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BOARD OF GOVERNORS  
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**SPECIAL**

Chairman Burns

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CENTRAL BANKING AND ECONOMIC DEVELOPMENT

The Record of Innovation

Remarks by

Andrew F. Brimmer  
Member  
Board of Governors of the  
Federal Reserve System

At the  
Tenth Anniversary Celebration  
of the  
Bank of Jamaica

Sheraton-Kingston Hotel  
Kingston, Jamaica

October 10, 1970



CENTRAL BANKING AND ECONOMIC DEVELOPMENT

The Record of Innovation

By

Andrew F. Brimmer\*

The ten-year life of the Bank of Jamaica coincides almost precisely with the "Decade of Development" proclaimed by the General Assembly of the United Nations in 1960. In fact, I understand that, when the organization of the Bank was being considered, serious thought was given to the possibility of combining central banking functions and responsibility for development financing in the same institution. However, that course was not followed, and the Bank of Jamaica has now accumulated a decade of experience in central banking.

Yet, it appears that the Bank has been concerned with problems of economic development almost as much as it has with the traditional functions of central banking. Of course, this is by no means surprising: while Jamaica has made significant economic progress in recent years, it still faces a difficult task in raising the standard of living of its citizens. And to this task, the Government of Jamaica has assigned a high priority.

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\* Member, Board of Governors of the Federal Reserve System.

I am grateful to several members of the Board's staff for assistance in the preparation of these remarks. Mrs. Dorothy Helprin provided information on recent economic developments in Jamaica. Messrs. Robert F. Emery, Yves Maroni, and Michael D. O'Connor conducted the survey of central banking experiences in Asia, Latin America, and in Africa and the Middle East, respectively. Mr. Frank O'Brien was especially helpful in knitting together the diverse regional experiences.





Thus, the celebration of the first ten years of achievement by the Bank of Jamaica is also a good occasion to review the role which central banks have generally played in promoting economic development in the last decade. It also provides a vantage point from which to look ahead to see what opportunities central banks in developing countries may have to encourage and assist the development process in the 1970's.

In focusing on the innovative steps that central banks have taken to help foster economic development, I am not overlooking the fact that virtually all of these institutions have performed most of the traditional central banking functions -- such as managing the note issue, serving as fiscal agent for the government, supervising the commercial banks, and managing the nation's foreign exchange reserves, including the operation of exchange controls in numerous countries. Moreover, many of the central banks have carried out these assignments with considerable skill.

Nor do I wish to ignore the crucial contribution that central banks can make to economic development by achieving -- and maintaining -- reasonable stability in domestic prices and equilibrium in the balance of payments. A central bank that uses its powers to discharge effectively these traditional central bank responsibilities makes a fundamental contribution to development because these are conditions that encourage and sustain growth. The converse of this is the fact that a central bank



that does not pay adequate attention to creating and maintaining the climate for growth -- or one that does not have enough independence to do so -- is undercutting the cause of growth, or permitting it to be undercut by others. One of the basic conclusions from a survey of the actions of central banks in developing countries suggests that the nations that have prospered most are also the ones that have the best long-term records in maintaining internal stability and external balance. It is also significant -- and encouraging -- that in the last few years many, perhaps most, of the countries that embarked in the 1950's on development programs that were unrealistic in view of their resources and inflationary in their effects, have shifted to more realistic programs. Most of them have found the road back to economic realism discouragingly long, and some of them are far from reaching the end of it yet. Consequently, whatever additional responsibilities a central bank may acquire, its basic commitment to the maintenance of economic stability -- both domestically and externally -- should not be downgraded.

In assessing the role that central banks in developing countries have played in the 1960's, several questions should be raised:

- Have central banks in developing countries -- while not ignoring their traditional tasks -- taken innovative steps to encourage economic development?



- Have these central banks been able to alter the flow of credit in favor of development needs?
- Have they assisted in creating institutions specifically designed to provide development finance?
- Have central banks in developing countries succeeded in efforts to encourage the mobilization of savings by private financial institutions?
- Have these banks used their proximity to the centers of political power to advise their governments as to the importance of monetary and fiscal stability in creating a climate conducive to investment and economic growth?
- Finally, what is the record of success -- and of disappointment -- harvested by these central banks in the struggle for economic development?

To answer these questions, a comprehensive survey was made of the special efforts made by central banks in developing countries to orient economic growth toward the goals of economic development. For the purpose of this discussion, these efforts can be grouped under four headings: the mobilization of savings, the fostering of development finance institutions, the allocation of credit for development, and advice on the development process.

Before proceeding further, I must explain the numerous references to particular countries in the comments below. In every instance, my purpose is to illustrate the general range and pattern of measures adopted by central banks to help promote economic development, and no country is singled out as a target for criticism or invidious comparison. The conditions mentioned are often widespread. However, without specific illustrations, we would be left with a collection of miscellaneous generalizations.



Mobilization of Domestic Savings

While external capital, from either public or private sources, can speed the development effort, the developing country must depend primarily on its own resources. This being the case, the mobilization of domestic savings is of fundamental importance. To the extent domestic savings are made available for development purposes, the prospects for noninflationary financing or development are enhanced. Thus, the central bank can make a significant contribution through policies which encourage savings to remain at home and to flow to financial institutions and away from money lenders, real estate, and other speculative activity. Moreover, savers must be assured as to the liquidity of the instruments issued by financial institutions in return for their funds -- as well as about the soundness of the institutions themselves.

Once the question of safety is answered, savings are attracted by the promise of reasonable earnings. Thus, the interest rate on savings deposits must be competitive with alternative uses of funds. However, in the highly inflationary environment of many developing countries, savings will not flow to financial institutions -- that could make them available for productive investment -- unless interest rates are high enough to yield realistic earnings in the face of inflation. This means that the rate of interest should be "positive" in the sense that it exceeds the rate of inflation.





Where deposit rates are negative in this sense, the flow of savings into financial institutions is restricted to a few special cases -- such as deposits by individuals with no other means of holding their funds, by those who use savings accounts for current transactions, and by those who deposit funds for special purposes, such as gaining access to bank credit. In the meantime, other institutions offer higher rates, such as finance companies, credit cooperatives, mortgage banks and the mortgage departments of commercial banks. In this respect, one should note that the Jamaican authorities have taken a **positive** step by freeing interest rates on time deposits of six months or over.

In Africa and the Middle East central banks are generally strictly limited -- in terms both of time and amounts -- in the extent to which they can lend to governments. However, by specifying certain asset ratios, central banks in this part of the world have channeled a share of private savings to governments -- so that they could be used for the purpose of development. Included in the composition of almost all such ratios were short-term government obligations. Given the fact that in Africa private demand for credit is often quite slack, commercial banks might hold idle funds -- or invest abroad -- if they did not hold Treasury bills to satisfy such liquidity ratios.

While this has been a successful means of mobilizing savings that could be made available for development purposes, it would not be desirable under all circumstances. If the liquidity ratio becomes an instrument for ensuring a market for the obligations of governments, it can lose some of its usefulness as a



monetary tool. Further, in an economy in which credit is tight, such mobilization of funds would squeeze the private sector from which the bulk of investment generally comes.

The Bank of Israel has encouraged the development of a wide variety of instruments attractive to savers. These measures include deposits denominated in dollars, deposits tied to the price index for value maintenance, and, recently, full removal of ceilings on interest rates. The result was an unusually high private savings rate. In Brazil and Chile, the value of financial instruments has frequently been linked to a price index to overcome the disabilities of low interest rates.

In Asia, several central banks in recent years have played a major role in the mobilization of savings for development through dramatic reform of archaic interest rate structures. The best example is that of Korea, where in 1965 interest rates on deposits were increased sharply -- from 15 to 26 per cent in the case of one-year bank deposits. Commercial bank loan rates were also raised substantially. This reform, supervised by the Bank of Korea, was followed by an increase in the national savings rate from 7 per cent in 1964 to 16 per cent in 1969, and inflationary pressures were simultaneously reduced. In this period also, Korea emerged as a country with an exceptionally high rate of economic growth, averaging 11 per cent per year from 1964 to 1969.

The lesson from this body of experience suggests that central banks might look to raising the real return that the banking





system is able to provide to the ordinary saver -- if more local resources are to be mobilized to finance the investment required for economic development.

One of the major obstacles to channeling potential savings to investment in developing countries is the lack of liquidity of financial assets. A number of countries have adopted measures to enable an investor to liquidate his holdings -- without incurring prohibitive capital losses. Mexico provides an outstanding example of action intended to assure the liquidity of savings. This involved a commitment by issuing institutions to repurchase their financial instruments at par at any time regardless of their maturity.

The Bank of Mexico, the Nacional Financiera, and, ultimately, the government, stood behind the financial institutions bidding for savings. In effect, this meant guaranteeing that these institutions would always be able to meet their obligations to savers.

