The President's Balance-of-Payments Program

On February 10, 1965, the President sent to Congress a message on the United States balance of payments in which he presented a program aimed at quickly achieving a substantial improvement in our balance-of-payments position. This program is clearly of major importance since the balance-of-payments deficit is a serious national problem.

A major responsibility in carrying out the President's program was placed on the Federal Reserve System and on the banking and financial community. The System has already taken the first measures in carrying out the program. On the day the Presidential message was delivered, the Federal Reserve Banks issued a circular soliciting the cooperation of the commercial banks and outlining specific steps to be taken by the banks. On February 18, in Washington, Chairman Martin and Governor Robertson discussed the request in detail with representatives of the banking and financial community, following a meeting of these representatives with the President of the United States. On March 3, Chairman Martin, in a letter to the chief executive officers of approximately 750 nonbank financial organizations, set forth tentative guidelines proposed by the Board for the foreign lending activities of these institutions. Because of the importance of these developments, this Bank's circular, the remarks of Chairman Martin and Governor Robertson, and Chairman Martin's letter to the nonbank financial organizations are reprinted below.

CIRCULAR NO. 5616—FEBRUARY 10, 1965

To All Member and Nonmember Banks
in the Second Federal Reserve District:

The President of the United States has today sent to Congress a message setting forth his program to improve the United States balance of payments.

In addition to stressing the vital importance of stability of domestic costs and prices, the President's program includes:

(1) Legislation to continue the interest equalization tax through December 31, 1967;

(2) Immediate action under the existing statute to impose the interest equalization tax on bank loans with maturity of one year or more;

(3) Legislation to apply the interest equalization tax, retroactive to February 10, 1965, to nonbank credits to foreigners if such credits have a maturity of one year or more;

(4) A call on the Federal Reserve System—in cooperation with the Treasury—to work with all banks to limit lending to foreigners;

(5) Legislation to provide immunity from antitrust laws for specified voluntary programs, if needed, with respect to foreign loans by banks;

(6) A call on the Department of Commerce to work with corporations with business interests abroad to effectuate a reduction of their capital outflows;

(7) A more vigorous export promotion drive;

(8) Encouragement of foreign investment in the United States through appropriate tax legislation;

(9) Legislation to reduce from $100 to $50 the duty-free allowance of tourists returning from abroad, and a "See the U.S.A. First" program designed to increase tourism in the United States;

(10) An intensified effort to reduce military expenditures abroad;

(11) Continued action to minimize adverse balance-of-payments effects of the foreign aid program.

The Federal Reserve System shares the President's concern about the deterioration in our balance of payments and his determination to improve our payments position and to strengthen confidence in the dollar. The System and the banking and financial community have been assigned major roles in the President's program.

The central focus of the program is on measures that will reduce the outflow of United States capital. Such flows have been heavy in recent years, and were particularly so in recent months. In the fourth quarter of 1964, for example, bank credit to foreigners expanded by $1 billion.

To assure the success of the program, the System is requesting all banks to limit credits to foreigners that are not clearly and directly for the purpose of financing exports of United States goods and services. Over all, the objective is to hold outstanding credits (including export credits) to foreigners during 1965 to a level not over 5 per cent above the December 31, 1964 outstandings. In most instances, this should be the minimum goal for individual banks. Within the over-all limits, certain countries may need to be given preferential treatment. You will be advised later concerning this.

Outstanding credit to foreigners includes loans, acceptance credits, deposits with foreign banks (including foreign branches and subsidiaries of United States banks), and investments and acquisitions of assets abroad regardless of maturity, whether or not they are subject to the interest equalization tax.

The Federal Reserve program will be further explained under the following procedures:

(1) The President is asking representatives of the financial community to meet with him to discuss the program set forth in his message to the Congress;

(2) The Chairman of the Board of Governors is asking the bank representatives present at the President's meeting to confer with him and the other members of the Board of Governors, and presidents of the Reserve Banks following that meeting;

(3) Each bank that has foreign loans and investments outstanding in excess of $5 million will be requested to meet individually with representatives of the Reserve Bank of its District for further discussion of the program;

(4) Technical advisory committees may be invited to meet with Federal Reserve officials concerning problems that arise under the System's program.

Implementation of the program limiting lending to foreigners will result inevitably in some hardships for individual lenders and borrowers. This is unfortunate, but the overriding long-run international position of the dollar is dependent upon your wholehearted cooperation.

