INTEREST EQUALIZATION TAX EXTENSION ACT OF 1969

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIRST CONGRESS

FIRST SESSION

ON

H.R. 12829

AN ACT TO PROVIDE AN EXTENSION OF THE INTEREST EQUALIZATION TAX, AND FOR OTHER PURPOSES

SEPTEMBER 3, 1969

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INTEREST EQUALIZATION TAX EXEMPTION ACT OF 1969

WEDNESDAY, SEPTEMBER 3, 1969

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 2221, New Senate Office Building, Senator Russell B. Long, chairman, presiding.

Present: Senators Long, Anderson, Gore, Williams, Miller, and Jordan.

Senator ANDERSON. The hearing will come to order.

Twice this year Congress has acted to extend the interest equalization tax for a 30-day period, pending an opportunity to consider the merits of a longer term extension of the tax. Under the law as it stands today, the interest equalization tax is scheduled to expire on September 30. The bill before us would extend it for an additional 18 months, until March 31, 1971.

The bill is supposed to help our long-suffering balance of payments by increasing the cost of foreign borrowing in this country and thus deterring the outflow of U.S. capital. Unfortunately, our balance of payments continues to be in a deficit position—a deficit of $3.8 billion in the second quarter alone.

I am hopeful that the Treasury Department in its statement this morning will put the balance-of-payments situation in its proper perspective and indicate the role the interest equalization tax has played since it was enacted in September 1963 in our overall balance-of-payments program and the contribution it can make if it is extended for an additional 18 months.

I believe it would be well to include at this point in the record a summary of the principal points of H.R. 12829, a copy of the chairman's announcement of this hearing, and the bill, H.R. 12829.

(The material referred to follows; testimony begins on p. 21:)

PRESS RELEASE COMMITTEE ON FINANCE

Senator Russell B. Long, Chairman, Committee on Finance announced today that on Wednesday, September 3, 1969, the committee will hold a hearing on the Interest Equalization Tax Extension Act of 1969 (H.R. 12829).

Undersecretary of the Treasury Paul Volcker and Senator Jacob Javits will testify on the bill.

The hearing will be held in room 2221, New Senate Office Building, at 10 a.m. on Wednesday, September 3, 1969.

ANALYSIS OF H.R. 12829, PROPOSED INTEREST EQUALIZATION TAX EXTENSION ACT OF 1969

Extension

The bill would extend the expiration date for 20 months from July 31, 1969, until March 31, 1971. The Administration proposed an 18-month extension but the

Ways and Means Committee did not want the tax expiring on January 31, 1969, at the beginning of a new Congress. (Section 2 of the bill).

Authority to Set Lower Rates on New Issues

The bill would authorize the President (within his existing authority to set IET rates between zero and the interest equivalent of 1½ percent) to establish lower rates on new and outstanding issues. This was proposed by the Treasury so that reliance on the interest equalization tax could be reduced as soon as possible. (Section 3 of the bill).

A. HOUSE AMENDMENTS

1. *Foreign trusts.*—The bill would put the burden of proof on whether a foreign trust (to which a U.S. person had made a transfer) acquires taxable foreign securities on the taxpayer. Under current law, it is very difficult for the Treasury to know whether such acquisitions have taken place. (Section 4(a) of the bill).

2. *Construction loans.*—The bill would make it clear that loans in connection with foreign mineral processing facilities can be made tax free by a person using only part of a facility. The new, alternative, requirement would be that the lender's use of the facility is substantial in relation to the part of the facility attributable to the loan. Current law defines "substantial" as 35 percent of the entire facility, but it would be 50 percent where the part of the facility attributable to the loan is taken into account. (Section 4(b) of the bill).

3. *Export credits.*—The bill would provide that an exporter could transfer export credit paper to an affiliate tax free without being required to establish that the loan was reasonably necessary to make the sale and that credit terms were normal. (Section 4(c) of the bill).