Of course, the development of almost every type of capital market institution enhances the liquidity of financial instruments. Countries such as the Philippines, India, and Malaysia have rather advanced capital markets, where funds can be marshalled and channeled for development purposes. The Central Bank of the Philippines has played a major role in developing an open primary and secondary market in Treasury bills. Such action, of course, requires that governments be willing to pay the higher interest costs associated with a free Treasury bill market.



The creation of efficient stock exchanges (where appropriate) would increase the liquidity of financial investments. However, where such exchanges do exist in some developing countries, inadequate public disclosure of financial data on listed firms is a principal holdback to the expansion of securities markets. In the case of the combined stock exchange of Malaysia and Singapore, extensive public disclosure has been a principal factor in making the exchange outstandingly successful. Other developing countries, and their central banks, pondering how to increase the availability of funds for investment, might well study this example. Other promising areas would appear to be development of a Treasury bill market and markets for commercial paper.

In addition to action to increase the attractiveness of savings and to ensure adequate liquidity, central banks may encourage saving in at least two other ways -- both aimed at reassuring savers as to the security of their deposits. One is by means of deposit insurance. The other is examination of banks with the objective of enforcing standards of sound banking.

#### Central Bank Assistance to Development Institutions

In some places -- the Latin American countries provide a rather widespread example -- central banks were founded to provide commercial banking, and some of them have even been given specific development banking assignments. Over time, however, there has been a separation of these functions, since experience indicated that their location in one institution tended to produce



conflicts of interest and to interfere with the effective performance of central banking functions. But this separation does not mean that central banks have played no role in the growth of development banking institutions. Central banks -- with varying degrees of appropriateness and effectiveness -- have provided capital for development lending institutions, such as agricultural and industrial development banks. They have extended credit to them, purchased their securities, or helped to create a market for their securities.

In Colombia, Bolivia, Ecuador, Guatemala, Jamaica, Mexico, India, Afghanistan -- and quite generally in Africa -- central banks have subscribed to some part, usually a minor part, of the equity capital of developmental institutions. However, on the whole, this technique has had only limited use. This is as it should be, because heavy dependence upon central banks for provision of equity capital would have been inflationary. In general, it is best that development institutions be financed by noncentral bank sources, including governments, intergovernmental agencies, and private investors, whose funds represent savings.

Extension of credit to development institutions by central banks is subject to the same difficulty. To the extent that the loans are renewed, and are never repaid, they assume the characteristics of a capital contribution that does not come out of savings. Much the same can be said of the fairly widespread practice, particularly in Latin America, of direct purchase by central banks of the obligations issued by development finance institutions.



In view of this inflationary potential, some central banks have turned to less direct -- and less inflationary -- methods of helping development finance institutions raise their capital. This has been done in El Salvador, Guatemala, Dominican Republic, Argentina, and Honduras. In all except one of these countries, the central bank has attempted to create a market for the securities of development finance institutions of various kinds. They have attempted to do so, in more or less noninflationary ways -- including the use of profits from the ordinary operations of the central bank. At various times over several decades, banks in Argentina, Guatemala, and Honduras have tried to increase the liquidity of investments through the use of repurchase commitments.

In general, it seems that central banks in developing countries have not exhausted their financial expertise in trying to make a contribution in this area. As an example, it appears that efforts to make markets for the securities of development institutions (which have been explored only tentatively) might be reopened, with greater determination and with more stress on ways to keep securities lodged in private hands. It might also be asked whether the guarantee instrument could be put to effective use here, without opening a line to central bank resources that would channel inflationary funds into the economy.





Allocation of Credit for Development Purposes

In a substantial number of developing countries, the commercial banks are foreign-owned, and most of them traditionally have concentrated on financing foreign trade and domestic commerce. In the face of this situation, a number of central banks have attempted to influence the flow of commercial bank credit away from such traditional uses and toward capital development projects. The central banks of Latin America, Asia, and Africa have all made extensive, and varied, efforts in this direction. In fact, it is probably in this area that the greatest amount of central banking expertise and effort has been expended with the objective of promoting economic development.

With the allocation of credit in mind, differential discount rates have been used in a large number of countries. In Latin America, these include Argentina, Bolivia, Brazil, Colombia, Costa Rica, the Dominican Republic, Ecuador, Peru, and Venezuela. In the Middle East and Asia, Israel, India, Indonesia, Korea, Pakistan, the Philippines, the Republic of China, and Thailand have also employed differential discount rates. Ordinarily, the central bank charges a preferential rate on discounts or advances against favored types of paper to induce the commercial banks to increase their lending or to reduce the cost of funds to those activities in which this paper originates.



Experience suggests that the use of differential rates has not been universally successful. The potential for effecting a change in the pattern of lending by the use of multiple discount rates would increase as recourse to central bank credit by the commercial banks became more extensive. But it could seriously frustrate efforts to pursue a restrictive credit policy at times when such a policy may be needed on overall economic grounds.

Several central banks have sought to allocate credit by the establishment of portfolio ceilings. This technique has been used in Costa Rica continuously since 1948, and to some extent in Colombia. It has also been used in the Philippines, Nigeria, and the Congo (Kinshasa). The Costa Rican regulations provide an **overall** ceiling for each bank with separate subceilings on loans for major economic sectors and on some subsectors. The system may have helped to change the pattern of credit flows, although the data are subject to questions as to the accurate classification of some of the commercial bank loans. The Colombian system, which was in use briefly in the early 1960's, may also have had some effect on the pattern of credit allocation. But the fact that it was discontinued suggests that the Colombian authorities were dissatisfied with the results, or that the difficulties of securing compliance were too great in view of the results achieved.

Central banks in developing countries have made extensive use of reserve requirements as a tool of monetary management. A number of these institutions have linked differential reserve requirements to the composition of commercial bank portfolios to





influence the allocation of credit. This technique has been employed in an elaborate way in Mexico. Commercial banks are allowed to maintain a lower cash reserve ratio, provided that prescribed percentages of their portfolio consist of specified types of loans or investments. The prescribed percentages may be changed as the central bank shifts emphasis from one type of loan to another. Portfolio ratios associated with reserve requirements have also been used to some extent in Argentina, Brazil, Chile, Colombia, the Dominican Republic, and Peru. In Colombia, the system was combined with a secondary reserve requirement under which the banks were to hold specified bonds of the State Agricultural Industrial and Mining Bank.

The Mexican authorities appear to be satisfied with the results obtained under their system, which has been in use for over 20 years. They believe that the system was instrumental in inducing commercial banks to take an interest in types of productive loans which they had not made because of inertia or force of habit. Furthermore, there seems to be a feeling that, since banks have become accustomed to making such loans and have them to be remunerative, they may well continue such lending in the absence of the regulation.

The import deposit requirement technique (primarily intended to deal with balance of payments difficulties) has also been employed by some central banks to influence the allocation of commercial bank credit. Generally, the deposits are required



to be held by the central bank. Alternatively, the commercial banks are required to hold with the central bank reserves equal to the deposits. Imports for development purposes and other essential needs may be favored with a low requirement, and a progressively higher requirement may be applied as the essentiality of the imports diminishes. The import deposit requirement technique (with differential rates) has been used in Argentina, Brazil, Chile, Colombia, Ecuador, Indonesia, Pakistan, Paraguay, the Philippines, Uruguay, and Vietnam.

As a technique to influence the allocation of credit under a policy of promoting economic development, the import deposit scheme may leave domestic producers of nonessential and luxury goods with ready access to credit. It may also provide domestic producers of all goods subject to the import deposit requirement with a degree of protection against imports that may not be needed in the long run.

Virtually all central banks in the African and Middle East regions have taken steps to influence the flow of bank loans to priority or favored activities within the private sector. Techniques used include credit guidelines, quantitative rediscount ceilings, direct approval of bank loans, and selective liquidity ratios. Countries using one or several of these techniques include Nigeria, the Ivory Coast, Tunisia, Congo (Kinshasa), and Israel. In general, the practice in the region is replete with direct and quantitative controls.



The results of these efforts appear to be mixed. However, at least in the Congo (Kinshasa), direct and quantitative central bank controls seem to have been successful in increasing significantly the amount of credit extended to agriculture while reducing the amount intended to finance imports.

The Bank of Israel has probably gone as far as any institution in encouraging favorable terms for development lending. Controlled credit is extended at about 9 per cent, whereas ordinary bank credit costs about 17 per cent. In recent years, credit controlled by the Bank of Israel has represented about 30 per cent of all bank credit outstanding to the private sector. These controlled credits include rediscounts, specified loans which give the bank an exemption from liquidity requirements, and credits granted on the basis of deposits received under approved savings schemes.

In a number of instances, central banks have given specific -- and in some cases quite detailed -- guidance with respect to the desired composition of the commercial banks' loan portfolios. The Central Bank of the Philippines has followed such a practice since April 1957. All bank loans are classified into four priority categories, with those in the more essential loan categories being given preference in central bank rediscounting operations. In addition, maximum ceilings are imposed on loans in the two lowest, less essential categories.



The conclusion reached on the basis of the foregoing discussion seems clear: a few attempts to allocate credit for development purposes seem to have been particularly successful. But, on the whole, the results have been rather mixed.