I am confident that the financial community stands prepared to join with the Federal Reserve System in this urgent national effort to restore balance-of-payments equilibrium and to maintain the dollar "as good as gold". In good part, the success of the President's program depends on us.

ALFRED HAYES,
President.

REMARKS BY WILLIAM McC. MARTIN, JR.
CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

The Board has invited you here so that we can present in more detail the part the Federal Reserve and the banking system as a whole have to play in helping to achieve the very important balance-of-payments objectives that President Johnson talked about to you earlier today.

Since you are, for the most part, bankers, let me speak in bankers' terms. As a reserve currency country, the United States occupies a financial position very similar to that of a bank. On the whole, the position is a good one, like that of a very solvent bank, with an enviable capital structure. Over all, we have international assets amounting to about $96 billion. Our total liabilities amount to only $56 billion, leaving an equity position of $40 billion, or a ratio of more than 40 per cent. Our reserve position also is strong. We have gold reserves of $15 billion, against liquid claims of about $32 billion, the equivalent of almost 50 cents of cash in the till for every dollar of "demand" deposits.

On the other hand, we are having a problem that is, basically, one of secondary liquidity. Our loans and investments have increased more rapidly than has the desire of others to hold with us "deposits" or dollar claims. We are therefore faced with "adverse clearing balances", and the international liquidity position of our country has worsened, particularly in the period since 1957. Over the seven years ending with 1964, our monetary reserves declined by $7 billion and our net position in the International Monetary Fund by $1 billion. At the same time, our short-term liabilities to foreign central banks and governments—liabilities we must always be ready to redeem in gold on demand—rose more than $6 billion, while our liquid liabilities to private foreigners rose by nearly $5 billion.

In the circumstances we, like a bank faced with a similar problem, can do either or both of two things. We can try to increase the willingness of depositors to leave money with us by offering higher interest rates and other inducements, or we can cut back, for the time being, on our lending and investing, or we can do both. We have already done quite a bit to enhance rate and other attractions. Since 1960, United States bill rates have moved up from around 2.25 per cent to nearly 4 per cent, and rates paid by commercial banks on foreign deposits and other short-term rates have increased correspondingly. We have offered foreign central banks the so-called "Roosa Bonds", payable in foreign currencies, to afford them protection against any fluctuation in the dollar's exchange rate.

When it comes to lending and investing, however, we have not so far made any move toward curtailment. The fact is our loans and investments, already at a high level following a long climb, began showing a further marked rise a few months ago. It is a sharp but necessary reduction in the elevation of this rate which the President now proposes, and which we should like to work with you to effect. I think you will all agree that this course would be a sound and prudent one for any bank to follow in similar circumstances.

It is in the interest of all of us to explore new means of dealing with the problem before us so that we can find a correction that is reasonable and workable and that will not start us down a path whose course and end we cannot foresee. Perhaps there is no form of action feasible, including that the Administration is urging, that is without pitfalls. The President's balance-of-payments proposals, on the other hand, have been chosen in part because they will not impinge severely on the functions of the market as the final regulator of business, and also because they will not burden unduly our domestic prosperity and growth nor be disruptive of international trade.

Under the President's new program, the banks are being asked to assume a central responsibility for restraint. This has not been an arbitrary decision. It necessarily follows from the relationship that bank lending has to the persistent redundancy of dollars in international markets and the consequent deterioration in our international liquidity.

I'm sure that all of you here will agree with me that unless we preserve the integrity and strength of the dollar throughout the world we cannot possibly sustain the prosperous economies here and abroad that depend upon the dollar and the trade it finances. And I'm also sure that we can count upon your aid in our efforts to see to it that confidence in the dollar is maintained the world over.

Let us now come down to some particulars of what the President's program means for your institutions. For that, I am going to turn the meeting over to Governor J. L. Robertson, to whom the Board has delegated responsibility for the day-to-day conduct of our program.

REMARKS BY J. L. ROBERTSON
MEMBER OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Let me discuss more closely what the President's program means for banks and other financial institutions—bearing in mind, of course, that what is asked of them is only part of the over-all attack on the balance-of-payments problem.

Given the urgent need for a decisive cutback in capital outflows this year, what is an appropriate and realistic target for the *banking* community? After a great deal of thought, the Federal Reserve has concluded that any expansion of bank lending abroad in 1965 should not be greater—and preferably should be less—than the rate of growth of domestic lending. Last year, in contrast, foreign bank lending rose three times as rapidly as domestic loans and investments.

