The Midwest and the Foreign Exchange Markets

Remarks of Mr. Robert P. Mayo, President
Federal Reserve Bank of Chicago
before the
Midwest Chapter of the Forex Association
of North America
Chicago, Illinois
October 25, 1974

I am pleased and honored to have been asked to speak at the inaugural meeting of the Midwest Chapter of the Forex Association. Traditionally, an inaugural meeting is one requiring a speaker to hoist the banner of challenge. He should provide enthusiastic encouragement. Then, when the audience has been appropriately inspired, he is expected to add a few words of caution about excessive fervor. I won't break with tradition tonight but I don't plan to make much effort to bring you to fever pitch. I simply want to add my humble support to your efforts. It's about time the Midwest had its own Chapter of the Forex Association!

As many of you know, and I hope the rest of you will discover tonight, I have tremendous enthusiasm for the future of international banking in the Midwest. And it is an enthusiasm that I know is shared by my colleagues in the other Reserve banks in the "heartland."

When I returned to Chicago in 1970 after my service in Washington, I was convinced that the Midwest could and should play an increasingly important role in international banking. I have argued publicly on many occasions for the positive encouragement of the growth of all elements of sound international banking in the Midwest. Such growth to me seems natural and appropriate--right in line with the economic facts of life. We're big and growing steadily.

The five states--Illinois, Indiana, Iowa, Michigan, and Wisconsin--parts or all of which are in the Seventh Federal Reserve District, alone account for one-quarter of the nation's manufacturing and agricultural output and about the same proportion of the nation's exports.

What has taken place in the last few years has exceeded my expectations. But now my appetite has been whetted further and my expectations have grown.

I make no apologies for giving my remarks a decidedly regional tone. I'm not being provincial either. I feel very strongly that I am on solid economic grounds in arguing that the Midwest is and will become even more important in international affairs in the years ahead and that developments here are an important element in understanding the shifts that are taking place in international financial activities.

But enough of these statements of enthusiasm for Midwest international banking. You have it already. Let's take a look at the likely environment in which your enthusiasm will be working. In particular, I would like to focus on the likely environment in which foreign exchange transactions will be carried out and what that implies for you as bankers and for me and my colleagues as supervisors and regulators.

It is perhaps an understatement to say that the foreign exchange segment of bank operations has been the focus recently of some concern--concern by bank management and by bank supervisory authorities. No one feels comfortable when there are instances of large foreign exchange losses--here or abroad. And even when specific losses are clearly related to fraud, honest bankers become uneasy and concerned. These instances highlight for all of us the need for a reassessment of the foreign exchange operations of banks in the light of a changed exchange rate environment. Floating exchange rates obviously offer the exciting challenge of a larger return--but at a cost of greater risk.

It seems to me that our planning and operations should be based on the likelihood of the continuance of a floating rate or managed float environment. We are not likely to have an international monetary system anytime in the foreseeable future in which there will be attempts by central banks and governments to confine exchange rates within narrow bands around declared par values as we had under the Bretton Woods system. At the same time, I am convinced that central banks will not walk away from their responsibilities to maintain orderly exchange markets. As you are well aware, the Federal Reserve System and other central banks have intervened in a well coordinated fashion since July a year ago on a number of occasions in order to maintain orderly exchange markets, even in the face of major external shocks. I can unequivocally state that there is a commitment on the part of central banking authorities to maintain in place an institutional structure of an efficient foreign exchange market. However, that does not necessarily imply any commitment to individual participants in the market.

Because the managed float does differ from the previous regime in terms of the magnitude of possible movements in exchange rates, participants in international transactions are likely to take into account more actively possible movements in exchange rates in planning their activities, leading in turn to more active foreign exchange markets.

At the same time, the inherent risk of foreign exchange operations mounts, requiring most careful control by bank management and more extensive scrutiny by supervisory and regulatory authorities.

The Federal Reserve and other supervisory agencies are alert to these impacts of the changed exchange rate environment. We can expect that the bank supervisory agencies will make additional efforts to adjust the examination function to make it as comprehensive and as rigorous a coverage of foreign exchange activity as today's circumstances require. As you know, the U. S. Treasury has already inaugurated a new statistical reporting program, with the first reports due at the end of next month, which will require the reporting of foreign currency transactions by banks in some nine currencies. The Federal Reserve banks will be acting as agents for the Treasury in this reporting program. The reporting program is designed to monitor current exchange market developments, provide the basis for a comprehensive analysis of the activities of banks and in addition provide information bearing on the exposure and changes in activities of individual banks.

