REVIEW OF TREASURY DEPARTMENT'S CONDUCT OF INTERNATIONAL FINANCIAL POLICY

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BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

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Tuesday, August 14, 1990

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry B. Gonzalez [chairman of the committee] presiding.

Present: Chairman Gonzalez.

The CHAIRMAN. The committee will please come to order.

I believe that one understands that this is a period of time in which the House or the Congress is in recess or adjournment, but we had announced these hearings, and we also are aware of the fact that Members, especially those that have families, have this period of time probably before the kids go to school and only this time, so that was understandable.

However, the fact remains that this should not reflect on anybody not being here. We do expect a couple of Members this morning, but they are going to have homework. We will just send the homework to wherever they are. That is, all the testimony gathered and transcript of the proceedings.

The relevance and the importance of the issue, plus the issues that we discussed last week in the two hearings we had, one was the subcommittee and the other was a full committee hearing, are of such a nature, and this year being an election year and the brevity of the working days available to us, legislative working days, makes it imperative that at least a portion of August be devoted to some formal work and hearings.

This morning's hearing I have called, and perhaps we can consider this as a sort of committee task force endeavor, though it is formally a committee hearing.

The reason I have called it is I and others are very concerned about several aspects of the Treasury Department's conduct of international financial policy. This has been true for some time.

It may not have been noticeable, but the record shows that no sooner was this committee organized last year at the beginning of the 101st Congress when we had our first hearing on this subject matter.

It is also becoming increasingly clear that the Treasury Department is willing to circumvent the congressional appropriation process called for under the Constitution in order to fund both foreign currency intervention activities and certain parts, at least up to now, of the Brady Plan.

The Treasury Department is spending hundreds of millions of dollars, and these are taxpayer funds, and done behind closed doors, without congressional authorization, in order to fund certain aspects of the Brady Plan.

Today the GAO will testify that the Secretary of the Treasury provides a $192 million subsidy to Mexico as part of the Mexico commercial banking debt agreement concluded earlier this year.

GAO calls this action poor public policy and a circumvention of the congressional appropriations process.

Treasury makes the commitment without informing anyone, and they leave it to Congress, of course, to face paying the bills. Documents obtained by the committee make it clear that certain Treasury officials wanted so badly to make the first Brady Plan deal a success, they were willing to put aside the best interests of the American taxpayer by pricing zero coupon bonds, sold to Mexico at a very favorable discount.

One memo written by a high ranking Treasury official argued for the Mexico subsidy because, and I quote, "without it the deal might collapse", end of quote.

Another Treasury memo actually stated, and I quote, "let's not blow this one for the Secretary of the Treasury", end of quote.

But Congress never authorized this use of taxpayer funds. Treasury did not even notify the Congress about the details of the zero pricing until after it was too late to stop.

As it now stands, there is apparently no limit on the amount of taxpayer money the Treasury Department can pour into its LDC debt initiative. I see little difference between FSLIC's $70 billion back-door financing scheme, called the Southwest Plan, and the Treasury Department's zero coupon pricing.

I cannot see how Congress can tolerate such back-door schemes that can endlessly obligate the taxpayer money without any kind of review, let alone formal approval.

The taxpayers should also be warned that another aspect of the Brady Plan is exposing them to huge potential liability by shifting the repayment risk associated with the debt owed to commercial banks to the backs of the taxpayers.

The Brady Plan calls for the World Bank and IMF to provide debtor nations with funds for commercial banking debt relief by making available $25 billion in loans to debtor nations. In return for this the debtor countries are supposed to undertake reforms that will eventually make them credit-worthy and thus able to repay their debts.

If the debtor nations prove unable to repay IMF and World Bank loans, the capital of the IMF and the World Bank will be wiped out, and they will need to be recapitalized. Since the United States is by far the largest shareholder in these institutions, our taxpayers would be responsible for bearing the brunt of the burden for bailing them out, no doubt to the tune of tens of billions of dollars.

The Exchange Stabilization Fund is yet another example of the Treasury Department's willingness to circumvent the appropriations process, using back-door financing in order to engage in massive foreign exchange intervention activities.

There are two troubling aspects of Treasury management of ESF. First, the Treasury Department, without clear legal authority, has borrowed $10 billion from the Federal Reserve to fund in foreign currency intervention activities. Three members of the Federal Open Market Committee objected to the Federal Reserve making such monies available to the ESF.

They are quoted in the March 1990 Open Market Committee meetings as saying, and I quote, "The transactions in question, which are repurchase agreements that have the characteristics of a loan to Treasury, could be viewed as avoiding the congressional appropriations process called for under the Constitution", end of quote.

Here again, the Treasury engages in the back-door financing scheme in order to avoid the congressional appropriations process.

Another troubling aspect of the ESF operations is a complete lack of public accountability surrounding the use of the funds.

The law actually states that, and I quote from it, "decisions of the Treasury Secretary as to the use of ESF are final and may not be reviewed by another officer or employee of the Government", end of quote.

Now, this, of course, is a 51-year-old provision in the law, and in order to understand its origin, and its existence even today, we have to evoke that period of time, 1939, and the war clouds that hung over the world and our desire to help England where the Bank of England was intervening pretty heavily at the time, so one could understand then. The first use of stabilization funds was back in 1933.

Franklin Roosevelt had, according to his statements, a very limited and differently intended purse at the time. Now, we have tried to have the fund audited by the GAO. Treasury, of course, appeals to this provision in the law, and refuses on the basis that they are not accountable to any other officer or agency of the Federal Government.

I find it indefensible that there is a $26 billion fund in the Government totally free from independent review.

To correct this, I will offer an amendment to H.R. 5153 that will remove the flagrant, not subject to review, language from the ESF statute.

The amendment will also give GAO audit authority over all ESF operations and prohibit the Federal Reserve from lending in any form money to the ESF.

The foreign currency holdings of the U.S. Government have increased from $10 billion in July of 1988 to over $46 billion today. The need to hold such large amounts of foreign currency raises serious concerns about the effectiveness of foreign currency intervention as well as the risk to the taxpayer from intervention.

We need, of course, a thorough evaluation of foreign currency intervention, including the cost to the taxpayer, the benefits to the taxpayer, if any, as well as the risks associated with such operations.

The Congress should and must determine how these operations will be funded, as well as which government agency should be responsible for this important monetary policy tool. The Treasury Department has repeatedly and inexplicably circumvented the congressional appropriations process by using back-door financing schemes to fund several aspects of its international financing and official operations.

The American public, which means the Congress, are left to pay the bill and bear the risk of such actions. This hearing will begin to explore these operations.

I want to thank our witnesses certainly for being here to answer some of these questions, and as I said earlier, it is expected that some of the Members will be arriving a little bit late during the course of the hearing.

Our first witness is our Under Secretary of the Treasury, Mr. Mulford, and we thank you, again, Mr. Mulford, for answering our call, and for the statement which was given to us in time to study and review, and you may proceed as you deem best.

Of course, as is the case always, your prepared statement will be in the record as you submitted it.

STATEMENT OF HON. DAVID C. MULFORD, UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Mr. MULFORD. Thank you, Mr. Chairman. I am very pleased to be here today to have the chance to testify before you.

I would suggest that I make a summary statement of the testimony which is rather long and which, as you say, would be fully incorporated in the record. If I may take about 10 minutes to summarize it, I would be grateful, Mr. Chairman.

The CHAIRMAN. Certainly, sir, without objection, so ordered.

Mr. MULFORD. The Treasury Department welcomes, Mr. Chairman, this opportunity to discuss with you issues relating to U.S. intervention in the foreign exchange markets and the use of the Exchange Stabilization Fund to finance Treasury's participation in these and other foreign exchange operations; and, second, U.S. support of the Brady Plan measures to reduce the debt and debt service burden of debtor countries undertaking economic reforms.

I will first address the issues relating to the Exchange Stabilization Fund, including intervention.

In order to support and give meaning to a nation's international economic and financial policy, its monetary authorities require a mechanism to undertake foreign exchange operations. For the U.S. Government that instrument is the Exchange Stabilization Fund in the Department of the Treasury.

Globalization of the world economy and financial markets has changed the nature and scope of strains on the balance of payments adjustment process. There is more latitude for exchange rates to fluctuate, and indebtedness problems have arisen with serious implications for world financial markets.

The ESF, Exchange Stabilization Fund, is the U.S. Government's only instrument providing the means for a rapid and flexible response to international financial disruption which can impact adversely on the U.S. economy. The ESF provides a powerful and flexible means for the Secretary of the Treasury, with the approval of the President, to support our obligations in the IMF, especially those concerning orderly exchange arrangements and a stable system of exchange rates.

The authorizing statute, which dates back to 1934, but which has been amended several times, gives the Secretary broad authority to deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary.

It also provides that his decisions are final and may not be reviewed by another officer or employee of the government. The history of the ESF reveals that Congress deliberately chose to place the ESF under the exclusive control of the Secretary and to veil its operations "in the greatest secrecy", unquote.

This is perhaps why Congress formulated the laws to emphasize that the Secretary's decisions are final and may not be reviewed, thereby reflecting congressional recognition of the need to be able to react swiftly and decisively to international financial developments, including unforeseeable disturbances in the markets.

However, despite the provisions for confidentiality, Congress retains its prerogative for continuing review of the ESF's operations through periodic reporting and the availability of Treasury officials for public testimony and for informal briefings.

The statute imposes no limits on the volume or composition of the ESF's assets, nor on how they are employed other than in a manner consistent with our obligations in the IMF. Buying and selling foreign exchange constitutes dealing in foreign exchange and thus is clearly authorized by the statute. Such transactions with the Federal Reserve fall in this category.

As specified in his authority to deal in instruments of credit and securities, the Secretary may also borrow dollars or foreign exchange to the extent necessary to carry out the purposes of the ESF. However, there is no statutory provision authorizing the Federal Reserve to lend to the ESF.

In this regard, another statute provides explicitly for the issuance by the Secretary of special drawing right certificates to the Federal Reserve banks in exchange for cash in order to finance the acquisition of SDRs or other ESF operations.

Secretaries of the Treasury are sensitive to the need to employ their authority judiciously and to keep Congress informed of their exercise of it and of the financial condition of the ESF, which is extremely sound.

The ESF uses funds that were either originally appropriated or obtained from a source other than the Treasury in accordance with the basic legislation for ESF operations or other authorizing legislation, thus its operations do not require further appropriations, reflecting their revolving, monetary nature.