The Central Bank as Development Adviser

Serving as adviser to governments is one of the oldest and most widespread roles of central banking. In the context of economic development, this role takes on special significance. Advice is particularly needed in four areas: (1) policies for domestic stability, with particular emphasis on appropriate fiscal policies; (2) exchange rate policy, with the objective of maintaining external balance; (3) the formulation of development plans that are feasible in view of the country's economic and financial resources; and (4) the broad range of policies affecting the climate for investment -- both domestic and foreign.

How a central bank performs as a development adviser will turn on a variety of factors specific to particular countries. However, a survey of central bank experiences in this regard clearly suggests that the relative freedom from involvement in day-to-day debates on economic policy has been crucial. In general, where the central bank has been allowed to maintain a reasonable degree of detachment, its advice has tended to be objective -- and respected -- even if not always received with enthusiasm. As a rule, the central bank is likely to be a well-equipped institution --



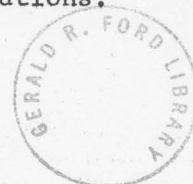


with respect to staff and financial resources -- to undertake the research and analysis on which a well conceived development plan must rest.

The opportunities open to a central bank to advise the government will also depend on the type of overall organization created to formulate and execute the plan. In countries with strong planning commissions or development ministries, the scope permitted to the central bank may not be very wide. But, on the whole, the evidence suggests that in many countries the central bank is a senior partner in the development enterprise.

Moreover, the particular role the central bank can play will be influenced by the type of development plan adopted by the government. Where, as in India, there is emphasis upon direct channeling of economic resources from both the private and the public sectors for the purpose of development, the central bank's advice is critical in every respect. Where, as in Korea, the development plan consists mainly of goals for the private sector to achieve, operating under a relatively free market system, the central bank's specific role may be focusing essentially on the adoption of measures to encourage private investment.

In conclusion, the evidence suggests that central banks have generally been a good source of advice to their governments on problems of economic development. However, in some countries -- especially where the overall planning machinery is quite elaborate -- the central bank may share the advisory role with other institutions.



The method of sharing varies greatly from country to country, and it is hard to make an assessment of the overall results.

Central Banking and Economic Development in the 1970's

Having surveyed the role of central banks in developing countries during recent years, we should now try to look ahead to see what course they may be expected to follow in the current decade. It is my impression that expectations about the availability of foreign assistance are much less optimistic today than they were in 1960 when the General Assembly of the United Nations proclaimed a "Decade of Development." The Assembly stated that:

" . . . the flow of international assistance and capital should be increased substantially so as to reach . . . approximately 1 per cent of the combined national incomes of the economically advanced countries."

This was a target for the total flow of resources, private and official. It was endorsed by the industrial nations in 1964, through the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development. In the five years before 1964, the target was exceeded. But in the concluding five years of the decade, net disbursements of official development aid by the DAC countries rose only slightly, in dollar terms, from just over \$6 billion in 1964 to \$6.7 billion in 1969. In terms of percentage of gross national product, this was a decline -- from approximately 0.5 per cent in 1964 to just over 0.3 per cent in 1969.





In contrast, the flow of private resources rose substantially. Net disbursements of private investors, together with private export credits, nearly doubled in dollar terms -- rising from \$3.2 billion in 1964 to slightly more than \$6 billion in 1969. This was a rise, in terms of percentage of the aggregate gross national product of DAC countries, from 0.26 per cent in 1964 to about 0.33 per cent in 1969. This increase in the flow of private investment from the DAC nations was almost large enough to offset the shortfall in official transfers. Therefore, total financial resources moving to developing countries, as a percentage of gross national product, declined only slightly. Moreover, the rise in private flows accounted for two-thirds of the absolute increase -- from \$9.14 billion in 1964 to \$13.30 billion in 1969.

The reasons for the shortfall in official development assistance can be traced to a number of factors. Widespread inflationary pressures created by excess demand in industrialized countries -- while public resistance to higher taxes was becoming stronger -- seriously limited the amount of budget resources that could be made available. In addition, some of the principal donor countries were also plagued by balance of payments deficits, and reductions in foreign assistance were a visible means of registering improvements.

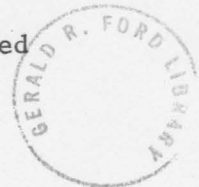
Expressed differently, there has emerged a worldwide shortage of capital, arising from a strong drive for economic and social advancement. The pressure for the use of capital to



finance these improvements has become as intense in the industrialized countries as it is in the developing nations. This shortage of funds cannot be expected to disappear at any time soon, and it is forcing nearly all countries to reexamine priorities in the harsh light of political realities. In this light, home needs increasingly are registering the first -- and strongest -- claims on resources.

Against this background, the Pearson Commission, sponsored by the World Bank, recommended that the DAC governments nearly double their official assistance during the 1970's. Many countries have already pledged to do so. If the goal is achieved, it would raise official flows of development finance to the developing countries to 0.7 per cent of their GNP, and the increase would take place gradually during the decade ahead. Consequently, countries expecting a flow of development resources in the 1970's that exceeds the amounts obtained in the 1960's may have to do more to attract private capital.

If developing countries do concentrate more directly on efforts to attract private investment, their central banks will have an enlarged opportunity to contribute to the development process. The more influential they are with their governments, the more successful they will be in supporting this effort. The task of attracting scarce private capital to the developing countries requires an investment climate that both domestic and foreign investors find compatible. Here it must be emphasized

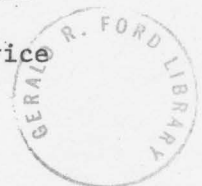


that it is necessary to create conditions conducive to domestic investors as well as to owners of foreign capital. Undoubtedly, developing countries will want their own citizens to own a substantial share of privately financed enterprises. This means that domestic investors will have to provide a sizable proportion of the required resources.

Attracting scarce -- and expensive -- private capital to developing countries also requires that the firms and industries financed must be able to survive under the pressure of international competition. This means they must not be overly sheltered from the winds of competition behind excessively high tariff or other protective walls. To the extent that the industries of developing countries are able to export products that are competitive in price and quality, they will have a better chance of penetrating foreign markets.

As stressed earlier, efforts to attract private capital also call for the careful building of capital markets. This includes increasing the flow of savings to financial institutions -- as well as building institutions that provide liquidity to investment.

All of these -- the economic stability that provides a good climate for investment, policies that avoid oversheltering of industries and which make them fit to compete and earn in foreign trade, the building of capital markets -- all are the results of policies which central banks are particularly capable of influencing through their own actions and through their advice to governments.



### Concluding Observations

The answers to the series of questions posed at the outset have been given at several points in the discussion. However, the conclusions can be summarized briefly for greater emphasis:

Central banks in developing countries, while experimenting with innovations to promote economic development, have not neglected the main functions traditionally associated with central banking. In particular, they have tried to maintain domestic price stability and equilibrium in the balance of payments. While many of them have been fairly successful in pursuing this objective, a number of them have also found the results of their efforts disappointing.

Central banks have adopted a variety of innovative steps to encourage economic development. The mobilization of domestic savings has been of primary concern. Where measures were taken (such as lifting low interest rate ceilings) to assure that savers received a realistic rate of return in the face of sometimes serious inflation, the results were generally satisfactory. Numerous arrangements to enhance the liquidity of financial investment have been fostered -- including the organization of stock exchanges and the development of other capital market institutions.

In some countries, central banks were also authorized to conduct a commercial banking business, and some of them were given specific development assignments as well. However, most of these





institutions have found such added functions to be incompatible with their basic missions.

Instead, a number of central banks have provided strong support to the formation of separate institutions to provide development finance. Some of them supplied capital for agricultural and industrial development banks; others extended credit to them, purchased their securities, or helped to create a market for their obligations. In general, it appears that most countries have recognized the inflationary potential of heavy reliance on central bank funds to finance development institutions, but in a few instances this apparently was not the case.

Perhaps the greatest amount of innovative effort by central banks has been concentrated on measures to influence the flow of commercial bank credit away from traditional uses (such as the finance of foreign trade and domestic commerce) and toward development projects. In pursuit of this objective, a wide range of instruments has been brought to bear. The most popular ones have included preferential discount rates, differential reserve requirements, guidelines on the composition of loan portfolios, and ceilings on specific kinds of credit. A few attempts to allocate credit seem to have been particularly successful -- but on the whole results have been rather mixed.

Central banks have generally been a good source of advice to their governments on problems of economic development. However,



in some countries, the advisory role has been shared with other institutions. Since the method of sharing varies greatly from country to country, it is difficult to make an assessment of the overall results.

Looking ahead to the 1970's, it appears that the developing countries can expect a considerable expansion in the volume of official resources received from the industrial nations. However, it also seems evident that they will have to concentrate on attracting a substantial amount of private capital. Thus, they will have to create an investment climate that both domestic and foreign investors find compatible. If they adopt this course, central banks will have an excellent opportunity to enlarge their contribution to the development process.





BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date October 27, 1970.

