest margins (or spreads) over LIBOR (the London Interbank Offer Rate). It has been argued that the reduction in spreads in Eurobanking has reflected a change from the uncertainties of the post-Herstatt era in the perception of risk as well as increased competition. If this is the case, it might now be reasonable to expect a widening of those spreads once again. Risks today are higher because of pressures stemming from rapidly rising oil prices and higher debt burdens of some countries. In addition, there is an increased awareness of political risks in international lending.

In fact, it would be desirable to see a widening of interest margins on Euroloans not only to allow for increased recognition of risk, but also to permit banks to earn a suitable return on capital. The low spreads on Eurocurrency loans in recent years have tended to lower the return on capital to U.S. banks, even though to some extent the reduced spreads may have been offset by larger income from fees or from collateral business. The impact of low spreads has been particularly strong on U.S. banks, whose capital ratios are higher than those of many of their European and Japanese competitors. U.S. banks, therefore, require a higher return on assets in order to obtain the same return on capital. In this light, the lessened participation by U.S. banks in Eurocurrency lending in an era of very narrow margins appears to me to have been sensible and prudent.

A further essential element of prudent banking practice is the diversification of loan and investment portfolios. This principle of diversification underlies the system of country risk evaluation now in use by U.S. bank supervisors. That system has already been described in other testimony before this Subcommittee, and I shall not review it here.

You have asked whether there is some critical percentage that in my view should serve as a maximum exposure for a U.S. bank in any foreign country. There are, I believe, sound reasons for not establishing a single maximum figure. Positions and capabilities of individual commercial banks differ widely. Moreover, risk has many dimensions that cannot be captured in a single figure. Risk exposure may be quite different for long-term and for short-term credits; exposure will vary depending on the type of security or collateral; and it will be greatly dependent on the economic and political conditions of the country. Moreover, too often a maximum may in practice tend to become a minimum as well.

Statutory limits on the volume of credit that a bank may extend to a single borrower vary. The limit for national banks is 10 percent of capital. For other banks it depends on the laws of individual states; it is 25 percent for loans to foreign governments by banks chartered in New York State. These limits apply to credit risk rather than country risk and do not limit the total credit that a bank might extend to a single country. The decision on exposure in a country is one that must be made by the management of a bank in light of the full range of factors affecting its banking business. As relative exposure rises, a bank should review its position carefully and continually. In my judgment, exposures as high as 25 percent or more of capital to a foreign country would warrant continual review by bank management, and for many countries the percentage should be much lower. Indeed, it is inherent in the new system for country risk evaluation that individual banks are to direct increased attention to their exposure to individual countries as such exposure rises.

Thank you, Mr. Chairman. I appreciate the opportunity to comment on these important issues.