The ESF may at times wish to exchange foreign currencies it holds for dollars. Warehousing entails a sale of foreign currencies to the Federal Reserve and its simultaneous repurchase of those currencies for future delivery at the same price. This is not a loan, but an exchange of assets. The Secretary's basic authority to deal in foreign exchange extends to warehousing operations. However, the Federal Reserve is not obliged to agree to warehousing.

The Treasury and the Federal Reserve cooperate closely. The Secretary is the principal financial officer of the United States, but the Fed Chairman is closely involved. For instance, he is the alternate U.S. Governor in the IMF and participates in many other international meetings and has frequent informal meetings with the Secretary.

Treasury welcomes the Fed's role, both as a participant with its own funds and as an advisor and agent for our operations. As fiscal agent for the ESF, the New York Fed is legally obliged to execute the ESF's operations at our direction. We do not have authority to require the Fed to undertake operations or to block operations they wish to undertake.

However, we are confident that various reports, correspondence and testimony, as well as our experience over the years, provide assurances that the Fed's operations will be fully coordinated with those of the Treasury.

Intervention is just one element of our broader economic policy. While the extent of its effect is limited, it can have a positive effect on market expectations, with important spill-over effects in domestic financial markets. Particularly when it is coordinated with actions by other countries, it can send signals that complement and reinforce our broader efforts to coordinate economic policies among the major industrialized countries.

It is not possible to estimate with any degree of confidence a quantitative relationship between intervention and real economic variables. Indeed, it is unlikely that a consistent relationship exists.

A key question is whether market participants believe intervention is consistent with fundamental economic variables or signals willingness to change policies. Prior to the Plaza Agreement in 1985, the dollar was seriously misaligned, rendering important sectors of U.S. industry uncompetitive and giving rise to protectionist pressures and financial market instability.

The small amount of intervention after this agreement encouraged the exchange market to determine a value for the dollar that was far more reflective of competitive realities. Since Plaza and Louvre, intervention has played a role in the effort to maintain exchange rates at levels more consistent with underlying fundamentals.

Greater coordination of economic policies has had a considerable success. Since 1985, more than 10 million jobs have been added to the U.S. economy and increased competitiveness has helped reduce the trade deficit about $60 billion from its 1987 peak.

Intervention sales of dollars when the dollars was under upward pressure have helped limit or prevent erosion of this enhanced competitiveness. Purchase of dollars when the dollar was under downward pressure helped to keep inflation relatively subdued.

We recognize that unusual market forces may at times keep intervention from being demonstrably successful. We also recognize that the impact of intervention can dissipate over time and that in the long run only more fundamental policies matter.

But in the short run, there can be significant dislocations resulting in job losses and distortions of trade and investment decisions. Failure to intervene may thus impose economic costs.

The table appended to my testimony, Mr. Chairman, shows a particularly large growth of foreign currency holdings in 1989 and this year, reflecting intervention sales of dollars to resist upward pressure on the dollar.

Although our holdings have grown considerably, they are relatively small when judged relative to the size of our economy. They also constitute a much smaller portion of total international reserves than is the case for other countries.

The risk of substantial valuation losses is relatively small and is more than compensated by the potential for using them to cushion the domestic economy against a sharp depreciation of the dollar.

Also, there is no reason to believe that gains are less likely than losses, and if any losses occur, they are likely to be relatively small and offset only partly the large recent gains.

The ESF's gains or losses on foreign currencies affect the U.S. budget only when they are realized as a result of sale of the currencies. The Fed's gains or losses, however, are reflected in the monthly calculations of income which form the basis for payments to the Treasury. The ESF's overall impact on the budget, which includes interest earnings and valuation gains or losses on SDR holdings, has been over $1 billion in each of the previous 3 fiscal years.

Congress initially decided, Mr. Chairman, that outside audits of the ESF would undercut its effectiveness, and has maintained this view through the many occasions when it has amended the underlying legislation.

Provision for GAO audit of the ESF's administrative expenses for a period of time, until the Secretary's authority to pay such expenses was terminated, was limited in scope and did not derogate from the underlying intention to give the Secretary broad and absolute discretion.

ESF audits are carried out by an office within the Treasury, currently the Office of Inspector General, which is independent of the offices responsible for implementing foreign exchange operations.

The rationale for maintain confidentiality of ESF operations remains valid today. They largely entail transactions with foreign monetary authorities and could tend to reveal those authorities' own transactions.

We do provide substantial information about our operations. Published information includes the report prepared every 3 months by the New York Fed and the ESF annual report. We also provide this committee, Mr. Chairman, with confidential monthly reports on intervention and the monthly ESF financial statements.

We have not received any indication that the Congress finds this information insufficient. Nevertheless, we will endeavor to respond in an appropriate manner to any specific requests for further information, subject to the need to protect sensitive details.

The debt difficulties of developing countries, Mr. Chairman, remain a serious global problem which requires cooperative efforts on the part of all parties. The approach proposed by Secretary Brady in the spring of 1989 to strengthen the debt strategy is intended to mobilize more effective external financial support for debtor countries' efforts to reform their economies and achieve lasting growth.

The strengthened strategy revolves around two themes, the need to give greater emphasis to debt and debt service reduction, and the need for debtor countries to implement sound economic policies designed to encourage investment and flight capital repatriation.

The IMF and World Bank, as part of the new approach, now allow a portion of these loans to be redirected to support debt and debt service reduction by commercial banks and provide limited interest support for these transactions. Such funding is made available under legal authority found in Article V, section 3(a) of the IMF Articles of Agreement and Article III, section 4(VII) of the World Bank Charter. As a safeguard, such operations are subject to detailed objective criteria developed and approved by the executive boards of both institutions.

IMF and World Bank support has helped to encourage the successful conclusion of several debt and debt service reduction agreements with individual debtor countries. Six countries—Mexico, the Philippines, Costa Rica, Chile, Venezuela and Morocco—have reached agreements with commercial banks. These countries account for approximately 46 percent of the total commercial bank debt outstanding of the major debtor countries.

The strengthened debt strategy also envisaged the use of zero coupon bonds as collateral to back debt and debt service reduction transactions. By statute, Congress has delegated the authority to borrow money on the credit of the United States to the Secretary of the Treasury with the approval of the President. Mexico purchased zero coupon bonds from several sources which included the United States, Japan, Germany, Switzerland, France, Canada, and the Netherlands.

The Treasury pricing decision for the zero coupon bond for Mexico was based on a number of factors, including the size of the Mexican transaction and the precedent of the 1987-1988 Mexican purchase of zeros.

The earlier Mexican deal was priced off the coupon rate because the strips market was deemed to lack sufficient depth to provide a basis for pricing a transaction of that size. The 1990 Mexican transaction size of $30.2 billion equivalent was even larger relative to the strips market.

The specific pricing formula for the 1990 Mexican transaction involved the average 30 year U.S. Treasury coupon borrowing rate for the 3-day period ending January 5, 1990, plus a fee. The other countries which sold Mexico's zero coupon bonds followed similar pricing formulas.

Use of zero coupon bonds has not been an element of all the agreements reached to date. We cannot predict the actual demand for such bonds, since that will be driven by the timing of banking agreements, the options available in those agreements, and banking interest in collateralized instruments.

The emphasis on debt reduction within the debt strategy has encouraged renewed vigor on the part of a number of debtor countries in undertaking difficult but needed reforms. Commercial banks are actively engaged in debt and debt service reduction to ease the burdens on debtor countries. Public resources to support this process are being provided on a limited and efficient basis. While much remains to be done, we are confident that we have a strategy with the flexibility needed to meet the challenge facing us.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Mulford can be found in the appendix.]

Mr. GONZALEZ. Thank you very much, Mr. Mulford.

You know, when we talk about intervention, I recall 1970, 1971, I believe it was August 15, when President Nixon took us off of the so-called gold exchange and, in effect, devalued the dollar by about 10 percent. Currencies and interaction between currencies were allowed to float.

I remember the justification as if it were today that the free market would establish the value, but now why all of this intervention? You all have turned out to be the biggest interventionists in the so-called free market so that obviously some of the discordant voices of that day, which were pretty much subdued, were raising those questions on the possibilities, but there is no getting around it.

The absence of congressional questions in the past is no justification for an allegation or a conclusion that there hasn't been concern about intervention. There has been.

It just hasn't been expressed from the levels that were noticeable. There have been concerns expressed all along.

Regarding the Mexico zero coupon bond pricing, there is no question that concerns were raised even in your inner circles. I have copies of memorandums here directed to Acting Secretary Robson from Robert R. Glauber, on the subject of pricing, to get down to the specifics on the Mexico deal, pricing Mexican zero coupon bonds.

In discussions on Thursday, January 4, 1990, Mr. Glauber stated, "We were essentially told by Mr. Mulford, if the Treasury bonds were priced below 7.9 percent, the whole transaction would fall apart. We have not independently verified this.

"Asssuming that you, therefore, wish such bonds to be priced at 7.9 percent, we wish the pricing to be explained as coupon less ⅛ percent rather than based off strips, as you referred, as it will necessitate a much less defensible position of strips plus 10 basis points."

He went on, "Nevertheless, we have certain grave concerns that remain: Market analysts, newspaper reporters and politicians, and I guess that means some of us, can be expected to discern that such pricing represents a contribution by the American taxpayer to Mexico, and some might even characterize it as an unauthorized appropriation. Treasury pricing and subsequent Brady Plan transaction must be done earlier in the process so we are not faced with a virtual accomplished fact that is not fully responsive to financial market realities. Accordingly, we expect to be included in such transactions before any verbal understanding or definitive documentation is achieved."

So here we have the very people on the inside of Treasury. Now, how can you expect Congress, after the fact, to be fully cognizant of what has even happened after the fact and anything it would want to do, even if it wanted to do it, but here you have in your inner-councils these voices that are high-placed voices, and I continue to quote, this is not a deal done in a closet. It is done in public. There is truth in the world. The market will calculate the difference between the market price and what we charge Mexico if we sell the zeros to Mexico below market price.

The amount of concession enhancement or subsidy, call it what you will, will be known to all.

The Secretary and you will have to explain to the press and to Congress why Treasury gave U.S. taxpayer money to Mexico. There may be good global political reasons, but they will have to be fully explained against the size of the subsidy.

We realize the sensitivity of the political aspect, but the central issue here is far more important and outweighs, and that is exactly what the fundamental question is confronting our Nation, the continuing basic question still unanswered is what we have seen so sadly in the case of the so-called S&L crisis now.

Just a few weeks ago we thought we had a crisis, judging by the sustained interest in approaching some resolution, why you would think there was no crisis, but that is still the question that I feel is fundamental.