More dollars are needed abroad day by day, month by month, to finance trade throughout the free world—but not as many dollars as we have been providing. Hence the need for voluntary restraint on dollar outflows—the need for a curtailment of the rate of expansion of the outflow. Here is a situation in which we can make progress by standing still awhile—as the need for dollars abroad increases.

Therefore, we have asked all banks to restrict credits to foreigners that are not clearly and directly for the purpose of financing exports of United States goods and services. While all exports must be financed, we seek to have outstanding credits to foreigners (*including* export credits) held during 1965 to a level not over 5 per cent above the amount outstanding on December 31, 1964. In most instances, individual banks should do better—especially the larger ones—to offset the fact that some bona fide export credits to foreigners may be granted by banks that had no outstanding foreign credits at all last year.

This target must apply to all foreign credits—loans and investments, acceptances, and deposits. And the target must be aimed at by all banks. The institutions represented in this room account for most of the outstanding United States bank credit to foreigners, but of course we expect the smaller banks also to participate in this program.

This target will take care of any possible increase in bona fide export credits. The National Foreign Trade Council has estimated that United States exports in 1965 will be about 5 per cent higher than the rate for the fourth quarter of 1964. Hence, an increase in export credits by 5 per cent of the amount outstanding at the year end should cover the requirements of export expansion, assuming no change in the proportion of exports financed by credit. Thus, even if *all* credits granted by banks to foreigners were export credits, the 5 per cent target would still be realistic.

Actually, as you know, only a fraction of bank credits to foreigners are used to finance exports of United States goods and services. In the case of long-term credits, we know that this fraction is only around 15 per cent. In the case of acceptances, it is about 40 per cent. In the case of other short-term credits, it may well be less than in acceptances, but assuming for argument's sake that the fraction were equally high, this would mean that altogether only $3 billion of the total of $10 billion of bank credits to foreigners outstanding on December 31, 1964 was for the purpose of financing exports of United States goods and services. An increase of $500 million in such credits would thus finance an export expansion, not by 5 per cent, but by more than 15 per cent—an expansion that, unfortunately, is highly improbable.

And in fact, this calculation is still too conservative. All of your short-term credits and a substantial part of your long-term credits will be repaid in 1965. Assuming —quite conservatively—that only half of your total nonexport credits outstanding will fall due this year, an additional $3½ billion would become available this year to expand your export credits. Although it is unrealistic to expect that extensions or renewals of nonexport credits could be cut back to zero, in theory you could (within the Federal Reserve target) increase your export credits outstanding from $3 billion to $7 billion—enough to finance an export expansion of 133 per cent!

You will understand, therefore, that I do not intend to lose any sleep about the possibility that our target might prove to be too restrictive to permit the granting of all bona fide export credits. You will have plenty of opportunity to cut down your nonexport credits, if that should prove necessary in order to make room for any imaginable expansion of export credits. We recognize that in some cases this adjustment cannot be made overnight, especially if the credits granted or committed during the first six weeks of this year have already taken you over the target. But you should be able to get within the limit in a reasonably short period of time. In fact, you will probably be able to maintain your nonexport credits to foreigners at a level which will not impose a serious burden either on you or on your domestic or foreign customers, since the target level will be one-third higher than your outstanding credits were at the end of 1963.

Within the limits set, we must avoid creating more problems than we can solve. Hence, it is assumed that, while abiding by the target, you will exercise discretion in allocating loans. Since it would be in your own best interest, undoubtedly you will concentrate on credits that are exempt from the interest equalization tax. This would mean that in the medium- and long-term field you will give preference to the less developed nations. Moreover, again in your own interest as well as in that of the United States economy at large, you will presumably avoid any cutback that would inflict a serious burden on less developed countries, whose economic growth is especially in our national interest, or on such developed countries as Canada or Japan (both of which are heavily dependent on United States finance) and the United Kingdom (which, as we all know, is going through a difficult period in its own balance of payments). But again, I am sure this problem will hardly arise in practice since you will be able to stay within the target limit and still meet the real needs of these countries.

The 5 per cent target is simple and straightforward. It requires a minimum of interference with your operations and no elaborate machinery or detailed supervision. With the understanding that bona fide export financing is to be given priority and met adequately, and that serious cutbacks in other credits may need to be avoided for certain countries, within this 5 per cent target each bank would be free—subject only to any guidelines that may be developed—to use its resources as it thinks best.

