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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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I am pleased to appear before this Committee once again to discuss the legislation now before you providing for an increase in the resources of the International Monetary Fund and to discuss related questions concerning the international financial situation and international lending by banks.

During the eight weeks since I last appeared before this Committee to examine these issues, considerable progress has been made in addressing the problems associated with the heavy indebtedness and external financing problems of some of the major international borrowers. However, the international financial system still remains subject to extraordinary pressures. Borrowing countries, the international banking community, the International Monetary Fund, and governments of the lending nations will all need to continue the efforts well started and to build upon the progress that has been made. The Senate Committee on Foreign Relations has acted promptly in reporting out the IMF legislation, and my hope is that this Committee, after due deliberation, will also act favorably on this important matter, critical to the entire effort. In my opinion, the proposed increase in the resources of the IMF remains the key element in a successful strategy of dealing with international financial strains for the short run as well as for the long run.

The federal bank regulators have completed a review of proposals for strengthening supervision and regulation of U.S. banks engaged in international lending. We have submitted to you a "Joint Memorandum" on our proposed program in this area.

In my testimony today I will touch briefly on each of these three areas of recent activity: the international financial situation, the IMF legislation, and our proposals with regard to international lending.

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International Financial Situation

During the past two months, further progress has been made in putting into place programs to deal with some of the problems of important borrowing countries that during the closing months of 1982 threatened the stability of the international financial system as well as their own economic prospects. This progress has involved strong actions of the borrowing countries themselves, supported by the IMF, by the international banking community, and in some instances by other governments and central banks.

In the important case of Mexico, the government has been effectively implementing its stabilization program approved by the IMF in late December. Economic activity had, of course, been severely affected by the balance-of-payments and economic pressures before the program could be implemented, and the shortage of foreign exchange has been reflected in a sharp drop in imports and in the current account deficit. But there are also early signs that more fundamental adjustment processes are beginning. Meanwhile, in late March, the first disbursement on the $5 billion bank credit took place, and a large part of earlier official "bridge" financing has been repaid. Other components of Mexico's external financial arrangements -- the restructuring of public sector debt maturing from August 1982 to December 1984 and of private sector debt -- are proceeding. Despite the decline in oil prices, prospects appear favorable that the adjustment program can be carried through successfully, laying the base for renewed growth.

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An important adjustment was made in the Brazilian stabilization program in mid-February when the cruzeiro was devalued sharply on February 18. The net effect should reinforce other measures to move toward external equilibrium, and Brazil, as a major oil importer, will ultimately benefit from the recent decline in oil prices. Meanwhile, banks have completed arrangements to loan new money to Brazil this year; the first drawdown was on March 10. In some respects, the Brazilian adjustment may not be as far advanced -- perhaps in part because the process started later -- and the objective of halving both its current account deficit and budget deficit this year is ambitious. But the Brazilian economy has, of course, great potential, and the challenge can be met.

A number of other countries in Latin American and elsewhere are also grappling with difficult and painful external financial problems and internal imbalances. These countries are in various stages of negotiations with the IMF and lending institutions. Obviously the period of extraordinary liquidity pressures on the international financial system is not over. While the problems are manageable, they will continue to require the skill and patience of all the parties involved. Ultimately, successful evolution will also require a reasonably favorable world economic and financial climate -- a circumstance which emphasizes the importance of policies in the United States and other leading countries. But it is also crystal clear that during this difficult period a great deal depends on the capacity of the IMF to provide leadership, and potentially resources, in the worldwide effort to maintain the kind of financial environment supportive of the needed growth. For that reason, I am gratified that the Senate

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Committee on Foreign Relations has completed its work on the authorizing legislation and that this Committee has moved expeditiously in its consideration.

Progress on the IMF Legislation*/

Three amendments were added by the Committee on Foreign Relations to legislation before you, each of which seems to me constructive. As I understand it, the first amendment essentially clarifies that Congress has to authorize any future changes in the General Arrangements to Borrow (GAB) that would affect the basic terms of U.S. participation or the fundamental structure of the arrangement.

The second amendment would establish the sense of Congress that consideration should be given to membership in the Bank for International Settlements (BIS), an institution that is playing an important role in dealing with the present strains on the financial system, as it has from time to time in the past. The BIS also provides a forum for more or less continuous consultation among central banks, and its role and functioning is of direct interest to the Federal Reserve.

For more than twenty years, the Federal Reserve has regularly participated in meetings at the BIS, including those of the G-10 Central Bank Governors and the Committee on Banking Regulations and Supervisory Practices. We have found this participation very useful but, on balance, have seen no urgent need to be a formal member and assume the seat on the Board of Directors reserved for the governor of the central bank of the United States.