4. *Resale of foreign securities by dealers.*—The bill would provide that the provision which permits dealers to buy foreign securities from foreigners and resell within a certain number of days to foreigners without any tax liability would also apply to a case where the resale was made to a foreign branch of a U.S. bank which under the Code is already permitted to purchase foreign securities up to three percent of its deposits. (Section 4(d) of the bill).

5. *Captive finance companies.*—The bill would completely rewrite the provisions with respect to captive finance companies under which such companies are permitted to finance sales of domestic and foreign affiliates with foreign borrowed funds. The purpose is to revise restrictive provisions which have been found to be unworkable so that the exemption can be used by taxpayers while at the same time protecting the balance of payments. (Section 4(e) of the bill).

6. *Filing returns.*—The bill would make it clear that the transaction tax return is not due in connection with a disposition to a foreigner which gives rise to the right to a full credit. Such dispositions would only have to be reported on the quarterly return. (Section 4(f) of the bill).

7. *Reporting requirements.*—The bill, correcting a legislative oversight, would conform the information reporting requirements of nonparticipating firms to the 1967 amendments. This would make it clear that such firms, as well as participating firms, are required to continue to file Form 3845. (Section 4(g) of the bill).

8. *Penalties.*—The bill would provide a penalty for nonparticipating firms who failed to report as required (see paragraph 7, above). (Section 4(h) of the bill).

91st CONGRESS
1st Session

H. R. 12829

IN THE SENATE OF THE UNITED STATES

August 7 (legislative day, August 5), 1969
Read twice and referred to the Committee on Finance

AN ACT

To provide an extension of the interest equalization tax, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE, ETC.**
4 (a) Short Title.—This Act may be cited as the
5 "Interest Equalization Tax Extension Act of 1969".
6 (b) Amendment of 1954 Code.—Whenever in this
7 Act an amendment is expressed in terms of an amendment
8 to a section or other provision, the reference is to a section
9 or other provision of the Internal Revenue Code of 1954.

1 **SEC. 2. EXTENSION OF INTEREST EQUALIZATION TAX.**

2 Section 4911 (d) is amended by striking out "August
3 31, 1969" and inserting in lieu thereof "March 31, 1971".

4 **SEC. 3. MODIFICATION OF TAX RATES BY EXECUTIVE**
5 **ORDER.**

6 (a) MODIFICATIONS PROVIDING LOWER RATES FOR
7 ORIGINAL OR NEW ISSUES.—Section 4911 (b) (2) (A) is
8 amended to read as follows:

9 "(A) IN GENERAL.—If the President of the
10 United States determines that the rates of tax im-
11 posed by paragraph (1), or provided in any prior
12 Executive order issued pursuant to this paragraph,
13 are lower or higher than the rates of tax necessary
14 to limit the total acquisitions by United States per-
15 sons of stock of foreign issuers and debt obligations
16 of foreign obligors within a range consistent with
17 the balance-of-payments objectives of the United
18 States (including achieving a minimum reliance on
19 the tax), he may by Executive order (effective as
20 provided in subparagraph (C) (ii)) increase or
21 decrease such rates of tax. To the extent specified
22 in such Executive order, the rates applicable to
23 acquisitions of stock or debt obligations which are
24 part of an original or new issue may be lower than
25 the rates applicable to acquisitions of stock or debt