We will need some informational reporting, mainly of a kind already supplied to the Treasury. Without adequate information, we could not spot points at which threats to the effectiveness of the program or problems of its equitable execution might arise; we could not gauge the success of the program and hence the possibility of relaxation; and we could not become aware that an uncooperative institution was taking advantage of the voluntary character of the program to compete unfairly with other banks. But let me emphasize that we have no desire to burden you with unnecessary reporting.

We are aware that a number of difficult problems are likely to arise in carrying out the program. For instance, relationships with your foreign branches will certainly pose complicated questions. Another major problem will be domestic credits which would affect the United States payments balance as much as credits to foreigners. I am thinking, for example, of credits to domestic borrowers that the borrower is going to use for financing operations abroad other than those directly connected with exports. Or some of your customers may be eager to increase the amount of their borrowings for export financing so as to free their own funds for uses inconsistent with our program. These are areas in which we will be working closely with you, and with the Department of Commerce in its efforts to limit foreign credits and investments of nonfinancial corporations.

In the case of the so-called Edge Act and Agreement corporations, the guiding principle, of course, is that banks with such subsidiaries be neither favored nor penalized in comparison with other banks. The most equitable solution, as a rule, seems to be to combine the parent bank and its subsidiaries for the purpose of calculating the 5 per cent target. Equity investments abroad, which are not available to banks without Edge Act subsidiaries, may require special treatment, but we are in a position to deal with that problem.

In connection with these investments and with banks' holdings of foreign securities or other foreign assets, problems may arise with respect to the disposition of those assets. It would obviously undermine the program if banks were to sell such assets domestically so as to free more of their own funds for investment abroad.

Transactions of banks for account of their customers and fiduciary accounts will also require attention.

I am sure that you will avoid encouraging customers to extend any credit to foreigners that you could not extend yourself within the target limits, and that you will avoid acting as brokers or intermediaries by diverting to them credits that you would normally finance out of your own funds in the usual course of business.

We will endeavor to develop, very soon, appropriate guidelines to deal with these and other problems. In doing so, we may request representatives of the banking community to serve on a small technical advisory committee to assist us. In any event—whether or not we issue guidelines or have an advisory committee—officers of our Reserve Banks will be in touch with you on an individual basis to assist in working out problems that you encounter.

As you know, this is not the only group that is being asked to make a strenuous voluntary effort to implement the President's program. You were joined at the White House today by representatives of leading business corporations that are being asked to make similar efforts. But the contribution that the banking system itself can make is crucial. And your economic interest in the success of the whole program and in the consequent continuing strength of the dollar is particularly strong.

The place of nonbank financial institutions in the President's program is somewhat different. To the best of my knowledge—which is admittedly imperfect in this field—most of these institutions have played a minor role in the recent expansion of credits to foreigners, although some of them have purchased large amounts of IET-exempt foreign bonds and also have placed part of their liquid funds abroad. What we must ask from them, at this time, is that their foreign credits and investments in 1965 also be kept within limits comparable to those we are suggesting for the banking community, and that no additional liquid funds be placed abroad.

Obviously, any potential foreign borrower whose credit application must be rejected by a commercial bank on account of the voluntary restraint program will be tempted to tap other credit sources. The pressure on investment houses, finance companies, insurance companies, and pension funds to extend foreign credits not subject to the IET —perhaps even credits that are—will no doubt increase considerably. Many if not most of these potential borrowers will be excellent risks and will offer excellent terms. It is asking a great deal when we request these institutions to resist the temptation. But, of course, we must do so. If such credits were granted, restraint by the banking system would be in vain. From the point of view of our payments balance, it makes no difference at all whether a credit to a foreigner is extended by a bank or by some other lender.

One problem involved in charting a course for nonbank financial institutions is the relative lack of data regarding their foreign lending. Only a few of them have undertaken transactions that are reportable on Treasury foreign exchange forms. We shall certainly have to request additional reports from these institutions.

Moreover, in the case of some nonbank institutions the problem of customer accounts will probably be even more troublesome than in the case of banks. And in the case of insurance companies, obvious exceptions must be made for foreign investments connected with foreign coverage requirements—exceptions that will have to be analogous to those made for the same reason in the IET legislation. But there is no denying that the Federal Reserve is far less conversant with the practices and problems of nonbank lenders than with those of banks. Hence, discussion of doubtful points with us in the System by the representatives of these financial institutions will be particularly important.

