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Statement of

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Chairman, Board of Governors of the Federal Reserve System,

before the

Subcommittee on International Finance
of the
Senate Committee on Banking and Currency

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For the second time in less than two years, a national program to reduce and eventually eliminate our large international payments deficit has been launched. Our first program, begun with President Kennedy's message to Congress of July 18, 1963, met for a time with a measure of success, but in the course of last year, signs of fresh deterioration appeared. The fourth quarter of 1964 brought a near-record payments deficit. During the first six weeks of 1965 tentative and fragmentary data indicated that a large deficit was in prospect for the first quarter of the current year.

The need for more vigorous action was clear. President Johnson's program of February 10, 1965, was in response to this challenge. For an important part of the program, the President called upon the Federal Reserve to assume major responsibility. Accordingly, we have now communicated to the commercial banks and other financial institutions of this country guidelines for a voluntary effort to restrain their foreign lending.

It may be helpful to you in the course of my statement to explain briefly the approach to our international payments problem followed by the Federal Reserve in laying down its guidelines.

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The magnitude of our payments deficit is determined by three main factors: first, the commercial balance on goods and services; second, our military expenditures abroad and our economic aid to foreign countries; and third, the net outflow of our private capital into foreign countries. The President's program attacks the deficit on all three fronts. But as the Federal Reserve is not asked to deal with Government expenditures, my comments will be directed primarily to problems on commercial account and private capital account.

It cannot be stressed too often, in my opinion, that the main contribution of monetary policy both to our continued domestic expansion and to the restoration of our international payments equilibrium is the maintenance of credit conditions that help bring about cost and price stability. Avoidance of both inflation and deflation not only averts one of the main perils to sustainable economic growth; it is also indispensable to preservation and improvement of the international competitive position of our industries at home and in world markets.

The further expansion of our commercial surplus depends on continued avoidance of cost and price increases--although, needless to say, many other factors, such as the level of economic activity at home and abroad, also play important roles.

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By providing monetary conditions favorable to price stability, Federal Reserve policy has, in my judgment, been as successful as could be expected in furthering a satisfactory development of our payments balance on current account. I do not want to minimize the importance of some signs pointing toward renewed upward cost and price pressures. As I said in my testimony before the Joint Economic Committee on February 26, I cannot avoid the feeling that we have been, and still are, sailing very close to the edge in this area. But the over-all changes up to now in per-unit costs of production, in wholesale prices, and in the cost of living, have so far not imperiled our international trade performance.

With regard to the Federal Reserve's contribution to minimizing outflows on capital account, the matter, unfortunately, is not quite so simple. While our commercial balance has shown record surpluses, our capital account has shown record deficits. The total net private U. S. capital outflow in 1964 amounted to over $6 billion--twice as much as our total payments deficit--and the net expansion of bank credit to foreigners alone accounted for more than one-third of this capital outflow.

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As a matter of principle, the aim of Federal Reserve policy is to maintain monetary conditions that are conducive to an adequate supply of credit and capital. This means a supply large enough to finance continuing economic expansion domestically without inflation, but not so generous as to make possible either an unsustainable investment boom or an undue spill-over of funds to foreign countries.

The supply of credit and capital in recent years, in my judgment, certainly has been large enough to meet all legitimate domestic financing needs. It has so far not given rise to an unsustainable boom--although developments in some fields such as construction need to be carefully watched. But our monetary policy has permitted credit in the United States to remain relatively cheap and plentiful in comparison with other major markets, and thus has been a factor in the magnitude of our private capital outflow.

While this capital outflow has played an important part in swelling our payments deficit, we must remain mindful that the United States is and will probably continue in the future to be an important source of credit and capital for the rest of the world. As the richest and most productive nation of the world, the United States is capable of generating the largest supply of savings, both in

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absolute terms and in relation to national income. Our accumulated stock of invested capital is also larger than that of any other country, again both in absolute amounts and in relation to national product. Hence, our domestic demand for new investment is more easily satisfied than in most if not all foreign countries. With a larger supply and a somewhat less strong demand than in other countries, the availability of credit and capital will tend to be greater, and the cost of credit and capital lower, than in the rest of the world.

This is not an unusual situation. In previous periods, the same relation obtained with respect to those nations that happened to be in the economic and financial lead for their time. France, the Low Countries, and especially Britain were for many generations a continuing source of credit and capital for the rest of the world, and during those periods their interest rate levels were naturally lower than in borrowing countries.

It is clear that restoration of our foreign payments equilibrium does not require our capital outflow to come to anything like a full stop. Arithmetically, a cutback in our private capital outflow of about one-half of the 1964 volume would suffice to wipe out the entire payments deficit provided all other elements in the payments balance remained the same. Realistically, it would be both impracticable and unwise to put the entire burden of correcting the payments deficit on private financing.