But now, I must turn to one of the traditional inaugural-meeting words of caution. The increased attention of the bank supervisory authorities and other agencies to the foreign exchange function should not be taken by the banks as an invitation to complacency concerning their own reassessment of adequacy of internal controls to contain the foreign exchange exposure of a bank within prudent limits. Its meaning is quite the opposite. This is without question a direct responsibility of the senior management of a bank.

In adding these words of caution, I do not intend to discourage you from extending your prudent foreign exchange activities. On the contrary, there is now a greater need for banks to provide knowledgeable foreign exchange services. The floating rate environment has not only brought with it additional risk, but has also brought with it the challenge that banks be able to provide a more sophisticated set of international banking services.

Midwestern banks have, in the past, demonstrated a considerable ability to adapt to changes in the international economic environment. For example, as Midwestern-based corporations have become increasingly more involved in international activities in the post-war period, particularly during the Sixties, Midwestern banks emerged from their previous insularity--I might almost say isolation. They have extended themselves in the international banking areas, both in terms of home office and overseas facilities, so as to serve their traditional corporate customers. Midwestern banks have adapted to and successfully met the competition offered by New York banks in servicing the Midwestern based multinational corporations. And in doing so the Midwestern banks themselves became multinational institutions.

As a result of the shift to the floating rate regime, corporate and other customers of Midwestern banks have experienced significant changes in their operating environment. For example, foreign exporters to the United States have increasingly sought to have trade invoiced in currencies other than the dollar, thus increasing the demand for hedging services on the part of U. S. importers. U. S. corporations with overseas operations, in attempting to assure the dollar value of anticipated repatriated earnings for purposes of financial planning, now seek to take a hedge against this expected receipt. It is also expected that the rise in foreign direct investment in the Midwest will create increased demand for international banking and foreign exchange services from Midwestern banks.

The formation of the Midwest Chapter of the Forex Association is a positive response in the adaptation by Midwestern banks to this increased demand for foreign exchange services by their traditional customers. Particularly deserving praise is the announced intent of the Chapter to engage in an educational program which holds considerable promise.

For the benefit of those of you from our sister cities outside Chicago, I should also mention a particular development of some interest to me personally. We have had, in the past year, a considerable addition to the international banking facilities located in our city as a result of the Illinois state approval of licenses by 17 branches of foreign banks from nine countries and the expansion of the number of out-of-state owned Edge Act corporations from two to seven. The placement of these facilities in Chicago is adding considerably to the broadening of the foreign exchange and other international banking facilities available in the Midwest. They will surely serve as meaningful competitors as well as welcome associates of Midwestern banking institutions in the servicing of Midwestern subsidiaries of foreign multinational corporations in their domestic or international banking requirements, as the case may be. This development reflects the expanding involvement of the Midwest in international trade and finance.

That expanding involvement has also extended to the Federal Reserve banks in the Midwest--an involvement which will continue to grow. Not only will we be making a contribution in our supervisory and regulatory role but in other areas as well. The Reserve banks have already made an effort to provide timely and worthwhile information on international banking to the financial community and to the public. In our case, we have continued to find a ready market for our weekly International Letter which we started about four years ago. We have increased the number of articles dealing with international economic matters in our monthly business review. We have sponsored several conferences and increased our efforts to respond directly and personally to requests for information. These efforts will be continued and expanded whenever possible.

I am not unmindful, too, of the interest that some of you have expressed in investigating the possibilities for the integration of Midwestern banks into the system for international settlement services now centered in New York. Such an investigation is appropriate. We hope that we can soon be working with you on it.

Foremost, however, in being able to act and react appropriately to the changing international environment is our need to be fully aware of the rapid changes taking place. The Federal Reserve Bank of Chicago, for which I can personally speak, and I am sure I could also speak for my fellow presidents of our other Midwestern Federal Reserve banks, intends to keep fully abreast of changes in the international banking environment, so that it can better aid the performance of the policy responsibilities of the Federal Reserve System.

Through these means, I am hopeful that we can play a constructive role in the Midwestern international community and facilitate the efforts of the Midwestern Chapter of the Forex Association.

It should be obvious to everyone that the formation of this Chapter is, in today's terms, "right on."