1 obligations which are not part of an original or new
2 issue. An Executive order which has the effect of
3 establishing lower rates for original or new issues
4 may be applicable to all original or new issues or to
5 any aggregate amount or classification thereof and
6 to acquisitions occurring during such period of time
7 as may be stated therein, and may provide for other
8 limitations and implementing procedures. In deter-
9 mining whether stock or a debt obligation shall be
10 treated as part of an 'original or new issue' for pur-
11 poses of this subparagraph, the provisions of section
12 4917 (c) shall apply."
13 (b) TECHNICAL AMENDMENT.—Section 4911 (b) (2)
14 (C) (i) is amended by striking out "Each increase" and
15 inserting in lieu thereof "Subject to the authorization to
16 establish lower rates with respect to acquisitions of stock
17 or debt obligations which are part of an original or new
18 issue, each increase".
19 **SEC. 4. OTHER AMENDMENTS.**
20 (a) TRANSFERS TO FOREIGN TRUSTS.—
21 (1) Section 4912 (b) (1) is amended to read as
22 follows:
23 "(1) CERTAIN TRANSFERS TO FOREIGN TRUSTS.—
24 "(A) EXTENT OF TAX LIABILITY. Any
25 transfer (other than in a sale or exchange for full

1 and adequate consideration) of money or other
2 property to a foreign trust shall, if such trust ac-
3 quires stock or debt obligations (of one or more
4 foreign issuers or obligors) the direct acquisition
5 of which by the transferor would be subject to the
6 tax imposed by section 4911, be deemed an acqui-
7 sition by the transferor (as of the time of such
8 transfer) of stock of a foreign issuer in an amount
9 equal to the actual value of the money or property
10 transferred or, if less, the actual value of the stock
11 or debt obligations so acquired by such trust. Con-
12 tributions made by an employer to a foreign pen-
13 sion or profit-sharing trust established by such em-
14 ployer for the exclusive benefit of employees (who
15 are not owner-employees as defined in section
16 401 (c) (3)) who perform personal services for
17 such employer on a full-time basis in a foreign
18 country, and contributions to a foreign pension or
19 profit-sharing trust established by an employer,
20 made by an employee who performs personal serv-
21 ices for such employer on a full-time basis in a
22 foreign country (and is not an owner-employee as
23 defined in section 401 (c) (3)), shall not be con-
24 sidered under the preceding sentence as transfers

1 which may be deemed acquisitions of stock of a
2 foreign issuer.
3 "(B) PRESUMPTION OF ACQUISITION OF FOR-
4 EIGN SECURITIES.—Whenever money or other prop-
5 erty is transferred to a foreign trust in the manner
6 described in the first sentence of subparagraph (A),
7 it shall be presumed, with respect to the calendar
8 quarter in which the transfer took place and each
9 succeeding calendar quarter beginning prior to the
10 termination date specified in section 4911 (d), that
11 such trust subsequently acquired stock or debt obli-
12 gations the direct acquisition of which by the trans-
13 feror would be subject to the tax imposed by section
14 4911, in an amount equal to the actual value of the
15 money or other property transferred. The transferor
16 may rebut this presumption with respect to each
17 such calendar quarter by submitting, on or before
18 the 30th day following the close of such quarter,
19 documents or other proof which will establish to the
20 satisfaction of the Secretary or his delegate that,
21 during such quarter, liability for such tax has not
22 been incurred or any liability which has been in-
23 curred has been paid."
24 (2) The amendment made by paragraph (1) of

1 this subsection shall apply with respect to transfers made
2 after June 9, 1969.

3 (b) FOREIGN MINERAL FACILITIES.—

4 (1) Section 4914 (c) (5) (B) is amended by add-
5 ing at the end thereof the following new sentence: "If
6 the proceeds of the loan by such United States person
7 constitute only a part of the cost of the installation,
8 maintenance, or improvement of such facilities, the sub-
9 stantial portion requirement in the preceding sentence
10 shall be satisfied if the percentage of the total capacity
11 of such facilities which will be used in connection with
12 ores or minerals (or derivatives thereof) extracted or
13 obtained in the specified manner is more than one-half
14 of the percentage of the cost of such facilities represented
15 by the amount of such loan and in no event is less than
16 10 percent of such total capacity."

17 (2) The amendment made by paragraph (1) of
18 this subsection shall apply with respect to acquisitions
19 made after the date of the enactment of this Act.