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The main problem confronting the Federal Reserve--and our nation at large--is how to reduce the net outflow of credit and capital without at the same time constricting the domestic supply so much that financing needed for our expanding economy at stable prices is unduly impeded.

Two alternative courses of policy are available to cope with this problem: one, a general increase in the cost and a lessening of the availability of credit; and the other, specific action designed to cut only the supply of credit and capital to foreigners without impinging on the needed supply to the domestic economy.

The Federal Reserve has to some extent followed the traditional course of the first alternative. At the time President Kennedy was formulating his program and in the prospect of its early announcement, the Federal Reserve shifted its policy posture in the direction of less domestic ease and increased its discount rate from 3 to 3-1/2 per cent, and shortly after lifted the ceiling interest rate on time deposits in the maturity range of 90 days to one year to 4 per cent. These actions were promptly reflected in financial markets. Within a few weeks the Treasury bill rate had risen by more than one-half a percentage point and over ensuing months long-term interest rates drifted upward by just over one-eighth of a point.

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These upward shifts in the level of domestic interest rates went some distance in better aligning our interest rates with those in foreign markets. Through the second half of 1963 and the early months of 1964, this alignment continued tolerably satisfactory. About this time, in major industrial countries abroad, strong credit demands accompanying strong economic growth and creeping inflation were carrying foreign interest rates to levels fully offsetting the advances that had been experienced in U. S. markets. In recognition of the pull that the higher foreign rates might exert on our credit supplies, the Federal Reserve in August firmed domestic money market conditions slightly further, with the result that the Treasury bill rate moved modestly above the discount rate.

Under continued pressure of inflationary trends abroad, however, the availability of credit came under increasing central bank restraint in various foreign markets. In these circumstances, capital outflow from the United States accelerated.

About the time we were experiencing this mounting capital outflow, an adverse payments balance for the United Kingdom put the pound sterling under strong pressure in international markets, resulting in large drains on Britain's monetary reserves. That country was obliged to take a number of emergency steps, including the establishment by its central bank of a discount rate of 7 per cent. To support the pound in international markets, the Bank of England arranged for a $1 billion drawing on the IMF along with about $3 billion of credits with other central banks.

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In view of uncertainties which developed at this point in international financial markets and in recognition of the advances in short-term rates that had been occurring in other international markets, the Federal Reserve raised its discount rate last November from 3-1/2 to 4 per cent. At the same time, ceilings on the interest rates that banks are permitted to pay on time deposits of over 90 days were raised to 4.5 per cent. Short-term rates in our money market promptly moved upward further about a quarter of a per cent in adjustment to these changes; long-term rates, however, continued to fluctuate narrowly within the range that had prevailed for several years, reflecting the continued large flow of domestic savings.

It is impossible to say how large the capital outflow in the fourth quarter might have been if we had not taken the actions when we did. All that we now know is that in spite of whatever inhibiting effect may have come from these actions and the accompanying increase in short rates, there was a further rise in lending and investing abroad.

Nevertheless, we have not moved further in the traditional way to constrain our renewed capital outflow. Considering the desirability of further reducing our level of unemployment and more fully utilizing our resources, we have risked permitting some spill-over of funds into foreign uses, and have sought other, more selective means of coping with the outflow problem.

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There are three selective ways by which capital outflow can be reduced: by tax measures; by exchange controls; or by enlistment of voluntary cooperation.

The Interest Equalization Tax is an example of the first approach. Experience with this approach so far has indicated both its strength and weakness. It is generally agreed that a tax is more consistent with the principles on which our economy is based than would be the use of direct controls or an appeal to voluntary cooperation. But a tax statute can hardly avoid some opportunities for legal escape, since it is extremely difficult in legislative drafting to foresee all loophole possibilities. Too embracing a tax, with many exceptions and qualifications, could be so complicated to administer that its effectiveness would be seriously impaired.

Exchange controls have not been tried in the past, except under wartime conditions, and I, for one, hope they will not be tried. By shifting decision making in individual business transactions from participants to some Government agency, this approach would be repugnant to the principles of our economic system. Also, experience everywhere has shown that exchange regulations, if couched in general terms, can be avoided as easily as a special tax; and if elaborated in great detail, become so oppressive that

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they also hamper business activities beneficial to our payments situation. And once this route has been chosen, experience has demonstrated the difficulty of retracing one's steps towards freedom from controls. Of the three methods of selective restraint, exchange controls are, in my judgment, the one that should not be seriously contemplated.

This leaves for comment the voluntary approach. This method also has shortcomings. The person, individual or corporate, adhering to a voluntary program may be penalized in favor of an uncooperative person. But if widespread voluntary restraint can reasonably be expected, the method has three advantages: first, it leaves the ultimate decision to the market participants; second, it is flexible enough to take care of changing circumstances and of the experience gained in the process; and third, given the good faith of all parties, it avoids the encumbrance of legalistic interpretations of the "rules of the game."