Otherwise, we can get ourselves all we want to, but we do not have a viable constitutional system of checks and balances. How could an agency such as the Home Loan Bank Board have committed the Treasury to $55 billion without going through the authorization and appropriation process?

The President can't do it except in this case where he gives his approval premature to the Treasury's action.

The Congress can't do it. That question has to be answered sooner or later.

It hasn't been.

Now, what was happening then when all the deals were being done in that area?

All the Congress got until January 10, 1989, were press releases, and this is pretty much what you get when you announce the Mexico deal. Now, the experts raise a question, and then some in the Congress are asked those questions, and this is what we are trying to do.

We are trying to see how we can answer them. Now, how important was the Mexico deal? That is, to do it in the manner and in the form that it was done, to the success of the Brady Plan in your opinion?

Mr. MULFORD. The Mexican deal was a very important deal in and of itself because Mexico is a very important country. The resolution of Mexico's debt problem is very important for Mexico, for the United States, and in general for the world financial system. The financing package was an important transaction, and Mexico has been an important participant in the debt strategy since its problem first arose in 1982. problem, Now it looks like Mexico is making reasonable progress as a result of its commitment to basic economic reforms to improve its situation very substantially.

The CHAIRMAN. Well, but still in all, given the fact, of course, Mexico is important but you have a series of nations right behind Mexico, some of them I would say relatively important. Are we going to handle them and this debt restructuring in the same identical manner?

Mr. MULFORD. As I mentioned in my testimony, there have been six countries which have reached agreements with banks using elements of the so-called Brady Plan in their negotiations. The main point, Mr. Chairman, is that each of those deals is structured differently.

We don't expect deals to be identical. We expect them to be either very different from one another or in some cases relatively similar, but not identical. It depends on each country's circumstances, the profile of the debt situation, and the views of the banks. There will be some deals that are similar to the Mexican deal, but so far there has only been one other deal that involves the use of zero coupon bonds issued by the Treasury—Venezuela.

The other four transactions do not make use of zero coupon bonds at all, but they do make use of the other elements of the Brady Plan.

The CHAIRMAN. Not thus far, but now, isn't Venezuela asking pretty much for the same treatment as Mexico got?

Mr. MULFORD. We have had no request from Venezuela as yet that I am aware of about the zero coupon bonds. We do know from their negotiations with the banks, which are nearing conclusion, they plan to use zero coupon bonds. Presumably when that deal is finally agreed and all the banks in the syndicate have returned to the Venezuelans with their responses to the proposal that has been agreed between Venezuela and the lead banks, we would then expect the Venezuelans to indicate to us their plans for using zero coupon bonds.

The CHAIRMAN. You use Mexico, intending to mean Venezuela just awhile ago. You said when Mexico——

Mr. MULFORD. I am sorry.

The CHAIRMAN. I was sure that is what you meant, but I wanted to corroborate.

Mr. MULFORD. That is right.

The CHAIRMAN. As I see it, it would be difficult to expect debtors not to seek the same relief sooner or later, but in the meanwhile, you also create an anomaly that I think, again, Mr. Glauber pointed out in another memorandum in which he says, as background for today's meeting, I want to provide some additional data and emphasize a few important points, one, pricing terms for Mexico more favorable than those accorded domestic entities for similar tailor-made securities. That is to our States.

Our States would love to get the same kind of terms as Mexico got, wouldn't you say? But they are not.

Mr. MULFORD. As I understand it, you are referring to what we call the SLUGS Program for States and local governments. Those are securities with coupons. They are not zero coupon securities in those cases.

The CHAIRMAN. I know that.

Mr. MULFORD. It is a different transaction.

The CHAIRMAN. Well, it may be, but I am sure they would love to have the same benefits as the Mexico deal.

Mr. MULFORD. I don't think it is really relevant in their case, Mr. Chairman.

The CHAIRMAN. Well, I will give you another example.

This is from, I believe, the Wall Street Journal. It looks like January 12, S&L bailout agency asked to be treated like debtor nation, dateline, Washington.

If they do it for Mexico, why not the savings and loan industry? The Resolution Funding Corp., REFCORP, set up by Congress to finance the savings and loan industry bailout wants to buy zero coupon bonds from the Treasury at the same cut rate price the Treasury gave to Mexico.

Quote, "We have asked them to give us the same deal, said Austin Dowling, Chief Operation Office of the Corporation. It certainly doesn't seem fair to us for Mexico to pay a lower price. You can't get around that." Those are the sort of anomalies that arise when we kind of bend things. Of course, I think that when you have accountability, those questions are asked before, not after the fact, and this is the reason for the basic concern that some of us have expressed and continue to express and will in the future.

Now, this debate that obviously was going on between the intra-Treasury officials, those arguing that Mr. Glauber and I just read awhile ago reflecting his position, you obviously would be arguing the other position, which is what prevailed, is that correct?

Mr. MULFORD. Mr. Chairman, may I just take a moment and ask for some guidance from you?

You are making a number of remarks here that show very clearly that we are talking about a very complex issue in technical terms.

The CHAIRMAN. That is right.

Mr. MULFORD. And maybe it would be helpful if I gave you a brief run-through of that issue so that your questions can be put in that context.

Would that be helpful if I did that or do you want to proceed on a basis where——

The CHAIRMAN. I think you are being condescending there.

Mr. MULFORD. I am not being condescending, Mr. Chairman.

The CHAIRMAN. I think you are.

I think this subject matter isn't that esoteric. I think the simple facts are that we had a very special arrangement here. The beneficiary was the Republic of Mexico, and the payee, the payor was the U.S. Treasury or the U.S. taxpayer.

Now, I don't think we have to get involved in financing jargon to say that it is that complicated to be unperceived. I think the basic facts are there, they are established, they have been reported.

We have had quite a number of reports in the press and in the financial pages of some of the outstanding financial newspapers of our country, this isn't a seminar or a briefing.

This is a hearing in which we are seeking and eliciting testimony in order to form judgment as to how to legislate and the need for legislation.

It is our intention to offer an amendment, and even though we had supporting testimony, the purpose of these hearings is to lay the predicate on a knowledgeable basis for legislation, not financial knowledge, knowledge of financial intricacies.

Mr. MULFORD. Mr. Chairman, may I then respond in simple terms?

The CHAIRMAN. Absolutely.

Mr. MULFORD. Let me just make two statements.

The CHAIRMAN. Please feel free to do so. I didn't want to cut you off.

I just wanted to make sure that I didn't get into a seminar.

Mr. MULFORD. Well, I wasn't proposing to conduct a seminar. Let's stay off the technical issues for a moment, but let me make some simple points. The first simple point is that there was no subsidy to Mexico in the pricing of the zeros.

The second simple point is that the U.S. taxpayer enjoyed a substantial advantage from the pricing of the Mexican transaction compared to the cost at which that money which Mexico invested in the United States would have been raised in the market by the Treasury. Those are two simple points that show you that there are other opinions and judgments than the ones that you have read to me.

The CHAIRMAN. Well, I see here that we have a very, very fundamental——

Mr. MULFORD. We do.

The CHAIRMAN. Difference as to interpretation as to what has happened here. You insist that Mexico received no subsidy.

Mr. MULFORD. That is correct.

The CHAIRMAN. Even though Mexico didn't go to the market. Why not?

Mr. MULFORD. Well, Mexico——

The CHAIRMAN. Why this sweet deal?

Mr. MULFORD. Well, Mexico didn't go to the market for reasons that are rather technical. I would like to go through those reasons this morning if we could. There are good reasons Mexico didn't go to the market.

Maybe it would be useful if I took a moment and summarized the points that are relevant here.

The CHAIRMAN. If you feel it is necessary to explain that position, certainly, I will listen.

Mr. MULFORD. On a complex issue of this kind there are differences of opinion, both inside the Treasury, in the markets, among academics and probably among Members of Congress.

There is a wide range of opinions on this matter because it is technically complicated. There are a number of possible options and benchmarks that could have been used.

There are different methods of pricing that could have been applied to this transaction.

I think we have to take that as a given. As long as that is true, there are obviously going to be different points of view.

I think a key determinant, Mr. Chairman, in making an assessment is to determine what the basis is that you choose for pricing such an issue. In this case, I would suggest that there were two imperfect benchmarks.

One was the so-called strips market, and the other is the so-called Treasury 30-year coupon market.

I say that neither of these two benchmarks is perfect for the job of pricing this particular transaction.

If you are governed in your approach by the comparability of the instrument involved, then you would move towards using the strips market as the benchmark.

If you are governed by the actual cost of money, of this money to the taxpayer of the United States, then you would move towards the coupon market. Those are two very simple differentiations.

Now, if you choose the comparability of the instrument approach and move toward the strips market, you have some fundamental problems to deal with. In our opinion these problems made it unlikely or inappropriate to use that solution.

One problem is that, in the regular Treasury market, there is no identical instrument to the strips issue or to the proposed Mexican zero issue. The reason is that there is not in the regular Treasury market a zero instrument that is issued directly by the Treasury.

The only instruments out there are strips that are a derivative of a market operation.

In other words, their price in the market is affected by their cost of production, the way in which those instruments are developed. The Treasury issues a 30 year coupon and the market strips them into one corpus piece, and in this case, 60 coupon pieces. Those instruments are all out there in the market, and the relationship between the various pieces of paper influences, in this case, the value of the long-term 30 year corpus. That is a problem that presents a distortion in the strips market that is very significant.

Second, there was the great size of the Mexican transaction. The size of the Mexican transaction, at about $30 billion, represented a substantial amount that was almost half the total size of the zero market outstanding in Treasury securities. As anybody in the financing business knows, you cannot bring a new issue into a market whose size is about half the volume of all the paper outstanding.

That is simply not possible to do effectively without affecting the price. That is the second problem.

A third problem is that the Mexican zeros have limitations on them that are not found on Treasury strips. The Mexicans are not free to use those bonds as they wish.

They don't have full liquidity, and, therefore, they are different from the Treasury strips outstanding.

Finally, and I think this is a very, very compelling point, it is widely agreed that if the Treasury itself were to issue large amounts of zero coupon bonds directly into the market as a part of its regular financing program, the yield differences between the strips and the Treasury coupons would disappear for all practical purposes. Therefore, you wouldn't have the anomaly between the two benchmarks.

So if you look at the strips market, you are looking at a market which has major distortions, major shortfalls as an appropriate benchmark.

If you turn to the 30 year coupon market, that has limitations as well, because that instrument is different from the zero coupon bond. It is a different instrument. We acknowledge that.

However, the advantage of using the 30 year coupon market is that this is the market the Treasury uses to raise 30 year money. When Mexico is buying our Treasury securities, we forget that Mexico is investing $3 billion of cash in the United States.