20 (c) TRANSFERS OF EXPORT CREDIT PAPER.—

21 (1) Section 4914 (j) (1) (A) is amended by re-
22 designating clauses (iii) and (iv) as clauses (iv) and
23 (v), respectively, and by inserting after clause (ii)
24 the following new clause:

25 "(iii) to an includible corporation in an

1 affiliated group (as defined in section 48(c)
2 (3)(C) of which such person is a member;".
3 (2) Section 4914(c)(7) is amended by striking
4 out "(j)(1)(A)(iii)" and inserting in lieu thereof
5 "(j)(1)(A)(iv)".
6 (3) The amendments made by this subsection shall
7 apply with respect to subsequent transfers (within the
8 meaning of section 4914(j)(1)(A) of the Internal
9 Revenue Code of 1954) occurring after the date of the
10 enactment of this Act.
11 (d) DEALER RESALE EXEMPTION.—
12 (1) Section 4919(c) is amended by striking out
13 "and" at the end of paragraph (1), by striking out the
14 period at the end of paragraph (2) and inserting in
15 lieu thereof "; and", and by adding at the end thereof
16 the following new paragraph:
17 "(3) the term 'persons other than United States
18 persons' includes any foreign branch whose acquisition
19 of stock or a debt obligation of a foreign issuer or obligor
20 from an underwriter or dealer is excluded from the tax
21 imposed by section 4911 by reason of the last sentence
22 of section 4914(b)(2)(B), but only with respect to
23 the acquisition of stock or debt obligations to which such
24 exclusion applies."
25 (2) The amendments made by paragraph (1) of

1 this subsection shall apply with respect to acquisitions
2 made by foreign branches after the date of the enact-
3 ment of this Act.
4 (e) CERTAIN FINANCING COMPANIES.—
5 (1) Section 4920(a)(3B) is amended to read as
6 follows:
7 "(3B) CERTAIN DOMESTIC FINANCING COM-
8 PANIES.—The terms 'foreign issuer', 'foreign obligor',
9 and 'foreign issuer or obligor' also mean a domestic cor-
10 poration to the extent provided in subsection (d)."
11 (2) Section 4920 is amended by redesignating sub-
12 section (d) as subsection (e) and by inserting after sub-
13 section (c) the following new section:
14 "(d) CERTAIN DOMESTIC FINANCING COMPANIES.—
15 For purposes of this chapter, the terms 'foreign issuer', 'for-
16 eign obligor', and 'foreign issuer or obligor' include a do-
17 mestic corporation if—
18 "(1) such corporation is exclusively engaged in the
19 trade or business of—
20 "(A) acquiring, servicing, or acquiring and
21 servicing—
22 "(i) debt obligations arising out of the sale
23 of tangible personal property produced, manu-
24 factured, assembled, or extracted by one or more
25 includible corporations in an affiliated group (as

1 defined in section 48(c)(3)(C)) of which
2 such corporation is a member,
3 "(ii) debt obligations arising out of the
4 sale of tangible personal property received as
5 part or all of the consideration in sales of prop-
6 erty described in clause (i),
7 "(iii) debt obligations arising out of the
8 sale of tangible personal property received as
9 part or all of the consideration in sales of prop-
10 erty described in clause (ii),
11 "(iv) debt obligations arising out of the
12 sale of tangible personal property or the per-
13 formance of services (or both), if not less than
14 85 percent of the purchase price is attributable
15 to the sale of property manufactured, produced,
16 grown, or extracted in the United States or the
17 performance of services by any United States
18 person (or both),
19 "(v) debt obligations arising out of loans
20 to dealers or distributors primarily engaged in
21 the business of selling property described in
22 clauses (i), (ii), and (iii), the proceeds of
23 which are used by such dealers or distributors
24 in such business,