*/ In view of the interest and concerns that have been expressed about the role of the IMF in promoting a liberal international trading system, I have attached an appendix to my statement on this subject.

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We would, of course, be glad to examine the matter again consulting not only with the Secretary of the Treasury and the Secretary of State, as provided in amendment, but also with our central banking collegues that are now members of the BIS. In that connection, I would point out that in addition to other considerations formal U.S. membership necessarily would involve some attention to the day-by-day banking operations of the BIS which are not of primary interest to us.

The third amendment to the IMF legislation would establish the sense of Congress that the IMF should strengthen its activities with regard to the collection and dissemination of information on the international borrowing and lending of its members and calls upon the Secretary of the Treasury to instruct the U.S. Executive Director of the Fund to discuss, propose and vote for procedures to increase the IMF's traditional role in this area.

I fully support the thrust of this amendment. As you have noticed, the program for improved supervision and regulation of international lending proposed by the federal bank regulators puts forward similar ideas. We have proposed that not only the IMF try to improve the information flow between borrowers and lenders, but also that the IMF should intensify its analysis for the benefit of members and the public of the trend and volume of international lending and should strengthen its surveillance activities in this area. The surveillance activities of the IMF involve all members -- including the U.S. -- whether or not they are currently borrowing from the IMF. The Fund should be encouraged to examine closely members' policies before international financial crises break. These activities are crucial to

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the IMF's central role in helping to guide the functioning of the international monetary system, and I believe they are not inconsistent with the general direction in which the IMF has been moving.

International Lending Proposals

Late last week the federal banking regulators distributed to the Senate and House Banking Committe a "Joint Memorandum" with supporting materials outlining a program for improved supervision and regulation of international lending. That package provides a rather complete treatment of our consideration of this important topic, and I will not repeat the analysis here.

I would note the basic premise of the program before you is not that international lending by banks is contrary to the U.S. interest or that it should be abruptly curtailed, but that banks should maintain adequate financial strength to deal with unexpected contingencies and be strongly conscious of the need to diversify risks and avoid undue concentration. Those concerns should be a continuing part of the supervisory effort.

At this particular point, I should also reiterate that abrupt action by lenders to withdraw from lending can only be mutually self-defeating, precipitating financial crises in otherwise creditworthy countries where sound economic policies are in place and damaging the stability of the international financial system. We need a balanced, sound, long-range approach, protecting against the possibility of a future crisis while permitting the flexibility to deal with the present situation. would point out that, in general, lending in conjunction with IMF programs can be extended without increasing the exposure of the banks in terms of ratios of their loans to capital or assets; in fact, these ratios should decline moderately.

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Against this background, the federal banking regulators have designed a five-part integrated program.

We propose a strengthening of the country risk examination and evaluation system established in 1979.

2. We propose additional reporting and disclosure designed to provide the public with more current, complete and consistent information about U.S. banks' aggregate exposure to countries and for individual banks where the exposure passes an established threshold.

3. We propose to require banks to make specific provisions -- to the extent that they have not already done so -- against certain country exposures where the country has been unable to service its debt over a protracted period of time and has no prospects of establishing arrangements to do so.

4. We propose to set forth guidelines for the accounting for fees on syndicated international credits, in general requiring spreading of those fees over the life of the credit.

5. We propose a strengthening of international cooperation in two areas. First, we would where possible coordinate our actions with bank supervisors abroad to limit competitive inequalities, to assure equal treatment of lenders and borrowers, and to reinforce the effectiveness of U.S. programs. We also suggest an increased role of the IMF in improving information flows (along the lines of the Committee on Foreign Relations' amendment to the IMF legislation) and strengthening its surveillance over member countries.

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You will note that our program does not include the establishment of country lending limits. We concluded that lending limits based upon objective criteria are likely to be entirely too rigid. More or less permanent limits would fail to distinguish between countries capable of carrying substantial debt without significant transfer risk and countries where smaller amounts of debt still raise large transfer risk problems. Lending limits based on subjective judgments that change over time are likely to have capricious and abrupt effects on flows of credit, imply a degree of foresight on the part of the regulators that may not be realistic, be difficult to administer fairly, and involve the impression of politically charged judgments. Moreover, extremely difficult transitional problems would arise in current circumstances.

Finally, we believe the bank regulatory agencies can use, and would plan to use, existing authority, including authority to define and prevent unsafe and unsound banking practices, to implement the program I have outlined. For that reason, legislation along the lines of the Heinz-Proxmire bill does not appear necessary, but I point out, with the exception of the country lending limits provision, our proposals parallel the subject matter of the bill. In view of the technical complexity of some parts of the program and the need to adapt the program in light of experience and economic circumstances, rigid or inconsistent legislative specifications would be undesirable. In any event, before this program is fully implemented we will want to consider comments from the Congress, the banks and the public, as well as from bank supervisors abroad.