We weren't just doing a transaction for them. They were investing approximately $3 billion of cash in the United States. That enabled us to avoid raising that money in the regular Treasury market. From the taxpayer's standpoint, the Treasury in this case, instead of paying 8.05 in the coupon market to finance our deficit, picked up over $3 billion at 7.92. Therefore, the taxpayer obtained an advantage in excess of $100 million in comparison to what it would have cost the Treasury to raise that $3 billion in the market.

On that benchmark, you have a very sound basis for saying that the taxpayer is getting an advantage. He is not giving a subsidy because the rate at which financing would normally be raised would have been done at 8.05, and the Mexican deal was done at 7.92.

Now, this doesn't satisfy some people of a technical bent who are troubled by the fact that the two instruments are not, strictly speaking, identical instruments. As I have already said, none of the possible benchmarks are quite identical anyway.

And the other argument ignores the market—the practical market fact that you simply cannot say to the Mexicans, go into the market and try to do the transaction yourself. You would completely disrupt the market, whether it was a Mexican transaction or any other transaction of that size.

Finally, Mr. Chairman, I think it's relevant that we sought the views of other governments on how they would approach the pricing of their zero coupon bonds in their currencies. All had a similar view about the pricing, namely to price against coupon securities in their market.

Frankly, that was the view we got from most investment bankers we spoke to. My point here is to say it was a highly complex transaction. There are differences of opinion—differences of opinion in the Treasury; and in the end, the Secretary of the Treasury made the decision himself.

I think it's possible to isolate what his key considerations were, and I would be happy to do that later if you wish. That, I think, gives the background more broadly than is presented, for example, in the Wall Street Journal, which is just one side of the story, or in the General Accounting Office testimony, which is inadequate in several respects and very selective in its use of information.

Chairman GONZALEZ. Well, you will pardon me for saying so, either way you go, strip or zero, been stripped and zero means goes against, in my jargon; taxpayer didn't benefit as you are trying to picture it.

You may very cavalierly dismiss GAO, but I think the facts speak for themselves. And you can involve yourself in the intricacies and difficulties and the maze of financial jargon, but you still have to come back to simple arithmetic.

Mr. MULFORD. Yes, Mr. Chairman, the simple arithmetic is the taxpayer got an advantage of ⅛, and Mexico didn't get a subsidy. That is the simple rendition.

Chairman GONZALEZ. Well, I'm certainly not in a position to try to persuade you to change your interpretation. The fact is that our oversight arm, the GAO, tells us that the Secretary's decision, the price of zero is based on the coupon bond rate resulting in an effective subsidy of Mexico of about $129 million as compared to the price for the zero based on the yield for strips.

You can get the statistics, and you have your options. We have them here. Mexican shortfall given yields at key dates. One strip or coupon minus ¼ of 1 percent. Mexican date deal July 23, 7.9.

Mexican request on zeroes August 15, 7.91. Even of RefCorp survey, October 26, 7.64. November 30, 7.65 percent.

Shortfall 44, 4115, 16, 2020, option two, strips minus ⅛ of 1 percent. Mexican bank deal date July 23rd, 7.78 percent. Mexican request of zero, August 15 of 7.79 percent.

End of RefCorp survey, October 26, 7.51. November 30, 7.5.

Option three, strips minus ¼ of 1 percent.

Mexican bank deal July 23, 7.65 percent. On July 23 was the Mexican bank deal date. Mexican request on zeroes August 15, 7.6 percent.

End of RefCorp survey October 26, 7.39 percent.

Yes, these reflect the current estimate of bank choices 44 percent for bond, 15 percent for new money, and we can use all of that jargon. The point, I think, is that we have a very, very serious question that we must resolve. We welcome your interpretation and your reasons for the decision, but we are going to hear from other witnesses as well.

We will submit specific questions in writing in order not to unduly tire you this morning.

Mr. MULFORD. Mr. Chairman, if I could say so——

Chairman GONZALEZ. Absolutely.

Mr. MULFORD. The question of the subsidy which you touched on and which the GAO touched on, as I tried to show in my brief remarks here, depends upon the method of pricing that you choose.

So if you choose one method, which in this case was thought not to be appropriate by the Secretary of the Treasury, then you can generate numbers that you claim were a subsidy.

You could even generate a third set of numbers that would be in disagreement with the GAO and make it look like the GAO's proposal produced a subsidy, even greater than the amount that they mentioned. So the numbers can be made to do various things.

My point here this morning is to explain that from the standpoint of the taxpayer, one has to look at the cost of money to the taxpayer at that time. And that cost, as I have explained, in the real world of finance with the Treasury issuing its bonds was 8.05 percent. We took in money from Mexico at 7.92 percent, so it was an advantage for the taxpayer.

I would just like to point out there is a very significant fact about the RefCorp deal, which you mentioned in your comments a moment ago, compared to Mexico. The REFCORP deal was only $4½ billion in face value, and as I have said, the Mexican deal was over $30 billion and represented about half of the amount outstanding in the strips market.

So, obviously, the size of the transactions is an important point here.

Chairman GONZALEZ. I believe the basic issue that we confront, regardless of how you can rationalize, it's not the Secretary of the Treasury's right, only the Congress has the constitutional responsibility to appropriate; and in effect, this was tantamount to an appropriation. That is our basic point.

It's not for the Secretary to decide, yes, in his opinion, given the circumstances and the political weight of his plan in balance to make X decisions or Y decisions that call upon outlays. That is the Congress' constitutional prerogative and responsibility.

Mr. MULFORD. I can assure you, Mr. Chairman, if an appropriation had been necessary for this transaction, we would have come to Congress to obtain it.

As I said, an appropriation was not required. There was no subsidy, and as the GAO report says, the Secretary of Treasury had the legal authority to set the price for this transaction.

The Secretary has broad discretion to set price and other terms of Treasury bonds in order to fund the national debt. That is what the Secretary of the Treasury did in this case. There was no appropriation necessary. That is why we did not come and seek an appropriation.

Had there been, or if there were appropriations required for other elements of the Brady Plan, obviously we would come and seek those appropriations from the Congress.

Chairman GONZALEZ. Then you would have debate, and you would have delay.

Did Mexico need more money than was originally anticipated?

Mr. MULFORD. You mentioned the question of a shortfall earlier in your comments. There were many reports during the period from roughly early September through the end of the year as the deal was coming together, interest rates were moving around, and market conditions were changing.

There were many reports of a possible shortfall in the Mexican transaction. I think the simple fact about all shortfall points on the Mexican transaction is that in any case shortfalls were generated by the pattern of demand from the banks for the instruments that had been proposed in the deal, regardless of the interest rate levels or cost of money.

The interest rates and cost of money were not irrelevant to the transaction, but it's not the main source that generated the shortfall concerns. And in the end, Mr. Chairman, those shortfall numbers to the extent they existed were never significant enough to unhinge the $50 billion Mexican deal.

Chairman GONZALEZ. Well, I will repeat in a certain way, accept in a different form—how important was the pricing of the zero coupon bonds to the successful completion of the Mexico restructuring deal?

Mr. MULFORD. What was important was to get them priced—the level of the pricing was not critical to the success of the deal. The success of the deal necessitated the provision of the bond, but the deal did not depend on the pricing of the zero coupon bonds.

The deal coming together was generated by a wide range of other factors, including the pattern of demand for the various options available. That is what brought the deal together.

Chairman GONZALEZ. Well, the point is that you obviously have calculated different pricing options in their relation to the shortfall?

Mr. MULFORD. Certainly, we always calculate the pricing options.

Chairman GONZALEZ. With relation to the Mexican shortfall?

Mr. MULFORD. Not in relation to the Mexican shortfall. We didn't sit down with the shortfall as the item that had to be resolved by a pricing decision. But the shortfall that was there, that was being discussed in the press and by others, was obviously a factor that could not be resolved until the zeroes had been priced. Then

Mexico and the banks could sit down and sort out whatever shortfalls they had between them.

But the shortfall——

Chairman GONZALEZ. I imagine the banks were delighted. We are talking about the taxpayers. That is where we come from.

Mr. MULFORD. The taxpayers should be very pleased.

Chairman GONZALEZ. That may be your opinion, but we feel a little bit different, and we are concerned. We think what you have here is an operation that is still open-ended.

Mr. MULFORD. In what sense, Mr. Chairman?

Chairman GONZALEZ. There is no question we cannot attack your legal right, but how many times will you resort to that legal right, without accountability to the Congress and the processes of authorization and appropriation? That is the central issue.

Sure Mexico is important; who says it isn't? It's our next-door neighbor. I come from a Mexican background, but I never felt that we had to give the family jewels in order to prove we were good neighbors.

Mr. MULFORD. We didn't give the family jewels.

Chairman GONZALEZ. I don't see how we can avoid the fact that we did dip into the Treasury, short of going through the appropriation process, as Mr. Glauber was arguing. I know that his view didn't prevail, and who am I to judge? That is your decision over there in Treasury.

What we are most importantly concerned about is the open-ended necessary possibility to these decisions in the future. The Congress ultimately is going to have to provide the funding, one way or the other, and ultimately does this mean that we will end up in actually subsidizing the banks in their overhang on the debts they have incurred?

Mr. MULFORD. Mr. Chairman, we have not subsidized the banks. I really cannot understand why the simple arithmetic is brushed aside. The United States raised $3 billion in cash from Mexico at 7.92. On that same day, if it had raised that cash in the market, it would have paid 8.05.

Now that may leave dissatisfaction in the minds of technicians for the reasons I have tried to explain here. But in the kind of simple political and financial terms you are talking about subsidies, it's clear the taxpayers benefited to the extent of over a hundred million dollars on that day, over and above what it would have cost to raise this money in our market at 8.05. That is the only technique used by the Treasury to raise 30-year money.

So 30-year money, approximately $3 billion from Mexico, in cash, was raised at 7.92, instead of 8.05 in the market. How can that be a subsidy? That is impossible. That is an advantage for the taxpayer.

There is no doubt of that in my mind, whatsoever.

Chairman GONZALEZ. Well, you could argue the same way with the cost of the S&L deals. You could say the taxpayer was a lead cause; they saved money by entering into all of these deals, instead of having to bankrupt the insurance fund, pay out, close down, pay out. What is the difference here? Aren't we kind of gilding the lily here a little bit, Mr. Under Secretary?

Mr. MULFORD. It's different, and it's a very straightforward proposition. Mr. Chairman, with regard to the future, I have already indicated to you that each of the deals done by debtor countries are different, and obviously, not every deal will use Treasury zeros. Obviously we will look at each transaction on its own merits and price it accordingly.