1 "(vi) debt obligations arising out of loans
2 to an includible corporation in an affiliated
3 group (as defined in section 48(c)(3)(C)) of
4 which such corporation is a member, if such
5 obligations are secured by debt obligations de-
6 scribed in clauses (i) through (v), or
7 "(vii) any combination of the foregoing,
8 "(B) acquiring, servicing, or acquiring and
9 servicing debt obligations otherwise arising out of
10 sales of tangible personal property,
11 "(C) carrying on other incidental activities in
12 connection with its sales finance business, or
13 "(D) any combination of the foregoing,
14 "(2) except for debt obligations arising out of de-
15 posits in commercial banks having at the time of the de-
16 posit a period remaining to maturity of less than one
17 year, and debt obligations of one or more includible cor-
18 porations in an affiliated group (as defined in section
19 48(c)(3)(C)) of which such corporation is a member
20 acquired as payment for stock, or as a contribution to the
21 capital, of such corporation—
22 "(A) at least 90 percent of the face value of
23 the debt obligations owned by such corporation at
24 all times during the taxable year consists of debt
25 obligations described in paragraph (1)(A), and

1 "(B) all debt obligations owned by such corporation at all times during the taxable year are debt obligations described in paragraph (1) (A) or (1) (B), or both,

5 "(3) all debt obligations acquired by such corporation (whether or not described in paragraph (1)) are acquired solely out of—

8 "(A) the proceeds of the sale (including a sale in a transaction described in section 4919 (a) (1)) by such corporation (or by a domestic corporation described in section 4912 (b) (3) which owns all of the stock of such corporation) of debt obligations of such corporation (or such other domestic corporation) to persons other than—

15 "(i) a United States person (not including a foreign branch of a domestic corporation or of a domestic partnership, if such branch is engaged in the commercial banking business and acquires such debt obligations in the ordinary course of such commercial banking business),

22 "(ii) a foreign partnership in which such corporation (or one or more includible corporations in an affiliated group, as defined in section 1504, of which such corporation is a

1 member) owns directly or indirectly (within
2 the meaning of section 4915(a)(1)) 10 per-
3 cent or more of the profits interest, or
4 "(iii) a foreign corporation, if such cor-
5 poration (or one or more includible corpora-
6 tions in an affiliated group, as defined in sec-
7 tion 1504, of which such corporation is a
8 member) owns directly or indirectly (within
9 the meaning of section 4915(a)(1)) 10 per-
10 cent or more of the total combined voting power
11 of all classes of stock of such foreign corpora-
12 tion, except to the extent such foreign corpora-
13 tion has, after having given advance notice to
14 the Secretary or his delegate, sold its debt obli-
15 gations to persons other than persons described
16 in clauses (i) and (ii) and this clause and is
17 using the proceeds of the sale of such debt obli-
18 gations to acquire the debt obligations of such
19 corporation (or such other domestic corpora-
20 tion),
21 "(B) the proceeds of payment for stock, or
22 a contribution to the capital of such corporation, if
23 the payment or contribution was derived from the
24 sale of debt obligations by one or more includible
25 corporations in an affiliated group (as defined in

1 section 48 (c) (3) (C)) of which such corporation
2 is a member to persons other than persons de-
3 scribed in clauses (i), (ii), and (iii) of subpara-
4 graph (A) and such debt obligations, if acquired by
5 United States persons, would be subject to the tax
6 imposed by section 4911,
7 "(C) retained earnings and reserves of such
8 corporation, or
9 "(D) trade accounts and accrued liabilities
10 which are payable by such corporation within 1
11 year from the date they were incurred or accrued,
12 and which arise in the ordinary course of the trade
13 or business of the corporation otherwise than from
14 borrowing,
15 "(4) such corporation does not acquire any stock
16 of foreign issuers or of domestic corporations or domestic
17 partnerships other than stock of one or more includible
18 corporations in an affiliated group (as defined in section
19 48 (c) (3) (C)) of which such corporation is a mem-
20 ber acquired as payment for stock, or as a contribution
21 to capital, of such corporation,
22 "(5) such corporation, in a manner satisfactory to
23 the Secretary or his delegate, identifies the certificates
24 representing its stock and debt obligations, and maintains
25 such records and accounts and submits such reports and