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Appendix

The Role of the International Monetary Fund in Promoting a Liberal International Trading System

Among the purposes of the International Monetary Fund (IMF) listed in Article I of its Articles of Agreement are the facilitation of "the expansion and balanced growth of international trade" and "the elimination of foreign exchange restrictions which hamper the growth of world trade." Article I also links the temporary provision of financial resources to members "to correct maladjustments in their balance of payments" with the avoidance of "measures destructive of national or international prosperity."

The IMF has two main channels to influence members' policies in this area: conditions associated with financial assistance it provides to members and its regular surveillance activities on the exchange rate and other policies of all members. The IMF has more leverage when a member comes to it for financial assistance; however, the scope for requiring a dramatic dismantling of trade restrictions is limited by the severity of the country's external financial situation. With respect to the use of both channels, the IMF is limited by the requirement that it respect the domestic social and political policies of members. Thus, to the extent that a member's policies adversely affecting the free international flow of goods and services are internal policies or associated with a member's economic system, the IMF understandably finds it more difficult to encourage liberalizing changes. Nevertheless, the IMF has a positive record in this area.

When a member approaches the IMF for financial assistance, it draws up an economic stabilization program. Such programs are often drawn up with the assistance of the Fund staff, but the basic policy decisions are taken

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by the political leaders of the country. The purpose of the program is to assist a country to bring about a configuration of its balance of payments considered to be sustainable over time. In this context, what is known as "IMF conditionality" refers to the practice of providing financial assistance only when, in the IMF's judgment, the country involved has formulated and is committed to implementing adjustment policies designed to reestablish a viable balance of payments position. Depending upon the particular circumstances of the individual country, the set of policies designed to achieve this objective is likely to contain measures to restrain aggregate domestic demand (through reducing fiscal deficits and restraining the growth of money and credit), to improve the efficiency of domestic resource allocation and thereby lay the basis for more rapid growth in output over a sustained period (by reducing or eliminating price controls and subsidies, reducing external exchange and payments restrictions, and moving toward the establishment of positive real interest rates), to improve and maintain external competitiveness (through appropriate exchange rate policies), and to foster net capital inflows (through maintenance of an adequate level of interest rates, appropriate exchange rates, and an overall mix of policies that will attract foreign funds and encourage the retention of domestic savings for use in domestic investment).

If successfully implemented, such policies can be expected to bring about adjustment in the balance of payments through a reduction in the current account deficit (i.e., the balance of exports and imports of goods and services) to a level that can be sustained through expected future net inflows of capital on terms compatible with the growth prospects of the

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country and without resort to trade and payments restrictions. Such adjustment may, but does not necessarily, entail a temporary reduction of imports. In fact, of the ten largest IMF-supported programs (involving more than SDR 500 million in IMF resources) currently in effect (Argentina, India, Mexico, Pakistan, Turkey, Yugoslavia, Brazil, Chile, Peru, and Romania), the programs for the first six of these, when approved, anticipated an increase in the value of imports in the first year of the program compared with the prior year.

Even in programs that anticipate an initial decline in imports -- often cases where the country has been clearly importing more than can be supported by the country's export and external financing capacity --IMF financial assistance and other financing that might not otherwise have become available with an IMF-supported program help to cushion the adjustment process and to avoid an even larger decline in imports that might have otherwise occurred as a consequence of harsher and more abrupt adjustment policies.

One of the standard conditions for making drawings that are phased over the life of an IMF-approved stabilization program is that a member must agree not to impose new, or to intensify existing, exchange and payments restrictions. But the IMF often goes beyond the proscription against imposing further restrictions by actively encouraging members to reduce or eliminate existing restrictions, including, for example, import deposit schemes, bilateral trading arrangements, and external payments arrears. At least three recent programs, those for Argentina, Mexico and Peru, call for significant easing of restrictions of this type. The programs

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for Yugoslavia and Romania also involve important reforms of internal pricing practices, bringing these economies close to a market system as we know it. In some cases (for example, in the programs of Pakistan and India approved in 1981 and in Kenya's program this year), liberalization of restrictions on imports constitutes an explicit element in approval of IMF-supported balance-of-payments adjustment programs. The IMF also encourages members to reduce or eliminate subsidies, such as those involving multiple exchange rates, that tend to stimulate exports and/or imports because such subsidies distort resource allocation and contribute to budget deficits.

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