We will take into account all the factors that I described here; the size of the issue, the condition of the market, the type of benchmark that would seem to be appropriate at that time. All this with the interest of the taxpayer in mind, the interest of Congress in mind, and certainly not, Mr. Chairman, to produce a subsidy for foreign governments.

We do not believe in producing subsidies for foreign governments. The entire debt strategy is an indication that our efforts have been devoted to curing this problem without recourse to taxpayers' funds.

Chairman GONZALEZ. It's far from resolved; I think you will admit that. And the point is—and I don't want to repeat what I said in my opening statement, that you have announced plans for the future in the IMF World Bank mechanism.

As I pointed out in the opening statement, we are the heaviest shareholders there. So this is where we are coming from. I don't mean to—I am not being necessarily critical. I understand that you are rationalizing your position, but you have got to understand that we are also aware of the statements that have been made as to future intentions with respect to these other routes.

We have had a difficult time legislatively speaking when it comes to eliciting from Congress the necessary funds for the replenishment of these institutions, so I don't think any one of us is necessarily deliberately trying to cheat.

I am saying that these are judgment decisions over which very reasonable and knowledgeable minds have very serious and conflicting viewpoints and conclusions.

I didn't mean to get into an argument with you, because I think it's fruitless. Second, it doesn't produce anything that would be of greater value to our understanding what we have to do legislatively.

It does contribute to the evaluation of the type of legislation that we could consider. So I have a couple more questions. I think the reasonable thing would be to submit those in writing as well as some of the other Members that have informed me, even though they couldn't be here, they will be submitting some questions in writing.

Mr. MULFORD. All right, Mr. Chairman.

Chairman GONZALEZ. I don't mean to close you out. If you have any additional statements to make or questions you want to direct to me, feel free to do so.

Mr. MULFORD. I would like to touch on just two points before concluding, which came up during the course of your remarks.

One is on the question of the appropriations to the IMF and World Bank. The IMF and World Bank are co-participants in world international financial affairs, including development around the world, and the smooth functioning of international exchange markets.

Also, they are important in the debt problem. But I want to assure you, Mr. Chairman, and point out to you for your comfort, with the passage of time since 1982 when the debt crisis first emerged, neither the World Bank nor IMF have rescheduled or rolled over their debt in the way commercial banks have been forced to do.

The resources provided as capital by the United States to those two institutions are being used in a broad range of programs in those institutions. Among those programs are those that relate to the debt strategy, but they are not exclusively aimed at tje strategy.

In those cases, what we have done is redirect the use of certain resources that would have flowed to these countries anyway more creatively to help support negotiations with the banks to reduce debt and debt service.

This is, I think, a sound use of those resources, and it does result in the banks taking losses. So the banks are not being bailed out, as you suggested. They are being placed in a position where they have to negotiate, and they take some pretty uncomfortable losses in the process.

So I hope that by testifying and by being willing to come visit you and other members of the committee privately, we can assure you that although there are differences on very complex issues, we can find a basis for broad understanding.

My second point, Mr. Chairman, refers to a comment—a question I thought I heard you ask at the very beginning with regard to intervention. You indicated your view on intervention and suggested that this is something that has materialized in a growing fashion since 1971 and is in some way doubtful or suspicious, at least, not appropriate.

I want to assure you that—as I said in my testimony, intervention is an appropriate tool. It's an important tool. It's sometimes overemphasized—too much attention is given to it among all the other economic policies. It's but one policy among many, that we use in the international policy coordination area, but it's an important policy.

It has its limitations, as I said; but it has its uses. You will hear a wide variety of opinions this morning, some of them very negative. It's, we think, a very useful instrument.

I want to point out it was in use before 1971, in the monetary system. It's been a normal part of the system for many, many years; and second, I wanted to draw your attention, Mr. Chairman, to the 1988 Trade Bill, which has in it language which I just would like to read on the question of intervention. It's very short.

It's in Title III, Subtitle A, paragraph marked number 9. It says—and this is the law, the trade law, "Under appropriate circumstances, intervention by the United States in foreign exchange markets, as a part of a coordinated international strategic intervention effort, could produce more orderly adjustment of foreign exchange markets and in combination with necessary macroeconomic policy changes assist adjustment toward a more appropriate and sustainable balance of current account."

So, that is a very strong preference expressed by the Congress for us to intervene within a coordinated pattern as a part of our overall economic policy coordination process, and I didn't want to leave the impression here that we are off on our own.

We think that we are responding to congressional views on this issue and that we are conducting policy coordination exercises, reporting regularly to a subcommittee of this committee on foreign exchange markets and intervention, and I think it's been a constructive exercise.

I just wanted to get that out before you, because we appreciate the opportunity to have that kind of liaison with the committee.

Chairman GONZALEZ. The 1988 act you referred to was one that was involved in the reconciliation process. And it involved some other committees that had much more of a contribution in that respect, than even the Banking Committee.

However, be that as it might, if you have the time, I would like to now address your seriatim. I think you first discussed the question of intervention or was that the second point?

Mr. MULFORD. The second point I made was on intervention.

The first point was about the contribution of capital to the institutions and the debt strategy.

Chairman GONZALEZ. With respect to the first—we will go seriatim, the institutions. I think you are well acquainted with the fact that there has been some concern about diverting from the basic intent and purpose of the World Bank, precisely along these lines—diverging it from economic into financial arm, the IMF was supposed to be exclusively in operation, so that there has been some concern expressed about how the World Bank has diverted from it's original economic improvement and and so forth, infrastructures and so forth.

With respect to the second, on intervention, I did mention the very serious question raised by three Members of the open market committee, and the reasons they gave, and that is that they questioned the usefulness of that tool in today's world.

Now, these are not politicians. These are not untutored minds like mine. These are guys sitting there in the open market committee making financial policy, determining among other things what Treasuries will be worth. So there is—you must admit, basis for very serious concern and very serious difference of opinion that has emanated only in the last few years.

Also, I think you will accept the fact that from the level of about some $10 billion in foreign currency reserves, just about 2 years ago—maybe less, you now have better than $46 billion in foreign currency reserves, in a very unstable world in which our holdings can appreciate or depreciate as the will of the whim of these currency markets dictate.

So I wanted to make the point that these are not any kind of demagogic efforts—also, anybody will tell you that there is no political mileage in this. If there was, you would see about half of these seats filled.

I was chairman of the subcommittee on what was then known as the international finance, for 10 years, and I became chairman because the fellow ahead of me said, Henry, I am going to pass it up because there is no political mileage in all of this.

But to me, the fact that we would have an exposure of the Treasury in a manner that is not consistent with the law, the Constitution, is vital enough political mileage if we are going to be worthy of discharging this trust that has been placed upon us by the people we represent.

So I just wanted to remove any doubt that there would be any personal or political or reason for the questions raised or the reason for the hearings.

We have been exposed enough over the course of years to some of this where we have some appreciable—not an expertise or an expert's knowledge, but some appreciable factor—and above all, we are very conscious of the trust and the responsibility that rests upon us, when there is or there isn't political mileage.

I think the facts also revealed—and we had testimony last year and earlier this year—in which we are not out of the woods in the so-called foreign debt. I think that there has been a profound and fundamental overlooking of history in this cavalier manner in which our chief banks went into this so-called sovereign debt considering sovereign debt sacrosanct or very safe.

History will show you that has been the most vulnerable. Those are the debts that have not been paid back, sovereign debts. You have to review the history of all the span, French and European kingdoms.

And so there is reason for concern. It's not a temporary or an evanescent thing with us. And there are other Members that are equally concerned. I am not trying to say I am the only one.

I wanted to thank you, though, and you are entitled to our gratitude to our response to your invitation under these circumstances. And I can assure you every Member will have a copy of your testimony, and they will have a copy of the transcript for their study. And we will hope and look forward to a continued and sustained communication—line of communication, and we welcome that.

Also, if you would be kind enough to convey our sincere thanks to the Secretary.

Mr. MULFORD. I will do that.

Thank you, Mr. Chairman. I appreciate being here, and I do think the dialogue we have with you and your subcommittees has been very useful these past few years.

Obviously, these are issues that are very complex. There are wide ranges of opinion, it's quite clear. It's important to keep discussing these things. I hope we have continuing access to you and your colleagues.

Thank you very much for allowing me to appear this morning.

Chairman GONZALEZ. Thank you.

Our next panel or witness is Mr. Allan Mendelowitz, who is the Director of International Trade, Energy and Finance Issues, the National Security and International Affairs Division of the U.S. General Accounting Office.

Thank you very much, Mr. Mendelowitz. Once again, you have been helpful. I know you have appeared before the subcommittee. Of course, we are sitting as a full committee this morning, but we want to thank you once again.

We wanted to thank you for your statement, which we have had with plenty of time to read once again, and it will be incorporated in the transcript as you gave it to us, and you may proceed as you deem best.

STATEMENT OF ALLAN I. MENDELOWITZ, DIRECTOR, INTERNATIONAL TRADE, ENERGY AND FINANCE ISSUES, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, UNITED STATES GENERAL ACCOUNTING OFFICE

Mr. MENDELOWITZ. Thank you, Mr. Chairman. I will be delighted to read a shortened statement orally and submit the full statement for the record.

Before I begin, I would like to introduce Mr. Berel Spivack, who is at my left, who is the Senior Economist in charge of the work we undertook at your request.

Chairman GONZALEZ. Thank you very much.

Mr. MENDELOWITZ. We are happy to be here this morning to discuss our review of Treasury's pricing of zero coupon bonds that were sold to Mexico in March 1990.

In addition, we are also commenting on proposals to extend GAO's auditing authority to the Exchange Stabilization Fund.

The Treasury sale of zero coupon bonds to Mexico was part of the restructuring of Mexico's commercial bank debt under the "Brady Plan." The sale was a private placement to Mexico; that is, the bonds were sold directly to Mexico at a negotiated price. A zero pays all interest and principal, together in one payment at maturity, and thus it's sold at a deep discount from its face value.

To date, Treasury issued zeroes only five times. In contrast, a coupon bond has multi semi-annual interest payments in addition to the principal payment. The sale of coupon bonds at auction is a usual way in which Treasury borrows medium and long-term.

However, dealers who trade Treasury securities have created an equivalent to a zero called "strips." They create strips by separating coupon bonds' interest payments from each other and from the bonds' principal and selling the rights of these payments straightly.

The United States encouraged negotiations between Mexico and its commercial bank creditors that culminated in the recent rescheduling. United States also encouraged the World Bank, the International Monetary Funds, and others to lend Mexico funds.