To Governor Brimmer

Subject: \_\_\_\_\_

From Frederick R. Dahl

Attached are some notes on the prospective London visit  
which you may wish to look over before our discussion this afternoon.  
I shall bring with me the list of institutions and ideas of people  
who might be contacted.

Attachments.



### International merchant banking in London

Background. The traditional London merchant bank combines features of commercial banking and investment banking, with particular emphasis on the latter. On the commercial banking side, merchant banks deposit facilities and finance transactions on an acceptance basis. On the investment banking side, they underwrite and deal in securities, furnish venture capital, provide investment advice, and act as middlemen in mergers and take-overs. In their commercial banking activities, they differ from the clearing banks in that they do not accept deposits generally from the public and do not provide the full range of credit and other banking services. They are not the only issuers, dealers and underwriters in the London securities markets; some other institutions specialize even more than merchant banks in these activities and are important participants in those markets. The recognized London merchant banks are the 16 institutions which are members of the Accepting Houses Committee, but a number of other smaller merchant banks exist as well and, as indicated, some other institutions perform similar functions.

London merchant banks emphasize their relatively small size, the flexibility of their operations, and their consequent ability to provide specialized and often tailor-made financial services to their customers. Traditionally, they have been oriented to the London market; but in recent years they have expanded their operations in international credit and capital markets--notably the Eurocurrency markets, the Eurobond market and offshore mutual funds.



The development of truly international markets for credit and capital, with their centers in London, has bred a number of new institutions. Multinational banks have been established by a consortia of banks drawn from a number of countries. The impetus for their establishment has been a desire to create larger institutions, backed by substantial national banks, capable of operating on a multinational basis in the Eurocurrency and Eurobond markets; in addition, these new banks would purportedly provide an institutional link between those short-term money and credit markets and the longer-term bond and capital markets. A number of them have announced their intentions to specialize in the medium-term lending area, with an emphasis on the two-to-seven year maturity range, and to provide financing in this area through short-term note issues and placements. Some variation in the coloration of these institutions exists, with some operating more as commercial banks with emphasis on term lending and others operating more as investment banks with emphasis on securities underwriting and dealing. A half-dozen or so of these institutions have been established with substantial American bank participation in partnership with European banks and merchant banks; others are in the process of being established; and still others, it may be presumed, are on the drawing boards.

This larger group of institutions--the traditional merchant banks and the newer specialized multinational institutions--make up the international merchant banking community in London. (See attached list.)



Object of visit. A short visit of the type contemplated cannot hope to cover all the institutions in the international merchant banking community nor to cover all the aspects of their activities. One can hope to obtain a better general view of their activities, a better feel of their role in the ongoing development of international credit and capital markets, and the nature and consequences of the involvement of American banks in this area. At the very least, this introductory survey should provide direction to our continuing observation, examination, and analysis of market and institutional developments in this area as they relate to our interests in the fields of international finance and supervision of the international activities of American banks.

I would suggest that this time around, visits be made to a few of the traditional merchant banks and to a few of the newer institutions formed with American bank participation. This should enable a sampling of broad spectrum of opinion and activities. In the attached list, the institutions which might be visited for this purpose are indicated, together with the persons in those institutions who might be the best to contact.





Questions for discussion. The following questions are unpolished and vary in degree of generality, ranging from the technical to the very broad. Some are more appropriate to the traditional merchant bank; others are more suitable to the newer multinational institutions. The questions are grouped by the areas of activity in which we have particular interest.

Securities activities and markets

1. What is the relative importance of securities operations--underwriting, dealing, and distributions of bonds, debentures, and equities--in your over-all activities?
2. In underwriting new international securities issues, do you act as syndicate manager or co-manager? What is the nature of your commitments in one underwriting operation? What considerations determine the size of your commitment as a member of a syndicate?
3. In arranging new issues, do the borrowers approach you directly for investment advice and assistance, or are they referred to you by their bankers and by your correspondents?
4. With whom do you place new issues? Institutional investors? Correspondent banks in Europe? Individuals? Are your relationships with such sources of investment funds firm enough that you have a pretty good idea of your ability to place a new issue?



5. On a securities offering, are you likely to hold your portion for any period of time before it is passed on for secondary distribution? Are you likely to hold onto a portion in your own name after the breakup of a syndicate pending delivery under firm or reasonably firm commitments from your own customers?
6. Comment on recent trends and developments in Eurosecurities markets as they affect your operations in those markets, and your outlook on your future operations.
  - a. After peaking in 1968, the volume of international bond issues has declined markedly. Recently there have been some indications of a pickup in new issues. Is there a significant backlog of demand waiting for more favorable market conditions?
  - b. The volume of straight debt issues has held up pretty well with most of the decline in convertible debentures. After recent experience, is there a future for "convertibles"?
  - c. What is your opinion of floating rates on long-term issues (e.g., in the \$125 million Ente Nazionale and the \$75 million PEPSICO issues)?
  - d. Are other changes in issuing and distribution techniques in process?



7. As opposed to debt issues of varying kinds, to what extent do you participate in equity issues? What is your view on the possibilities of the development of an international equity market comparable to the Eurobond market?
8. Do you deal for your own account in international bonds and equities? Do you help maintain a secondary market in international issues?

Venture capital financing

1. Do you provide venture capital financing in the sense of taking equity positions (in connection with debt financing or otherwise) in new companies or companies insufficiently established to put forward a public offering?
2. If so, over what period of time would you normally expect to provide such financing and to maintain an equity position? What equity position might you contemplate?
3. Would these be companies operating internationally or companies operating in national markets?
4. What sources of funds would you rely on to provide such financing?
5. Is this type of financing likely to grow in importance among the activities of international merchant banks?





Medium-term lending

1. How does the medium-term lending of international merchant banks differ from the term lending of the international commercial banks? Are the sources and types of customers different? Or the projects or activities to be financed? The source of funds? The risks undertaken?
2. Assuming satisfactory credit risks, what would be the maximum amount you would lend to a single borrower? How would this relate to your capital position?
3. In large medium-term loans to international companies or governments, do you organize or participate in lending syndicates? How are these arranged? In what respects do they differ from syndicates underwriting new issues?
4. In lending at medium-term, do you attempt to match maturities of the funds you obtain with the maturities of the loans? How do you match currency risks?
5. Are there any limits (self-imposed or otherwise) on the amount of funds you may borrow or otherwise obtain to finance your activities--say, in relation to your capital position?

General

1. To the traditional merchant banks:
  - a. A number of new multinational banking institutions have been formed in recent years. Has the emergence of these institutions caused you to alter the scope of your activities or to alter the services you emphasize to customers?





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General

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  - a. A number of new multinational banking institutions have been formed in recent years. Has the emergence of these institutions caused you to alter the scope of your activities or to alter the services you emphasize to customers?



- b. What is your relationship or association with these institutions?
  - c. A number of them have substantial American bank participation--either one or more. What is your view on American commercial banks becoming involved in this way in international investment and merchant banking? Are there any problems for them which you might foresee? In a few of these institutions, the American participants (while substantial and respectable banks) are not themselves substantially involved in international banking and do not have a great deal of expertise: in the circumstances, can the American bank participation contribute much except for capital funds to the effectiveness of these organizations? Are there pitfalls for such banks?
2. To the newer institutions:
- a. What role in international financial markets do you envision for yourself (as for this class of institution collectively) as opposed to the traditional institutions including international banks, merchant banks, and investment houses?
  - b. What is the relationship between the institution and its shareholding banks? As source of customers? As partners in financing undertakings? As competitors?
  - c. What advantages accrue from multinational ownership? What problems are encountered in trying to operate an institution with multinational ownership of this sort?



- d. (For those controlled by American banks). What impediments or handicaps, if any, are posed by the Board's regulatory requirements on foreign subsidiaries of American banking institutions?

Attachment.





Merchant Banks in London

Traditional merchant banks

<u>Name</u>	<u>Known officers</u>	<u>Other contacts</u>
Brown Shipley & Co.		
Hambros Bank *		
Wm. Brandt's Sons		
Charterhouse, Japhet & Thomasson *	Hilton Clarke (BE)	
Antony Gibbs & Sons		W.G. Underwood
Baring Brothers & Co.		
Samuel Montagu & Co.		
Morgan Grenfell & Co.	John Stevens (BE)	P. Coldstream
Hill, Samuel & Co.	Kennth Keith	
Lazard Brothers & Co.	J. Rootham (BE)	M. Kelton
Kleinwort Benson		
Guinness Mahon & Co.		
Arbuthnot Latham & Co. *	Thompson-McCausland (BE)	
N.M. Rothschild & Sons*		
S.G. Warburg & Co.	Eric Roll	
J. Henry Shroder Wagg & Co.	Gordon Richardson G. Bell	J.R. H. Cooper
-----		
Keyser Ullman *		
Ansbacher & Sons *		





Multinational Institutions with U.S. Participants

Western American Bank (Europe) Ltd.