As you see, the success of this entire sector of the President's program depends on your acceptance, your dedication, and your unremitting effort to achieve its purpose. Given the present circumstances of our nation's economy—and the desire of all of us to avoid rigid controls—the Government believes that, in this area, it would be in the best interest of all to rely on voluntary restraint—rather than on laws and regulations—to reduce the outflow of dollars on capital account. With your cooperation, the country's balance of payments in 1965 can be leveled in the direction of full equilibrium. Your actions could have a decisive effect, and world confidence in the dollar would reflect it.

LETTER OF CHAIRMAN MARTIN TO THE NONBANK FINANCIAL ORGANIZATIONS

As you know, the President has launched a program designed to improve our international balance-of-payments position. An important element of the program is the President's request that banks, other financial institutions, and business corporations exercise all practicable restraint in their foreign lending and investment activities. The Department of Commerce has the responsibility for administering this voluntary program, so far as business corporations are concerned. And the Federal Reserve System, in cooperation with the Treasury, has been asked to carry the program to the financial institutions of the country. Governor J. L. Robertson is coordinating the System's activities in this matter here at the Board.

The purpose of my letter is to acquaint you with the tentative guidelines on foreign lending that we are proposing for 1965. These are detailed in the attached circular. In addition, within a few days you will receive a statistical questionnaire from the Federal Reserve Bank in your District designed to supply some bench-mark information on the extent of your foreign lending and investment activities, if any. This information will help us judge the appropriateness of our guideline objectives.

If you have questions concerning the actions that can be taken to effectuate the program, we urge you to contact the Federal Reserve Bank. Its officers will be glad to counsel with you. Your support in achieving the President's goal—one which is essential to the continued strength of the dollar at home and abroad—will be deeply appreciated.

Sincerely yours,

(Signed) WM. McC. MARTIN, JR.

TENTATIVE GUIDELINES ON FOREIGN LENDING AND INVESTING NONBANK FINANCIAL INSTITUTIONS (PURSUANT TO THE PRESIDENT'S BALANCE-OF-PAYMENTS PROGRAM)

1. *Deposits and money market instruments.* Holdings of liquid funds abroad should be limited to the 1964 year-end total, and the longer term objective is to reduce such investments in a gradual and orderly manner to the December 31, 1963 level. Included in this category of liquid investments are dollar-denominated deposits held in foreign banks and foreign branches of United States banks; short-term securities of foreign governments and their instrumentalities; foreign commercial paper, finance company credits, and bankers' acceptances; and all other negotiable instruments maturing in one year or less. Foreign bank deposits denominated in local currencies may be maintained to the extent needed to support ordinary business operations in that country.

2. *Foreign credits with original maturities of five years or less.* Holdings of investments other than those listed above, and written to have final maturities in five years or less, should not be increased by more than 5 per cent during calendar 1965. Included in this category are securities, mortgage and other loans, and credits of all other types. The 5 per cent growth ceiling is to be measured against the total of all such holdings at the end of 1964, without regard to type of instrument or country of origin. Priority should be given to credits that directly finance United States exports, however, and special care should be taken to avoid the extension of credit to borrowers who would have been accommodated by commercial banks in the absence of the voluntary restraint program.

3. *Foreign credits with original maturities over five years.* In the area of long-term financing, there would seem to be no present need for a guideline under the voluntary restraint program. Developments in the long-term credit area will be followed closely, however, so that we may be alert to excessive foreign financing demands if they should materialize. The issues of industrialized countries are subject to the Interest Equalization Tax, and have been very small in volume since that tax became effective. Borrowing by the less developed countries has been relatively light also, and in any event should not be substantially restricted in view of our national policy encouraging productive investment in these countries. In the case of Canada and Japan, separate agreements will serve to limit aggregate financing in United States capital markets.

4. *Direct investment in foreign branches and subsidiaries.* Some types of financial institutions may conduct operations abroad through foreign offices, branches, and subsidiaries. In such cases, institutions are urged to limit their additional investment in these operations to the fullest extent practicable during 1965. Particular care should be taken to restrict any increase in net loans and advances outstanding to foreign branches and subsidiaries; ordinarily, expansion in such credit during 1965 should be held within 5 per cent.

In the case of insurance carriers doing business abroad, these guidelines are not applicable to holdings of foreign investments in amounts up to 110 per cent of foreign policy reserves.

Board of Governors,
Federal Reserve System.
March 3, 1965.