Mexico received assistance in the following ways: Most of the commercial banks exchange their Mexican loans for two types of new Mexican Government bonds. One type had a face value that was 35 percent lower than the principal of the loans they replaced. And the other types replaced the original loan's variable interest rate with a lower fixed interest rate of 6.25 percent.

A few commercial banks provided new loans to Mexico, equal to 25 percent of their outstanding medium and long-term Mexican loans.

The U.S. Treasury zeros discussed above are being used as collateral to secure the principals of new Mexican Government bonds. Mexico can exchange these new bonds for about 93 percent of the debt owed to foreign commercial banks.

The restructuring agreement also called for 18 months bond interest to be guaranteed by funds placed in an escrow account by Mexico.

However, Mexico was to receive interest earned on this account. When the agreement in principle was made on July 23, 1989, the parties to negotiations expected that the principal and interest arrearages and guarantees would cost Mexico $7 billion.

During the 5 weeks preceding the pricing decision, the U.S. Department of Treasury had an intense and internal debate over the proper pricing of the zeros that would be sold to Mexico. Central to the debate was a disagreement over whether to base the price of the zeroes on the strip rates or on the Treasury coupon bond rate. The price of the zero is determined by its interest rate. The lower the interest rate, the higher the price.

And during this time period, the yield on strips was about 25 basis points lower than the yield on coupon bonds. One side of the debate called for selling the bonds at a price that was based on the yield on strips. Similar bonds traded on U.S. markets arguing in part this was the closest to a market price for the private placement.

The other side called for selling the zeroes at a lower price based on the yield for 30-year coupon bonds arguing in part. In addition, this side argued pricing the zeros based on the yield on strips would endanger the restructuring agreement.

At a Treasury meeting on January 4, 1990, proponents of coupon-based pricing argued that a price with a yield under 7.9 percent would cause the whole transaction to fall apart. At a lower yield, Mexico would not have the resources to complete the restructuring.

On January 5, 1990, the Secretary decided to price the zeroes based on the 30-year coupon bond yield. Treasury used the interest rate prevailing in the market on January 3 to January 5, 1990, less ⅛ of 1 percent accommodation fee, which equaled 7.925 percent. We have no official documents from the Secretary explaining the rationale for his decision.

On March 28, 1990, the Treasury sold Mexico $30.2 billion in zeroes at face value for $2.99 billion. A Treasury official told us even after they were priced at 7.925 percent Mexico needed approximately $311 million more than had been expected when the agreement in principle was reached in January–July 1989.

This shortfall arose because interest rates had declined, thus increasing the price of the zeroes and the bank chose a different mix of options than had been expected.

Mexico covered this shortfall by contributing slightly less than $100 million in additional reserves and by funding the escrow account somewhat differently than originally called for.

Considerable controversy has developed concerning the pricing of these zero coupon bonds. As you requested, we reviewed the issue and concluded that Treasury set a price for the bonds that involved an effective subsidy of approximately $192 million.

In our view, the interest rates used to set the price of the zeroes was indicated by comparable rates of interest which lowered the price of the private placement.

We believe the Secretary of the Treasury had the legal authority to set this price for the transaction under review. The Secretary has broad discretion to set the price and other terms of Treasury bonds in order to fund the national debt.

However, while it was in the Secretary's legal authority, we think that the pricing decision was neither appropriate nor good public policy. The Secretary's decision to price the zeroes based on the coupon bond rate resulted in an effective subsidy of Mexico of about 192 million as compared for the price of zeroes based on the yield on strips.

I have to point out at this point, Mr. Chairman, we reviewed all documents associated with this transaction based on Treasury providing us the information and ensuring us we had, in fact, seen all documents.

We brought the necessaru analytical talent to bear to complete the work, and I believe the estimate of 192 million of effective subsidy is both accurate and probably the only disinterested and unbiased number you are going to hear today.

There may be credible arguments that can be made to support a U.S. Government financial contribution to the solution of the less developed country debt crisis, and it's not clear whether the Mexican restructuring would have succeeded without some such contribution.

Nevertheless, we believe if Treasury wished to help Mexico, the correct way would have been to obtain congressional approval through the authorization and appropriations process rather than with an effective subsidy provided to the underpricing of zeroes.

In the long run, this decision could set a precedent that would cost the United States many times more than the 192 million. The Mexico deal was the first in many agreements anticipated under the Brady Plan. Foreign governments and commercial banks may well expect the U.S. Government to contribute resources so that their own concessions can be reduced.

Again, such contributions may be in our national interest, but they ought to be funded through explicit congressional authorization.

Regarding the Exchange Stabilization Fund, we understand the Treasury is concerned with the confidentiality with respect to the information related of the transactions. We believe we can maintain that confidentiality as provided in law and as provided in legislation recently introduced, and which support the extension of GAO's audit authority to also include the activities of the Exchange Stabilization Fund.

This concludes my summary comments, and would be happy to try to answer any questions you might have.

[The prepared statement of Mr. Mendelowitz can be found in the appendix.]

Chairman GONZALEZ. Well, first I must thank you most sincerely. I happen to have unqualified admiration for the GAO generally, and you specifically, for competency.

But you were here, I am sure, a while ago, and you heard the Secretary say—I agree with you, what is tantamount to a subsidy in effect was not, that actually the taxpayers benefited.

Apparently, as I gathered it from what he was explaining, the Secretary was saying that you ignored the financial benefit of Mexico's investment—I think he said what was 3 billion?

Mr. MENDELOWITZ. Yes.

Chairman GONZALEZ. How would Mexico invest if it's a debtor nation and by all definitions was broke, unless the United States loaned the $3 billion to begin with or somebody else did?

I wonder if you could elaborate on that?

Mr. MENDELOWITZ. Well, I think—and as everyone knows, Secretary Mulford is a fine financial analyst, but I must say his comments about accessing the pricing of the zero coupon bonds did nothing to enhance that well deserved reputation.

I would say it was rather disingenious to try to turn the discussion of an effective subsidy of $192 million into a claim the American taxpayer benefited by about a hundred million dollars.

Let me give you what I think is an intuitive explanation with what went on with respect to the pricing of the zeroes.

Take a car dealer who sells Chevrolets day in and day out, the trucks arrive and deposit Chevrolets in the sales room. One day a truck arrives and offloads a Cadillac. He looks at it and says, it's a car, but it looks a little different. What should I sell if for?

And one of his salesmen stands up and says, a car's a car; let's sell it for what we sell all our other cars, namely price it like a Chevrolet.

Another salesman stands up and says, it's not a Chevrolet; it's really something different. Let's go out and see what the world charges for this different thing, for this Cadillac, and let's price it the way the world prices it.

Well, basically, that was the argument in Treasury between pricing the zeroes on the coupon bond yield versus pricing the zeroes on the strips yield. Our judgment is they used the inappropriate measure and, as a result, underpriced the bond.

Second, with respect to the issue of the benefit to the American taxpayer, the first thing—and Mr. Mulford knows how the national debt is financed—the Treasury does not set out to find the national debt with some fixed proportion of different maturities of debt. They have a very sophisticated and very complex process in which they are always looking at the market.

They are always looking at the yields on different maturities of bonds, and they determine the maturity structure of new offerings in a way that minimizes the cost to the American taxpayer.

Therefore, just to say that because Treasury was able to borrow 30 years at ⅛ of 1 percent less than the coupon yield means the U.S. taxpayer received a benefit is not analytically defensible because Treasury would not have as an alternative gone out and necessarily borrowed 30-year coupon.

That is number one—if I can go back to number one, for example, on the same day Treasury was borrowing for Mexico at 7.925, they could have borrowed 1 year at 7.905 and had an even lower cost of borrowing. That is just an example of the point I was trying to make.

Second, the sale of the zeroes was an accommodation for Mexico. The United States obviously has a very strong interest in the success of Mexico restructuring. The United States had an interest in moving along, helping out if it could, but the reality was we weren't looking to lend or to borrow—excuse me—we were not looking to borrow $3 billion at 30-year zero coupons. We have no such instrument, other than specially tailored offerings to accommodate a specific need.

Mexico's alternative to having the Treasury accommodate their need for the zero coupon bonds would have been to go to the strips' market and buy strips that were comparable to the zero coupon bonds.

Now, if Mexico had done that, that would have represented a tremendous increase in demand for zero coupons or strips. The price of strips would have been bid up and Mexico would have paid substantially more than it had paid or, in fact, would have paid if it had used the strips price to buy the zero coupons from the Treasury.

For example, one estimate that I saw predicted if Mexico went to the strips market, it would have raised the price of strips to the extent that the yield would have fallen by a hundred basis points over the then prevailing market price.

That means that Mexico would have had to pay almost a billion dollars more than it paid to buy comparable instruments in the strips market.

So I think that—we stand by our assessment, that in fact there was in effect a subsidy. We stand by our assessment that the Treasury did not appropriately price the bonds. And we stand by our assessment that the American taxpayer did not receive a benefit from this transaction.

Chairman GONZALEZ. In other words, Treasury sold a Cadillac for the price of a Chevrolet.

Mr. MENDELOWITZ. Exactly.

Chairman GONZALEZ. And call it what you will, by any standard of definition, it amounted to a subsidy of 192—approximately.

Mr. MENDELOWITZ. That is our conclusion.

Chairman GONZALEZ. I had read some quotes from other Treasury officials in which obviously they deal with of paramount importance to some viability of the Brady Plan.

I think the Secretary answered their particular decision to financed as they did was essential to the successful—what they consider the successful completion of the Mexico restructure.

But where he, I think, kind of shaded things was where Mexico was coming from. That is, did Mexico have or not have a shortfall as it was entering into the negotiations, because then it would seem to me that whatever the U.S. did would have to be tailored to that exigency, and this is where I think he didn't really give me a very clear answer.

Mr. MENDELOWITZ. The time period between the agreement in principle between Mexico and the banks and Treasury's decision with respect to pricing the zeroes was about 6 months.

There was another period of about 3 months between Treasury's decision on how to price the zeroes and the actual sale and the closing. We are dealing with a world in which financial variables are constantly changing. Mexico's foreign currency reserves go up and down with changes in the price of oil. They go up and down with changes in repatriation of flight capital.

For example, the needs—the financial needs to close the deal change depending upon what interest rates were prevailing in the market at the time and how the banks ultimately chose to choose amongst the menu of options they had with respect to granting concessions for Mexico.

Basically, what analysts at Treasury determined after 6 months had passed, following the agreement in principle, was that more resources would be needed by Mexico to close the deal.