J.E. Baird  
John Pryor

National Bank of Detroit  
Wells Fargo Bank  
Security Pacific National Bank  
Hambros

International Commercial Bank

D. Robson

Irving Trust  
First National Bank of Chicago  
Commerzbank  
Hongkong & Shanghai Banking Corporation  
Westminster Bank

Atlantic International Bank

National Shawmut Bank  
Manufacturers National Bank of Detroit  
First Pennsylvania Bank & Trust Co.  
United California Bank  
Charterhouse Japhet & Thomasson  
Banco di Napoli  
Neuflize de Schlumberger  
F. Van Lanschot

Rothschild Intercontinental Bank

Stonor

National City Bank of Cleveland  
First National City Bank of Houston  
Seattle-First National Bank  
N.M. Rothschild  
Banque Rothschild  
Banque Lambert  
Pierson Heldring & Pierson  
Banque Privee

Manufacturers Hanover Ltd.

M. Zombanakis

Manufacturers Hanover  
N.M. Rothschild  
Riunione Adriatica

Bankers ~~Str~~ Trust International Ltd.

C. Bridge

Bankers Trust Co.



Multinational institutions with U.S. Participants (yet to be formed)

London International Bank

Northern Trust  
Chemical Bank  
Baring Brothers  
Credit Suisse

United International Bank

Crocker Citizens National Bank  
7 others

Unnamed

Mercantile Trust  
Indiana National Bank  
Maryland National Bank  
First National Bank of Atlanta  
First Western Bank  
Keyser Ullmann

First Chicago Ltd.

First National Bank of Chicago

Orion Ltd.

Chase Manhattan Bank  
Royal Bank Of Canada  
National Westminster Bank



Dr. Burns:

Governor Brimmer dropped this by -- it  
is an outline of the issues he will be raising  
on his trip to London to talk about merchant  
banking.

cm





BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date \_\_\_\_\_

To Chairman Burns

Subject: VFCR Effect on Export Financing--

From Governor Brimmer *CHB*

Proposed Comment to Secretary

Stans on FAC Discussion.

Following the last meeting of the Federal Advisory Council, you said it might be useful for you to send the Secretary of Commerce a letter on the FAC discussion of the VFCR and export financing.

I submit the attached proposed letter for your consideration.

Attachment.

cc: R. Solomon  
S. Pizer





C. 11/13/78

Chairman Burns

Governor Brimmer

VFCR Effect on Export Financing--  
Proposed Comment to Secretary  
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cc: R. Solomon  
S. Pizer

BN:bbs

*O.K. affB*



FILE COPY

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE 11/13/70

TO Chairman Burns

FROM ANDREW F. BRIMMER

Attached is a draft of my reply to the letter from Bill Lawson at the Bank of Canada. I would appreciate any comments you might have.

The Joint U.S.-Canadian Cabinet Meeting on economic policy will take place toward the end of next week. Consequently, I would like to send my letter to Bill as early as possible -- hopefully today before I go off to Europe.

The staff in the International Finance Division worked on the letter, and Bob Solomon has also seen a copy of the draft.

Attachment



DRAFT  
SP:AFB:las  
11/13/70

Dear Bill:

In the light of the comments in your letter of October 16, I have been reviewing my remarks in Montreal of September 28. As I indicated in the speech, my principal aim at the time was to speak of long-run tendencies in our respective balance of payments positions, to try to look ahead a bit as to our own balance of payments, and, of course, to examine how these tendencies fit into the relationship between the United States and Canada.

I judge from your letter that, insofar as the discussion dealt with the change in the Canadian current account with the United States, there is not a basic difference of view -- although you would perhaps have wanted to stress more than I did the reduction in your surplus with us after mid-year. As to my discussion of your trade with other countries, I would agree that -- to the extent I considered 1969 as the terminal point for comparisons -- the analysis tended to overstate the deterioration that had occurred. On the other hand, it is also unlikely that 1970 would yield a satisfactory rendering of trends. However, I did take note of the dramatic change in your trade accounts this year. If one were to use the period from mid-1969 to mid-1970 as a more suitable terminal point for comparisons, one would find that the overall current account in the Canadian balance of payments had improved by \$1.3 billion since 1966, of which the gain vis-a-vis the United States would be \$1.5 billion. I do not advocate this as a very satisfactory way of viewing this extremely complex set



of transactions, but it illustrates the kind of tendency in current transactions I had in mind.

Respecting Canada's access to the U. S. long-term capital market, I wanted to stress very clearly that I was not calling this into question, and as far as I can tell this was accepted. In speaking about short-term capital flows, although I tried to put this in a very low key, I was impressed by the shift in the flow of Canadian funds toward Europe. You are quite right to emphasize that borrowing by U. S. banks in the Euro-dollar market was a dynamic element, and this should have been said. On the other hand, I would like to note that -- although U. S. banks drew large amounts of funds from their foreign branches in 1969 -- those branches were at the same time adding sizable amounts to their claims on and loans to non-U. S. borrowers.

My sketch of the understandings between the United States and Canada is very brief, and I regret that I failed to refer to the exchange of letters between Mr. Fowler and Mr. Benson in December, 1968. It was certainly not my intention to express a rigid attitude toward the arithmetic involved, and I do not believe that is the impression given by my remarks viewed as a whole. I did not state that there was any formal U. S.-Canadian agreement in the matters referred to in that paragraph, but I was expressing at least my own view of the underlying rationale of our arrangements.





As I said in the paper, the relations between Canada and the United States -- fortunately -- are such that we have been able to speak to each other with considerable candor about our mutual concerns. This I tried to do in Montreal. In that speech -- as I stress in all of my speeches -- I was speaking for myself -- and not for the Federal Reserve -- and certainly not for the U. S. Government.

If I may, I would like to follow your suggestion and defer discussion of the questions you pose at the end of your letter. I hope I have succeeded in at least disspeiling some of the questions that my talk seems to have raised.

Sincerely yours,

AFB



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date November 25, 1970

To Chairman Burns

Subject: VFCR Program

From Governor Brimmer *cyb*

I thought you might like to see a copy of the memorandum which President Hayes sent to Secretary Samuels in the State Department with respect to the VFCR program for 1971.

Attachment



FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, NEW YORK 10045

November 24, 1970

The Hon. Nathaniel Samuels  
Deputy Under Secretary of State  
for Economic Affairs  
Department of State  
2201 C Street, N.W.  
Washington, D.C. 20520

Dear Nat:

When I had the pleasure of calling on you in Washington a few weeks ago, you asked for any thoughts I might have on the subject of possible relaxation of restrictions on capital flows to foreign countries. While you were thinking principally of the OFDI program and the interest equalization tax, our own area of primary interest is of course the Voluntary Foreign Credit Restraint program for banks and other financial institutions. Recently we had prepared in this Bank a brief memorandum outlining the reasons for our feeling that the VFCR program should not be relaxed in 1971. While we have not dealt specifically with the OFDI or the interest equalization tax, we would feel generally that the line should be held on both of these for essentially the same reasons.

I recognize that this memorandum is a bit stale for your purposes, but perhaps it may be of some interest.

I enjoyed very much hearing you at the Council on Foreign Relations the other day. Your remarks struck me as lucid and very much to the point, and my impression was that the audience as a whole felt as I did.

With warm regards,

Sincerely,

A!

Alfred Hayes

Enclosure

cc: Governor Brimmer





~~CONFIDENTIAL--F.R.~~

By TMH NARA, Date 4/18/22

## THE VOLUNTARY FOREIGN CREDIT RESTRAINT PROGRAM FOR 1971

There is a considerable temptation to relax the Voluntary Foreign Credit Restraint (VFCR) program for 1971. Although financial institutions have adjusted their operations to remain without much difficulty inside program limits and there is no substantial evidence that the program has hurt United States exports or long-term credits to less developed countries, such a selective control is out of tune with the main thrust of our post-war economic policy --freer international trade and payments. This "temporary" program appears more permanent as its ending "as soon as possible" is put off for yet another year.

To relax the program at this time, however, would entail very serious risks. Relaxation would come on the heels of exceptionally heavy dollar reserve gains by foreign central banks and at a time when the dollar has been quite weak in the exchange markets. This action would precede a probable worsening of our trade balance, as European demand slows and the pace of our economy quickens. It would take place when widening interest differentials and improving liquidity of United States financial institutions would favor large new outflows into the Euro-dollar market and European national markets. Relaxation thus carries the risk of enlarging the balance of payments deficit at a time when it is already large. There is, furthermore, another important risk.





Relaxation could lead the E. E. C. countries to speed plans for increasing their independence from the dollar. These countries are in the process of making major decisions about future economic and political relationships. If these decisions are made in a climate of anger or spitefulness over U. S. policies, the results could hardly be calculated to favor U. S. interests and could lead to a weakening of the international payments system.