With regard to the expansion of credits to foreigners granted by banks and other financial institutions, the prospects of general compliance with voluntary efforts are particularly good because a comparatively few institutions account for the great bulk of the total funds involved. And the response the Federal Reserve has encountered in its initial efforts to implement the President's program has been quite encouraging.

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Last week, the Federal Reserve issued its guidelines to the banks and to other financial institutions. The guidelines provide that any bank may expand its credit to foreigners by 5 per cent of the amount outstanding at the end of 1964. Such a figure is consistent with the expected growth of our national product and also the expected growth of international trade. But it is much smaller than was the rate of last year's credit outflow. All of us realize that the restraint asked for may create hardship in individual cases.

Our guidelines, which are directed to each bank individually, are designed to distribute the burden as equitably as possible and to avoid unnecessary inconvenience. In particular, they are designed to avert any adverse repercussions on our international commerce; on sound development efforts of less developed countries; and on such countries as Canada and Japan, which are largely dependent on U. S. financing, and Britain, which is suffering from serious payments difficulties of its own.

We expect that banks will continue to grant bona fide export credits; such credits are to be given absolute priority. Obviously, no priority can be claimed for credit extensions that substitute a credit sale for a cash sale or that substitute financing by U. S. banks for financing from nonbank or foreign resources.

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We also expect that banks will continue to finance sound development projects of less developed countries. But clearly a less developed country should not rely on U. S. credit for projects that can and should be financed either with the country's own resources, or by other industrial nations--e.g., where the project envisages imports from European suppliers.

The guidelines explicitly state that substantial cutbacks are expected only in nonexport credits to those fully developed countries that are not customarily dependent on U. S. financing and that do not suffer from payments difficulties. Most if not all Continental European countries should fall into this category.

The guidelines for nonbank financial institutions are more general and tentative in their specifications. They envisage cutbacks in the placement of liquid funds abroad, primarily in the so-called Euro-dollar market. In the case of short- and medium-term credits, the guidelines for banks are in effect applicable to nonbanks. But in the case of long-term credits (with a maturity of five years or more), which are probably more important in the case of nonbanks than of banks, no specific target has been set. Most longer-term credits to fully developed countries are subject to the Interest Equalization Tax. No effort is being made to discourage continued long-term investments in less developed countries, which need this type of assistance more urgently than additional bank credits.

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While I am optimistic about the effectiveness of the voluntary restraint efforts, it would be impossible to give any quantitative estimate of their probable impact on our payments balance this year. Some banks greatly increased their credits to foreigners during the first six weeks of this year; some made very heavy advance commitments which they will have to honor; some carry many long-term credits among their outstanding assets, on which only small repayments are expected this year; others expect to have to increase their export credits and their loans to less developed countries without being able immediately to reduce sufficiently their nonexport credits to industrial countries. Banks that find themselves in such predicaments as these have been given 12 months to reduce their outstanding credits to no more than 105 per cent of the 1964 level.

Moreover, we realize that in spite of all good will and vigilance there may be some shifting of bank credit to nonbanking institutions. The effect of this shift on the over-all reduction of nonbank credits to foreigners cannot be predicted at this stage.

For the moment, we appear to be making good progress indeed. But of course, the real test of the program lies ahead. Meanwhile, I should not like to say more than that we expect the net expansion of both bank credit and total credit to foreigners to be reduced this year by a substantial amount.

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This reduction in capital outflows will be welcome. But in itself it will not be sufficient to assure the success of the President's program. For that, two things more are required: a further increase in our export surplus and a further decrease in our Government expenditures abroad. To borrow a word from the other side of the Iron Curtain, the program is like a troika, which cannot move if only one of its three horses keeps going.

Since I envisage success for the program, there is no need for me to dwell on actions that might become necessary if the program were not as successful as expected. But the inference from the analysis of the situation is unequivocal. With exchange controls decidedly inadvisable, and with tax measures unlikely to be more effective than voluntary action, a return to the traditional recipe of further restraint may be necessary in the monetary sphere, as may be further restraint in the spheres of military expenditures, economic aid and tourism.

But even if the program of voluntary cooperation achieves the greatest possible degree of success, we cannot think of it as a permanent institution. This program can serve as a dyke for a period of time, but still farther ahead we have to look for a more basic adjustment of our international payments balance. The better we succeed in keeping our industries competitive in international

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commerce, and the better we succeed in reducing our Government payments abroad, the less we will need to be concerned about our capital outflow, and the sooner we can return to a system that leaves balance on capital account to the forces of a free market.

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