Second, how large that shortfall and available resources was could be very seriously affected by how we choose to price the zeroes.

As I stated in my testimony, even pricing the zeroes off the coupon bond yield left Mexico with a shortfall of about 300 million. They were able to cover that shortfall by dipping a little bit more into their national reserves and by changing the way in which they met their escrow obligations for the interest payments.

However, it's unclear if, for example, we had priced off the strips and the shortfall had jumped from about 300 million up to 500 million that Mexico would in fact had the resources to close the deal, and it's unclear whether restructuring could have been successful.

Chairman GONZALEZ. The essential question, though, I think is what you were addressing, and I think that is where we also come from, and that is that as much as the Secretary has the legal ability, the methods and means and actions derived from those—from that pattern, in effect, amount to a lack of accountability to the Congress in the expenditure of actually public funds.

Is that a fair way to describe it?

Mr. MENDELOWITZ. I think that captures the spirit of the comments that we provided today. Basically, as I concluded in my statement, while we believe the Secretary had the legal authority to do what he did, it doesn't mean that he should have done it, and it doesn't mean that it's good policy.

It doesn't mean that it should be done again in the future.

Chairman GONZALEZ. And it's a policy matter that should be inherent in the national policy making body, which is the Congress.

Mr. MENDELOWITZ. I think that is correct. The Constitution places with the Congress the authority to appropriate funds. While the Secretary had the legal authority to do what he did, the effect of what he did was to provide a benefit to a foreign country or the banks, depending on what incidents the benefits was determined to fall.

And because we, in effect, provided this benefit, we think it's appropriate for the Present or the Secretary to come to the Congress to receive approval for such undertakings.

Chairman GONZALEZ. The testimony to the effect that there is some form of accountability by reports issued or reports available, would you say that that was at best a most disingenous response to——

Mr. MENDELOWITZ. Considering with respect to the Mexico restructuring deal, if you receive a report from the Secretary in which he tells you the American taxpayer received a net benefit, and that is his report, I would say that is not a very effective way of—for the Congress to receive information on which to conduct oversight of such activities.

Chairman GONZALEZ. You are precisely right. Certainly we are most grateful for GAO.

I have a couple of other questions, but actually they are not of such consequence they have to be asked at this moment. I will follow through and submit them.

[The information referred to can be found in the appendix.]

Chairman GONZALEZ. I wanted to thank you very much for your constant help and cooperation, particularly with our staff. You have been invaluable.

Mr. Spivack, do you have any observations or points that you think ought to be made for the record?

Mr. SPIVACK. Nothing additional to add.

Chairman GONZALEZ. Thank you very much, sir.

If you have any additional comment, we will be glad to hear it. Thank you very much.

Our next panel is composed of Professor Allan Meltzer, GSIA, Carnegie-Mellon University; Dr. Anna J. Schwartz, National Bureau of Economic Research; Martin Mayer, Author, New York, New York; and Christopher Whalen, the Senior Vice President, The Whalen Co..

Ladies and gentlemen, thank you very much. We are deeply grateful. Particularly the testimony you gave us was most comprehensive, and it was given to us again in sufficient time to have read it overnight and looked at it and analyzed and educated ourselves.

I understand, Mr. Meltzer, you have a plane to catch at 1:00 p.m.

Mr. MELTZER. I have an appointment at 1:30 here in the city. I would like to be able to leave no later than 1.

Chairman GONZALEZ. Is there any objection if we recognize Mr. Meltzer first? If not, then Mr. Meltzer, we will recognize you.

STATEMENT OF ALLAN MELTZER, GSIA, CARNEGIE-MELLON UNIVERSITY

Mr. MELTZER. Thank you, Mr. Chairman.

It is a pleasure to appear again before this committee. Although the issues today appear to be narrow and technical, in my judgment, they are not. Today's hearing touches on basic issues in economics, public policy, accountability, and the use of public funds.

In the past 2 years, and particularly in 1989, the amount of exchange market intervention has increased substantially, and the balances held by the Treasury's Exchange Stabilization Fund and by the Federal Reserve have reached unprecedented levels.

Part of the increase in the holdings of the Exchange Stabilization Fund has been financed by loans from the Federal Reserve. These loans are outside the budget process and have not been subject to review or congressional authorization. Indeed, the business of intervention and its financing has, until today, proceeded without the benefit of congressional authorization or oversight.

No public purpose has been achieved by recent exchange market intervention that could not be achieved otherwise. Studies of exchange market intervention by virtually all economists and analysts show that exchange market intervention has no effect on exchange rates unless accompanied by a change in monetary policy.

This finding, replicated many times, has led analysts to distinguish between sterilized and unsterilized intervention. Sterilized intervention is simply an exchange of domestic for foreign assets on the Federal Reserve's balance sheet.

Unsterilized intervention occurs if the central bank increases or decreases bank reserves and money as a consequence of its exchange market intervention.

The practical point to the distinction between sterilized and unsterilized intervention is this: The Federal Reserve can achieve in its ordinary operations whatever can be accomplished by foreign exchange market intervention. Unsterilized intervention differs insignificantly from domestic open market operations that change reserves and money; interest rates, exchange rates and money stock will not be noticeably different if the same volume of reserves is injected or removed by operations in the foreign exchange market or in the domestic government securities market.

The operations in the exchange market are redundant for such goals of policy as employment, output, or inflation. Nor does sterilized intervention alter our balance of trade or payments with foreigners.

If you compare the patterns in recent years, you reach three conclusions: First, intervention in the foreign exchange market achieves nothing that cannot be achieved by domestic monetary operations. The monetary expansion that contributed to the devaluation of the dollar in 1986 was achieved principally by domestic operations.

Second, the principal way in which foreign exchange operations and domestic monetary operations change the value of the dollar is by changing the anticipated inflation rate.

If market participants believe that U.S. monetary policy has become more inflationary relative to inflation in major countries, the dollar falls. If they believe that monetary policy has become less inflationary, the dollar rises.

Third, there is no close or reliable relationship between the size or frequency of foreign exchange operations and changes in the value of the dollar. The relatively large net foreign exchange purchases of 1989 had little effect on the dollar's external value. The much smaller net foreign exchange purchases of 1986 or 1985 were accompanied by substantial dollar devaluation.

The committee's letter asks whether intervention has raised or lowered the rate of inflation. My answer is that the excessive monetary growth of 1986 to reenforce the devaluation of the dollar begun by market forces in March 1985 is a leading cause of the higher inflation experienced in 1989 and 1990.

The growth of money at first drove down the value of the dollar. With a lag, devaluation raised prices of imports and stimulated exports.

I might add that if it didn't do that, then it wouldn't do anything, With a lag, faster money growth encouraged domestic expansion also. Under the stimulus of monetary expansion and devaluation, growth of real output remained well above its trend rate of growth in 1987 and 1986.

With a somewhat longer lag, monetary expansion and devaluation spilled over into a more rapid increase in consumer prices and in unit labor costs in 1989 and in early 1990.

The Federal Reserve responded to the excessive money growth in a timely way to avoid a return to a high inflation regime. Their actions have now brought the economy to the edge of recession and perhaps beyond.

The long-term effects of exchange rate changes on output, employment, standards of living and trade balance depend on whether the exchange rate change is monetary or real.

Real exchange rate changes affect standards of living. A familiar example is the increase in the Japanese standard of living as their economy has grown and their exchange rate has appreciated against virtually all currencies in the world.

Treasury and Federal Reserve operations in the foreign exchange market would have no long-term real effects if inflation were always neutral.

There are many reasons why inflation is not neutral in either the short or the long term. The October 1987 stock market crash is an example of a short-term real effect of unsterilized intervention and exchange rate policy on the economy and the public.

Exchange rate policies are not the sole cause of the stock market decline. I doubt that anyone will identify all of the causes, but exchange rate policy contributed importantly by creating conditions under which interest rates rose and stock prices declined.

These conditions could have been avoided by permitting the exchange rate to adjust to market forces in 1986 and 1987. Intervention did not prevent the adjustment. It delayed it and increased the cost.

The 1987 experience produced a dramatic result. The main lesson should not be lost. Attempts to control or influence exchange rates have been costly. The goal of relatively stable, noninflationary growth does not require exchange rate manipulation or foreign exchange intervention.

No one knows the level of the exchange rate that is consistent with noninflationary growth. Even if the rate were found, it would not remain constant. Intervention and exchange rate manipulation can be costly, as the inflation of 1989 and the 1987 market break attest.

Congress should eliminate or severely restrict both intervention and efforts to control the exchange rate. Questions 7 and 8 of the committee's letter can be answered together. The level of the foreign exchange rate depends on interest rates, anticipated and actual rates of inflation, real growth of productivity and labor force, tax rates, regulations, and tariffs at home and abroad.

The exchange rate is a price, the price of domestic money and other assets in terms of foreign money. In a free market economy, operating as our economy does, the current price is determined by the decisions of buyers and sellers acting in the marketplace.

As I have indicated, there is not a single unchanging correct price for our currency. The historically high value of foreign currency holdings by the Treasury and the Federal Reserve, $46 billion at the end of March, will increase in value if the dollar declines and rise in value if the dollar appreciates.

No one can predict reliably which of these two events is more likely. The Treasury and the Federal Reserve are in the same position as speculators who have invested heavily in foreign currencies. If the dollar appreciates, they lose. Unlike the speculator, however, the Treasury and the Federal Reserve do not bear any losses because they are speculating with the taxpayers' money.

Treasury losses are an expense. Federal Reserve losses reduce profits of the Federal Reserve and their contribution to the budget. The record of losses and gains is available from published reports of the realized and unrealized profits on foreign exchange operations.

As holders of between 6 and 10 billion dollars of foreign exchange from 1980 to 1985, the Federal Reserve and the Treasury lost money during the period of a rising dollar, as they would be expected to do.

The cumulative value of the loss reached $1.5 billion, approximately 20 percent of the average holding. The depreciation of the dollar, beginning in 1985, first erased these losses, then produced a profit that reached $2 billion in 1987 on holdings of approximately $13 billion at the end of that year.

Since 1987, reports have shown some quarters with realized and unrealized profits and others with losses. At the end of April 1990, the cumulative profit was $2.9 billion, the highest recorded. Early this year, depreciation of the yen cost the taxpayers more than $1 billion. This loss was offset by appreciation of the German mark, so it will not appear in the published record.

A 7.65 percent appreciation of the dollar, given current holdings, would wipe out all of the recorded profit of $2.9 billion. Such fluctuations are well within the market fluctuations of the dollar and other currencies over the period we have been talking about.