The tendency of E. E. C. countries to seek, collectively, a greater degree of economic independence from the dollar has greatly accelerated this year. Spokesmen for E. E. C. member governments and central banks have increasingly referred to a buildup of dollar reserves as a problem in the management of their economies. The view that our seeming inability to bring either inflation or the balance of payments under control has been the major cause of inflation abroad, while simplistic, has struck a responsive chord both in foreign political circles and with foreign public opinion. Attention on the problem of the dollar has been strengthened by the better alignment of European currencies following parity changes in Britain, France and Germany. At the moment, with the E. E. C. currencies all at or near their upper intervention points in relation to the dollar, the exchange market itself seems to suggest common action.

The plan of common action is set forth in the Werner report. This report envisages gradual transition to a unified E. E. C. monetary and exchange policy. The first step, proposed to begin on January 1 of next year, is a narrowing of the exchange rate variation of these



currencies with respect to the dollar. This step need have no practical consequences for the moment, since E. E. C. currencies are now clustered near their ceilings and the exchange markets might not even note an effort to maintain a narrow variation among them in relation to the dollar.

But other decisions have yet to be made. One step which has been raised for discussion is for the E. E. C. countries to widen the permissible range of variation of their currencies collectively with respect to the dollar, whether within or expanding upon I. M. F. limits. Aside from the eventual merits of such a move, European proponents speak frankly of using it as a means of "bipolarization" between the dollar and E. E. C. currencies, which clearly means in their minds an effort to weaken the dollar's relative position internationally. A broader discussion of the E. E. C. margins at this time might induce already uneasy exchange markets to anticipate overnight or over any given weekend a widening of the E. E. C. bands, if not perhaps a general revaluation of the E. E. C. currencies. Given the freedom of investors to shift funds internationally and the immense dollar resources provided by the Euro-dollar market and our economy, these anticipations could result in a massive speculative flight from the dollar. Such a disruption could prejudice future foreign holdings of dollars and have far-reaching economic and political consequences for this country.



These plans are thus now in a critical formative stage. E. E. C. countries are, of course, finding their natural divisions an impediment to rapid development of a unified currency bloc. It would thus seem especially important at this time for the United States to avoid actions that might result in E. E. C. decisions prejudicial to our interest.

A decision to relax the VFCR program for 1971 would no doubt be seen by many Europeans and other foreigners as additional evidence of our inability to come to grips with the balance of payments problem. Even if speculative snowballing does not develop, the decision to relax the program would almost certainly be followed by additional outflows. As the decline in United States interest rates precedes those abroad, a substantial shift to lending from United States sources would, in the absence of the program, be expected. Furthermore, with liquidity positions improving here, our financial institutions should become more willing to lend additional funds. The wish of some non-bank financial institutions to diversify their portfolios with a greater proportion of foreign securities is also strong. These probable outflows would surely augment the reserve gains of foreign central banks and put downward pressure on the dollar in the foreign exchange markets.

Even without such additional outflows, we may have some serious balance of payments financing problems next year. While the flow of funds into foreign monetary reserves next year may be smaller than the extremely large flow of this year, the dollar gains may be less acceptable abroad. The consequences of dollar reserve gains this





year have been attenuated, because the accruals have generally been by countries needing to repay debt, desiring to rebuild reserve lost earlier, or willing to hold them. Continuing large reserve gains are weakening these motives.

Maintaining the VFCR program another year will by no means resolve our international payments problems. But it will avoid an inappropriate and risky change at this critical time.







BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D.C. 20551

ANDREW F. BRIMMER  
MEMBER OF THE BOARD

December 4, 1970

To: Federal Open Market Committee

From: Andrew F. Brimmer

Enclosed is a report on the meeting of the  
Economic Policy Committee of OECD, held in Paris on  
November 16-17, 1970. I promised to make such a  
report at the FOMC meeting of November 17, 1970.

*Andrew F. Brimmer*

Enclosure



Economic Policy Committee Meeting, November 16-17, 1970

The Economic Policy Committee of OECD met in Paris on November 16 and 17. I was present on the first day, and Mr. John Ghiardi covered the meeting for me on the second day. The Committee discussed the problem of inflation in OECD countries and efforts to improve policy coordination among member countries. Other agenda items included the status of OECD studies on fiscal policy and the coordination of export credits.

Much of the meeting was spent in discussion of the report prepared by the Secretariat on the present problem of inflation.

The main theme of the report is that there should be a concerted effort to deal with the problem of inflation in all OECD countries. Each country should, as far as possible, adopt a global or multi-policy approach, encompassing not only firm demand-management policy, price-income policies, active manpower policies and competition policy, but also intensified efforts to identify and eliminate inefficiency and waste throughout the public and private sectors.

Surveying recent wage and price trends, the report notes that while signs of an easing of price increases have become manifest in more recent months, the pressure on wages seems to have strengthened further in most of the countries. Fourteen out of sixteen OECD countries have of late recorded much higher year-over-year wage increases than in 1969. As to prospects for 1971, the general picture is that the pace of inflation should abate somewhat, particularly in the United States, Canada, and Germany, but only to a rather moderate extent in the rest of the OECD area. The Secretariat forecasts that the aggregate price rise will slow



down from 5-1/2 per cent this year to around 4-1/2 per cent in 1971. This would still be unsatisfactory by earlier standards, particularly since it follows a lengthy period in which all the major countries have been pursuing restrictive demand-management policies.

The Secretariat report stresses that the present inflation may prove more difficult to stem, particularly through demand-management policies, than would have seemed likely on the basis of experience in the earlier part of the 1960's. Although in the short run the prospect is for some improvement in price performance, unless it is more marked than now expected, a serious inflationary problem could reemerge. Governments will have to make it clear that they are prepared to pursue restrictive demand-management policies until there are signs that better price stability is being restored. A permanent and significant rise in unemployment would not be acceptable; nor would it necessarily be an effective barrier against inflation over the longer run. What is needed, however, is that all segments of the public -- and especially employers and trade unions -- should be more conscious of the inevitable link between the moderation they exercise in price and wage decisions and the demand-management policies followed by the authorities. In the present situation, a major reduction of inflationary expectations during the cooling-off period is a prerequisite for the resumption of normal growth rates and the return to higher levels of employment. The essence of the problem today is that the cumulative economic, social and political



consequences of inflation, which up to now some may have regarded as tolerable, could begin to build up rather quickly. This is why such a heavy responsibility lies on informed opinion to stress the dangers in the present situation and the urgent need to give a higher priority to price stability.

There was general agreement with the broad lines of the Secretariat's inflation report, but committee members were outspoken and unambiguous on their insistence to avoid any public interpretation that specific elements of the report were accepted.

The committee members felt that the situation varies from country to country and the general prospect is for improvement in price performance. The problem is widespread and serious, however, and the committee agreed on the urgent need for further progress. The committee agreed that it was necessary to bring about a significant reduction in inflationary expectations in the near future. There was general appreciation that, first, there should be a concerted effort to deal with the problem in all OECD countries; and, second, that each country should pursue a range of measures appropriate to its situation and institutions, encompassing effective demand management, and other policies designed to improve price performance and to increase competition and efficiency in their economies. The committee, without taking a position on the various recommendations, was sympathetic to the general approach, in the light of the problems faced by all countries in reconciling high employment and price stability.





In order to get the committee's agreement to send the inflation report to the OECD Council with a view to publish it on Secretary-General Von Lemep's responsibility, he had to accept some key revisions in the report that softened the reference to the need for creating unusual resources in order to combat price increases and the implication that price stability should have first priority among member countries' policy objectives.

The Committee expressed general appreciation for the broad principle of improving coordination among OECD governments with regard to economic policies, but stressed that such consultation should avoid too formalistic arrangements and should be pragmatic. We and several other delegations stressed the importance of the consultation that takes place in the Economic Policy Committee and in the Committee's Working Parties.



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date December 11, 1970

To Chairman Burns

Subject: Conversation with

From Governor Brimmer

representatives of IT&T

Because of your unavailability, I met with representatives of IT&T on Thursday, December 10. In the group were Mr. Hart Perry, Senior Vice President for Finance, Mr. Lyman Hamilton, Treasurer, Mr. William Merriam, Director of IT&T's Washington office, and Dr. Raymond Saulnier.

Their principal concern focused on the impact of OFDI's regulations on IT&T's overseas operations. The arguments they advanced are spelled out in substantial detail in the attached letter addressed to you and a number of other government officials.

Cutting through the entire argument, IT&T would like to see OFDI's regulations relax to the point where companies would be allowed to retain 50 per cent of earnings as opposed to the 30 per cent provided for in the existing regulation.

The visitors fully understood the nature of the U. S. balance of payments problem, and they fully understood the impossibility of scrapping the program at this time. However, they also believe that some modest relaxation could be justified.