I do not know any reason to expose taxpayers to the speculative losses or gains implied by the current $46 billion of foreign currency holdings. Congress should put a limit on foreign exchange holdings.

A large part of the recent buildup of foreign exchange balances at the Exchange Stabilization Fund has been financed by loans from the Federal Reserve. These loans are off budget. They do not go through the appropriation process.

They have been made by an agreement between the Treasury and Federal Reserve known as warehousing. Congress has not been asked whether it wishes to finance these operations of the Exchange Stabilization Fund, or whether it approves of the large increase in foreign exchange holdings and the inherent risks in the speculative position, or whether it wishes to permit warehousing.

In my opinion, the operations are unwise and unnecessary. I do not believe that any public purpose has been served by recent foreign exchange operations. Further, I believe it is unwise to permit the Federal Reserve to lend money to the Treasury.

If the Treasury is to engage in foreign exchange market operations, expenditures for these operations should, like all other Treasury expenditures, be subject to standard congressional appropriation procedures. Warehousing and any other direct financing of the Treasury should be barred.

Part of the committee's letter raises the relevant question of whether operations in the foreign exchange market should be conducted by both the Federal Reserve and the Treasury.

In my opinion, it is wasteful for the Treasury to operate in the foreign exchange market while having the Federal Reserve offset the monetary effects by sterilizing the Treasury's action, and it's wasteful for the Federal Reserve to buy or sell foreign exchange and offset the effects by selling or buying domestic securities.

This merely churns the markets. Authority for monetary policy has been delegated by Congress to the Federal Reserve. Decisions to intervene in the exchange market should be made a part of monetary policy and made a responsibility only of the Federal Reserve,

The Exchange Stabilization Fund is a relic of the inter war gold exchange standard. I recommend that the Exchange Stabilization Fund be closed and that the decisions to intervene be made a part of the regular monetary policy process.

My preference would be to have foreign intervention limited to those rare and infrequent occasions when there is turmoil in the foreign exchange market, such as occurred following the illness, sudden death or attempted assassination of our presidents.

Even if that recommendation is not adopted, I believe that accountability and efficiency are enhanced by concentrating responsibility and authority in a single agency. Since the operations are part of monetary policy, the Federal Reserve is the appropriate agency.

The committee's last question asks who should determine the value of the dollar. The value of the dollar is determined in the marketplace in response to information, including information about policies at home and abroad.

The foreign exchange value of the dollar should not be a policy objective. The Federal Reserve should concentrate on the one task for which monetary policy is best suited, maintaining the domestic purchasing power of the currency. If they succeed in that task, there is no reason to be concerned about the exchange rate.

If, by inflating or deflating, the Federal Reserve does not maintain the domestic value of the currency, it will not maintain its foreign value. Operations in the foreign exchange market cannot prevent the consequences of mistaken policies from affecting the domestic and international value of the currency and the public's standard of living.

Congress should restrict these operations and prohibit warehousing.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Meltzer can be found in the appendix.]

Chairman GONZALEZ. Thank you very much, Mr. Meltzer; excellent statement.

Dr. Schwartz.

STATEMENT OF ANNA J. SCHWARTZ, NATIONAL BUREAU OF ECONOMIC RESEARCH

Ms. SCHWARTZ. Thank you, Mr. Chairman.

The committee has asked me to provide some historical perspective on U.S. foreign exchange market intervention, and I will begin by discussion of the origin of U.S. intervention activities.

The Gold Reserve Act of 1934 established the Treasury's Exchange Stabilization Fund with $2 billion in capital. That was part of the profit the U.S. Government obtained at the time by raising the price of all the gold in the country from $20.67 to $35 an ounce.

The Act authorized the fund to deal in gold and foreign exchange. Its capital was reduced in 1947-48 when $1.8 billion was withdrawn to pay for the U.S. subscription to the IMF.

The Treasury activated the Exchange Stabilization Fund for the first time in the post war period March 13, 1961, acting through the Federal Reserve Bank of New York as its agent, when it sold Deutsche marks to reduce the premium on that currency.

On February 13, 1962, the Federal Open Market Committee authorized the Federal Reserve Bank of New York to buy or sell foreign currency on its account in both spot and forward markets. For this purpose, access to a stock of foreign currencies in addition to the limited amounts held by the Exchange Stabilization Fund was needed.

For this reason, the Federal Reserve negotiated a network of swap facilities with the central banks of other countries. The legal authority for Federal Reserve is moot. Nothing in the Federal Reserve Act of 1913 and as amended authorized foreign currency operations by the Federal Reserve system.

There is no general and positive legislative authorization for the system to operate in foreign currencies.

Section 14E, which empowers the Federal Reserve to maintain accounts with foreign correspondents, nevertheless served as the legal justification in January 1962 for approval by the Federal Open Market Committee of a program of system foreign currency operations to be conducted by the Federal Reserve Bank of New York.

The approval as based on an opinion of the FOMC's general counsel, concurred in by the general counsel of the Treasury and the attorney general of the United States, that the Federal Reserve banks under existing law were authorized to conduct such operations.

Two governors dissented. One believed that legislation was needed to clarify the system's authority to acquire, hold and sell foreign currencies.

The other also questioned the legality of the proposed operations, and in addition saw no need for two separate agencies to be engaged in buying and selling foreign exchange, since Congress had conferred upon the Treasury's Exchange Stabilization Fund such authority.

These dissenting views have not lost their validity since they were expressed 28 years ago. Congress has never examined the legal grounds for Federal Reserve intervention in foreign exchange markets. Such an examination is long overdue, and these hearings should serve to prod Congress to undertake this study.

Congress should also examine the legal grounds for Federal Reserve warehousing of foreign currencies for the Treasury, an action it took for the first time in November 1963. Warehousing amounts to a direct loan from the Federal Reserve to the Treasury to enable it to finance purchases of foreign currencies without the resources to do so.

Warehousing, in effect, bypasses congressional appropriations. Initially, the Federal Open Market Committee found justification for warehousing by relying on the Thomas Amendment to the 1933 Agricultural Adjustment Act.

The amendment authorized the Secretary of the Treasury to sell the Federal Reserve $3 billion in Treasury bills in addition to those in the Federal Reserve's portfolio. The amendment was extended every 2 years after 1933 until 1981, when it was allowed to expire.

Since 1977, when the FOMC agreed to a suggestion by the Treasury that the Federal Reserve again undertake warehousing when resources of the Exchange Stabilization Fund were inadequate, the amount set rose from an initial $1.5 billion to $10 billion set in September 1989, and to $15 billion in March 1990.

In December 1978, the FOMC extended warehousing to the Treasury's general fund, in addition to the Exchange Stabilization Fund. Why the Treasury's general fund should have been included as a recipient of warehousing in addition to the Exchange Stabilization Fund merits congressional scrutiny.

Since it appears that at its last meeting the Federal Open Market Committee voted to discontinue warehousing, the practice of warehousing may now be regarded as of historical interest only. In my judgment, the issue of the legal authority for warehousing even so should be reviewed by the Congress, including the relevance of the Thomas Amendment until 1981 as legal underpinning for the practice.

Although Secretary Mulford indicated that he thought Congress obtained all the information it needed on the record of foreign exchange market intervention, I think that both the Board of Governors and the Treasury Department should supply much additional information over and above what is included in the quarterly reports that are presented with a lag of 3 months and in their annual reviews.

The published record gives information on the dollar amount of an individual currency or of several currencies combined bought or sold on particular dates or some inclusive time period, but never prices at which transactions were executed.

It's important to know the price at which individual currencies were bought or sold. In any event, the compilation of a systematic set of returns of what has been bought and sold at which dates seems to be the very minimum needed to examine what the monetary authorities have been engaged in.

The authorities should make the full record available for at least past periods. Congress should request such data for the period since the abandonment of the Bretton Woods system. With the abandonment of Bretton Woods, although swaps continued to be used, the authorities engaged in outright purchases and sales of foreign currencies to an extent that was not previously the case.

With the exception of the first Reagan administration, official intervention has been directed to maintain what authorities decided was the right open market price of an individual currency.

At the Plaza Hotel in New York City on September 22, 1985, the finance ministers and central banking governors of five industrialized countries announced their agreement that in view of the present and prospective change in fundamentals, some orderly appreciation of the main nondollar currencies against the dollar was desirable.

They were ready to cooperate more closely to encourage this. Repeated meetings of the participants reaffirmed the principles of the Plaza Agreement until the group of 6 major industrial countries met at the Louvre Palace in February 1987 when they announced that existing exchange rate ranges were broadly consistent with economic fundamentals and that they would cooperate closely to foster stability of exchange rates around current levels.

The authorities, however, have never explained the basis on which they determine that a price is right. That is the question the Congress should ask the Treasury and the Federal Reserve to answer.

At the latest date in 1990, for which information is available, total foreign currencies held by the Federal Reserve and the Treasury amount to $46 billion plus, mainly in D marks and yen. If the dollar appreciates against these currencies, taxpayers will experience losses in proportion to the appreciation of the dollar.

Large foreign currency positions are vulnerable to loss. Does the Congress support such gambles by the monetary authorities?

Dr. Meltzer has already discussed the economics of foreign exchange market intervention. I would only like to add one thing about sterilized intervention which presumably is what the Federal Reserve is engaged in.

How do we know that it's really sterilized intervention unless we know in advance what was the money growth rate that the Fed was seeking before it started the intervention, and that that's exactly the monetary growth rate that has been achieved following intervention?

Even if sterilized intervention by the Federal Reserve does not change the desired U.S. money supply, it is the rate of growth of the U.S. monetary supply relative to that of the money supply of other countries that determines bilateral exchange rates.

One consequence of foreign exchange market intervention is that it tends to introduce distortionary effects on monetary growth rates. In pursuit of a weaker dollar until the end of 1986, U.S. monetary growth expanded.

From the end of 1986 to the end of 1988, when the exchange value of the dollar was a adjudged weak by finance ministers of the G countries, central banks loaded their portfolios with huge dollar holdings, thus creating domestic money while the U.S. monetary growth rate was restrained.

Absent its preoccupation with managing exchange rates since the Plaza Agreement, the Federal Reserve could have concentrated on achieving low money, price, and real income variability. Less variability in these variables would have made exchange rates less variable.

A consequence of sterilized intervention, whereby central banks sell corresponding amounts of domestic assets in the open market to offset foreign currency purchases as the Federal Reserve invariably does and the other central banks do intermittently is that they raise domestic interest rates.

In addition, foreign exchange market intervention distorts foreign currency prices. Intervention has interfered with market adjustment of the exchange value of the dollar. Intervention simply adds noise to the decisions traders make about pricing currencies.