Attachment



# INTERNATIONAL TELEPHONE AND TELEGRAPH CORPORATION

320 PARK AVENUE

NEW YORK, N. Y. 10022

HAROLD S. GENEEN  
CHAIRMAN AND PRESIDENT

December 8, 1970

Honorable Maurice H. Stans  
Secretary of Commerce  
Department of Commerce  
14th Street and Constitution Avenue  
Washington, D.C. 20230

Honorable George P. Schultz  
Director, Office of Management  
and Budget  
The White House  
1600 Pennsylvania Avenue, N.W.  
Washington, D.C. 20500

Honorable Henry A. Kissinger  
Assistant to the President for  
National Security Affairs  
The White House  
1600 Pennsylvania Avenue, N.W.  
Washington, D.C. 20500

Honorable Paul W. McCracken  
Chairman, Council of Economic  
Advisers  
Executive Office Building  
Washington, D.C. 20506

Honorable Arthur S. Burns  
Chairman, Board of Governors  
Federal Reserve System  
Washington, D.C. 20551

Honorable Paul A. Volcker  
Under Secretary of the Treasury  
for Monetary Affairs  
15th Street and Pennsylvania Avenue  
Washington, D.C. 20220

Dear Sirs:

The mandatory control of foreign direct investment transfers was imposed on January 1, 1968 as an emergency measure. At that time, when the U. S. balance of payments was deteriorating rapidly as a result of the war and inflation, it was understandable that restraints on U. S. foreign investment were necessary. In fact, the large U. S. corporations with affiliates abroad had been cooperating with the Government under a voluntary program to secure the greatest possible improvement in the U. S. balance of payments. In many respects, the voluntary program was a more practical and more effective means of maximizing the balance of payments benefits of U. S. direct investment enterprises than the present much more restrictive mandatory program.

The United States now has three major methods of controlling capital outflow, but the incidence applies unevenly for portfolio investment, bank loans, and for direct investment. A U.S. purchaser of foreign securities for portfolio is not seriously affected by the Interest Equalization Tax, for there is no serious cost to an investor if he must place his funds in domestic rather than foreign securities and, in fact, foreign share prices have not done as well as U. S. shares since July 1963 when the IET was enacted. Nor is there any real burden on banks if increases in their foreign loans is limited under the Federal Reserve guidelines and, in fact, with the tight credit situation U. S. banks were more concerned with their own borrowing abroad rather than with foreign lending. The effect of controls on direct investment, however, are far more complex and far more onerous.

U. S. direct investment affiliates are operating companies. They must meet the requirements of foreign markets and, if they are to retain their competitive position in their industries, they must continue to expand. What is jeopardized by the foreign direct investment controls is not merely additional profitable investment abroad, but the efficient operation of a vast network of enterprises with a book value of \$71 billion at the end of 1969 that yielded income of \$9,109 million in that year (\$1,369 million in license and royalty fees remitted by the affiliates to their parent companies, \$5,639 million of remitted earnings, and \$2,101 million of reinvested earnings).

Remittances from U. S. direct investment enterprises abroad have been and must be a basic element of strength in the long-run payments position of the United States. While the trade surplus fell from \$6.8 billion in 1964 to \$600 million in 1969, and the deficit on services (excluding military transactions and investment income) rose from \$800 million in 1964 to \$1.1 billion in 1969, the remitted earnings from foreign direct investments (including fees and royalties) increased from over \$4.4 billion in 1964 to \$7.0 billion in 1969. Furthermore, there is good reason for expecting earnings of foreign direct investment enterprises, if not impeded, to grow



at the same or a better rate in the future. To impair the earning capacity of U. S. foreign direct investment enterprises through excessive restraints in order to secure a temporary and nominal improvement in the balance of payments is to risk an important national resource.

U. S. direct investment enterprises operate under numerous and complex regulations. The regulatory pattern of the Office of Direct Investment (OFDI) is set forth in approximately 89 pages of the Federal Register, 20 of which are Regulations and 69 are equally important explanations of the Regulations. Domestic business would suffocate under such regulation, and in the long run U. S. foreign enterprises abroad will be stifled unless these Regulations are changed. The most oppressive aspects of these Regulations are the ban on the transfer of new funds from this country for direct investment in the highly developed countries (Schedule C) and unrealistic requirements for repatriation of earnings.

Until recently, the limitations on the transfer of new funds for foreign direct investment did not have a seriously adverse effect on the efficiency and profitability of the foreign affiliates of most U. S. companies. That is because U. S. companies are permitted to undertake foreign direct investment, provided they finance their requirements for additional funds by borrowing abroad. From 1965 to mid-1970, U. S. corporations issued nearly \$5 billion of debt, often through foreign subsidiaries formed primarily for this purpose, and the borrowed funds made it possible to maintain foreign direct investment at a fairly constant level since 1965. The fact that U. S. companies were willing to pay large underwriting costs (about \$150 million), very high interest rates, and offer attractive convertible securities to raise these funds indicates the importance they attach to enabling their foreign affiliates to operate efficiently. As Professor Houthakker, a member of the Council of Economic Advisers, said in a speech at the Louisiana State University on May 4, 1970: "In fact we should be grateful that these measures [limiting direct investment] were not far more effective, and that they did not prevent an increase in the balance of investment income from \$2¼ billion in 1960 to nearly \$5 billion in 1968."

It will be impossible for U. S. companies to continue to borrow on the scale of recent years in order to finance their foreign affiliates. The capital structure of their subsidiaries is heavily burdened with debt and this has reduced their creditworthiness. In any case, foreign investors have been saturated with securities issued to finance U. S. enterprises abroad, and some brought large losses to foreigners in 1970. It is worth noting that since the peak of such issues in 1968 (\$2.14 billion net of underwriting costs), the new issues of U. S. corporations in the Eurobond market fell to \$1 billion in 1969 and to \$422 million in the first half of 1970. More and more, U. S. corporations have had to depend on short-term borrowing in the Eurodollar market. The large amount and high cost of foreign borrowing to finance direct investment is itself harmful to the balance of payments. The interest rates are high (recently 9 per cent or more), they increasingly take the form of a variable rate dependent on the London interbank rate and often without any ceiling, and the payments are invariably free of withholding taxes by the United States.

The repatriation requirements on earnings have also become more burdensome. They do not take into account the fact that the proportion of earnings remitted, and the form they take, has traditionally varied considerably from country to country because of tax considerations. A high rate of remittance from a country because of tax advantages was of no importance when the same funds could be sent back for investment. With a ban on the transfer of new funds and the limitation on use of reinvested earnings for direct investment, the regulatory compulsion to remit earnings has become a heavy burden in some countries. Moreover, the requirement to remit earnings to the full extent of the Regulations takes no account of explicit or implicit limitations placed by foreign countries on remittances of profits, or on contractual commitments to reinvest earnings, or on pressing need for reinvestment to expand output and service. Unless such needs and commitments are met, the value and profitability of large investments now in place may be lost.

International Telephone and Telegraph Corporation has encountered great difficulty in its foreign operations because of the restrictive manner in which OFDI Regulations are applied. Foreign affiliates of ITT are very large remitters of funds to the U. S. in the form of dividends, interest, and license and royalty fees. The earnings brought to this country by ITT have increased at an average annual rate of 17% and for 1970 are estimated at \$111 million. We are confident that the earnings remitted to this country will continue to grow at a very high rate, provided our operations abroad are not undermined by the restrictions on new investment and the requirements for excessive repatriation of earnings. ITT's principal activity abroad is the manufacture of telecommunication equipment. In this activity, ITT must deal with the foreign governments whose communications administrations are its customers, and compete with their own domestic companies, often under adverse conditions because of actual or possible Government preferences to its competitors. In some countries, ITT is

under legal compulsion to invest sufficiently to provide the necessary output and to retain earnings for that purpose. It can remain in effective competition only if its operations abroad are in the forefront of technological innovation, and this requires adequate new investment.

An emergency measure restraining foreign direct investment and requiring remittance of a high proportion of foreign earnings is tolerable if it is temporary. The OFDI Regulations are basically inequitable to the companies that complied faithfully with the voluntary program and most inequitable to the companies that have a high rate of growth in their foreign operations. At great cost and with considerable difficulty, ITT and other large American enterprises have hitherto made the necessary adjustment to the Regulations of OFDI. Our capacity to operate under the Regulations as they are now administered is being rapidly exhausted. Unless there is relief from these arbitrary Regulations, our business will suffer injury, and the contribution that ITT has been making to the long-term strength of the U. S. balance of payments will be reduced.

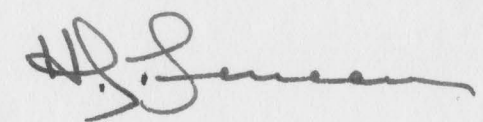
When OFDI was created in January 1968 it was presented as a temporary measure to meet an emergency, and it was stated that "as in the voluntary program, overall and individual targets will be set." That position was repeated in the January 1968 Report of the Treasury Department, "Maintaining the Strength of the United States Dollar." Despite these assurances, the administration of the program is marked by inability or unwillingness to take into account the problems of particular companies. As a result, the highly complex OFDI Regulations have been applied to all direct investors, except those whose annual foreign direct investments are below the exemption figure, or are engaged in international air transport and international construction, which activities have been granted special dispensation in the Regulations.

Whatever its temporary usefulness may have been in compelling U. S. companies to finance their foreign direct investments by huge borrowings abroad, the OFDI Regulations have by now become counter-productive. The "mining" operation in foreign financial markets has become very costly and is near an end. The inability of U. S. companies to finance their most urgent foreign direct investment needs has initiated demands for greater national autonomy in the fields in which U. S. foreign direct investment has been most successful. One expression of these views is a recent report of the Commission of the European Communities entitled "The Electronic Industry of Countries of the Community and American Investments." One of its conclusions is that the role of affiliates of American electronic companies operating in the Common Market must be kept under control. In March 1970, another report of the EEC, "The Industrial Policy of the Community," recommended measures to increase the competitiveness of EEC companies, including some form of discrimination against awarding contracts to subsidiaries of companies based outside the EEC. These threats to American companies abroad are intensified when they are unable to invest enough for their foreign affiliates to remain in the forefront of technological advance.

We submit that reconsideration of the policies on U. S. foreign direct investment is essential at this time. It is impossible to continue to operate indefinitely on the basis of a temporary measure instituted for an emergency and applied by inflexible formula to companies with different economic problems. The inequity of the present Regulations is aggravated by the fact that it imposes the heaviest penalties on companies that were most faithful in cooperating under the voluntary program. The 1969 change in the Regulations to make it possible for a direct investor to retain up to 30% of annual earnings of the preceding year was a modest step in the right direction. An increase of that percentage at this time to 50% would further recognize the need of companies with increasing foreign earnings and would encourage further increases of foreign earnings, with attendant increases of remittances from abroad.

While continued limitation on U. S. foreign direct investment may be necessary for a time, the Regulations should be made more liberal to reflect greater concern for (i) the special needs of some companies because of their foreign commitments, and (ii) the special benefits to the U. S. balance of payments from investment by companies whose remittances are large and are growing rapidly. Unless the program is administered with great consideration to the long-run importance of foreign direct investment to the U. S. balance of payments, earnings from this source will grow at a declining rate, and at the very time when payments on the enormous foreign borrowings caused by the OFDI program will be growing at an accelerating rate.

Sincerely,





12/21/70

Governor Brimmer

I have estimated the expansion at double the short-term credits now outstanding under the short-term ceiling — that is, an expansion of \$220 million. It may well prove generous.

An expansion (liberalization) of \$110 might be reasonable.

*[Signature]*



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date December 21, 1970

To The Chairman

Subject: Possible Liberalization of the

From Andrew F. Brimmer

VFCR

## Problem

If the Administration decides to liberalize the Commerce Department's Foreign Direct Investment Program (FDIP), what change, if any, should be made in the Voluntary Foreign Credit Restraint (VFCR) program?

## Recommendations

If a significant liberalization is made in the FDIP for 1971, some relaxation should be provided in the VFCR. In particular, if the Commerce program is liberalized to permit an outflow on the order of \$300 to \$350 million above the outflow that would take place with no change in the FDIP regulations, I would recommend a VFCR liberalization of \$200 to \$250 million. Furthermore, I would recommend the VFCR liberalization take the form of exempting export credits from a subceiling on short-term credits to developed countries of continental Western Europe.

## Discussion

### Reason for VFCR liberalization

A significant liberalization in the Commerce Department FDIP - \$325 million being the figure we have heard as the outflow to be permitted over what would occur with no change in regulations - should call for a corresponding liberalization in the VFCR. The two programs are complementary (along with the IET). There should be equity between corporate direct investors and the financial institutions in bearing the burden of balance-of-payments restraints.

I believe something on the order of \$200 to \$250 million in VFCR liberalization would be accepted by the public as, in a broad sense, equivalent to the FDIP liberalization.

### VFCR bank guidelines

Within the VFCR guidelines, the focus of attention continues to be on the provisions applicable to banks. The provisions applying to insurance companies, pension funds, and other nonbank financial institutions restrain only a minor fraction of the foreign assets of those institutions. Any modest liberalization should be confined to the provisions for banks, the so-called bank guidelines.



TO: The Chairman

SUBJECT: Possible Liberalization

FROM: Andrew F. Brimmer

of the VFCR

Overall increase in ceilings - not meaningful

Of the alternative means of liberalizing the bank guidelines, the most obvious - but not necessarily the most desirable - would be an increase in the General Ceiling or in the Export Term-Loan Ceiling or in both. But this would not make much sense, given the magnitude of the change we have in mind - about a quarter of a billion dollars. The nominal leeway under the two ceilings amount to almost \$2 1/2 billion. Probably about half this is effective leeway. That is, if banks were faced with greater demand for foreign loans, they might use about \$1 1/4 billion - the remainder being made up of amounts kept by some banks as a safety margin, or representing leeway that some small banks do not have the capability of exploiting. To add some \$200 million to this leeway, whether that leeway is considered now to be \$1 1/4 billion of \$2 1/2 billion, would not be meaningful.

Export exemption from Western Europe subceiling - proposed

Of other alternatives, I believe one of the simplest, most meaningful, and most compatible with VFCR principles would be to exempt export credits from the so-called Western European subceiling. Within each bank's General Ceiling, there is a requirement that short-term credits (not over one year maturity) extended to residents of developed countries of continental Western Europe be held to 75 per cent of the amounts of such credits outstanding on December 31, 1967. This ceiling was established some time ago as one of several supplemental restraints on credit to those Western European countries.

a. Size of subceiling and outstandings. At present, the aggregate ceiling on short-term credits to those countries amounts to \$413 million. (Outstandings in the aggregate are in fact in excess of the ceiling. They are \$560 million.) By way of comparison, the aggregate ceiling is equivalent to less than 10 per cent of the aggregate General Ceiling.

b. Estimated amount of liberalization. If we exempted export credits from the subceiling, such exempted credits might increase by \$200 or \$250 million. This projection is based on an estimate that one fifth of the credits charged to the ceiling are export credits. This means about \$110 million of the \$560 million are export credits. I would guess that exemption might be followed by an increase of double the amount of export credits now charged to the subceiling. Thus, there could then be \$330 million in short-term credits to developed countries



TO: The Chairman

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of the VFCR

of continental Western Europe, with \$110 million already outstanding and \$220 million in new credits. (The net increase would reduce correspondingly the leeway under the General Ceiling, of which the subceiling is a part.)

c. Minimum adverse announcement effects in Europe. This liberalization should not have significant adverse announcement effects on governments abroad, despite its applying to Western Europe.

First, the proposed measure would modify one of two parallel supplementary restraints on Western Europe but not abolish either one. One such restraint prevents banks from extending to residents of those countries any new term loans (with a qualification I will mention); the other requests banks to keep short-term credits to those borrowers to 75 per cent of the banks' end-of-1967 level.

Second, the proposed relaxation would introduce into the second restraint (the short-term subceiling) the same exemption as already applies to the first restraint (the prohibition of new term loans), namely, an exemption for credits to finance exports.

Third, the exemption would apply only to the Western European subceiling; the export credits exempted from this subsidiary restraint would still be subject to the General Ceiling.

d. Reinforce established priority. Exemption would be compatible with the long-standing VFCR request that banks give priority to export financing.

e. Practical benefits. The exemption would respond to widespread demands inside and outside the Government (not necessarily well founded) for further exemption for export credits. It would also assist some banks which are participating in the CCC Export Credit Sales Program for "surplus" agricultural products. Furthermore, it would relieve the subceiling's tightness, due at least in part to overdrafts connected to Eurodollar transactions and to difficulties in handling working balances.

f. Administrative factors. We have often explained that one problem in exempting short-term credits from restraint is the difficulty of distinguishing such credits from non-export credits. We would have to make known - in the announcement, in guidance to banks, or in reporting instructions - that export credits, to be exempted, must be clearly identifiable as financing exports for





TO: The Chairman

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of the VFCR

example, be bankers' acceptances or other "documented credits" and not open lines of credit drawn on for unidentified purposes).

g. The revision might run along the following lines (changes shown by brackets and underscoring):

VFCR Guideline section II-A-3, as amended March 17, 1970, concerning credits to residents of the developed countries of continental Western Europe

"3. Western Europe

\* \* \* \* \*

"b. RESTRAINT ON NEW NONEXPORT TERM LOANS. A bank should not make new term loans to such residents, except loans that finance U.S. exports.

"c. SHORT-TERM CREDITS. A bank should hold the amount of non-export short-term credits (having a maturity of not over 1 year) to such residents to not more than 75 per cent of the amounts of such credits outstanding on December 31, 1967 of all short-term credits to such residents."

Attachment

VFCR Position of Banks, October 31, 1970

cc: R. Solomon  
Lowrey



Attachment

VFCR - Position of Banks

October 31, 1970

Number of banks reporting		170
<hr/>		
General Ceiling		
Aggregate ceilings		\$9,985
Leeway		1,182
Western Europe Short-Term Credits		
Aggregate sub-ceilings	\$413	
Overage	148	
Estimated export credits outstanding	110	
Export Term-Loan Ceiling		
Aggregate ceilings		1,384
Leeway		1,237
General and Export Term-Loan Ceiling		
Aggregate ceilings		11,369
Leeway		2,419