1 other documents as may be necessary to establish that
2 the requirements of the foregoing paragraphs have been
3 met, and

4 "(6) such corporation elects to be treated as a
5 foreign issuer or obligor for purposes of this chapter.
6 The election under paragraph (6) shall be made, under regu-
7 lations prescribed by the Secretary or his delegate, on or
8 before the 60th day after the organization of the corporation
9 or the 60th day after the date of the enactment of the Interest
10 Equalization Tax Extension Act of 1969, whichever day is
11 the later. Any such election shall be effective as of the date
12 thereof and shall remain in effect until revoked. If, at any
13 time, the corporation ceases to meet any requirement of
14 paragraph (1), (2), (3), (4), or (5), the election shall
15 thereupon be deemed revoked. When an election is revoked,
16 no further election may be made. If an election is revoked,
17 the corporation shall incur liability at the time of such
18 revocation for the tax imposed by section 4911 with respect
19 to all stock or debt obligations which were acquired by it
20 during the period for which the election was in effect and
21 which are held by it at the time of such revocation; and the
22 amount of such tax shall be equal to the amount of tax for
23 which the corporation would be liable under such section if
24 it had acquired such stock or debt obligations immediately
25 after such revocation. For purposes of sections 4912 and

1 4915, a corporation which has made an election under
2 paragraph (6) shall, during the period for which such elec-
3 tion is in effect, be treated with respect to acquisitions from
4 such corporation as a foreign corporation which is not
5 formed or availed of for the principal purpose described in
6 section 4915(c)(1)."

7 (3) Section 4915(c)(3) is amended to read as
8 follows:

9 "(3) FOREIGN FINANCING COMPANY.—A foreign
10 corporation—

11 "(A) 50 percent or more of the voting power
12 of all classes of stock of which is owned directly or
13 indirectly (within the meaning of subsection (a))
14 by a domestic corporation (or by one or more in-
15 cludible corporations in an affiliated group, as de-
16 fined in section 48(c)(3)(C), of which such do-
17 mestic corporation is a member),

18 "(B) which, if it were a domestic corporation,
19 would be eligible to make an election under section
20 4920(d), and

21 "(C) gives notice to the Secretary or his dele-
22 gate within the period for making an election under
23 such section,

24 shall, during the period after the date of such notice dur-
25 ing which it would, if it were a domestic corporation,

1 meet the requirements of paragraphs (1), (2), (3),
2 (4), and (5) of section 4920(d), be treated as not
3 formed or availed of for the principal purpose described
4 in paragraph (1) of this subsection. If such corporation
5 ceases to meet such requirements, such corporation shall
6 be treated as having been availed of for the principal
7 purpose described in paragraph (1) of this subsection
8 at the time of such cessation."

9 (4) The amendments made by this subsection shall
10 take effect on the date of the enactment of this Act.

11 (f) TRANSACTION TAX RETURNS.—Section 6011(d)
12 (1) (B) is amended by inserting after "subparagraph (A)"
13 the following: "(unless such disposition is made under
14 circumstances which entitle such person to a credit under
15 the provisions of section 4919)".

16 (g) REPORTING REQUIREMENTS OF NONPARTICIPAT-
17 ING FIRMS.—Section 6011(d)(3) is amended to read as
18 follows:

19 "(3) REPORTING REQUIREMENTS FOR CERTAIN
20 MEMBERS OF EXCHANGES AND ASSOCIATIONS.—Every
21 member or member organization of a national securities
22 exchange or of a national securities association registered
23 with the Securities and Exchange Commission, which is
24 not subject to the provisions of section 4918(c), shall
25 keep such records and file such information as the Sec-

1 retary or his delegate may by forms or regulations pre-
2 scribe in connection with acquisitions and sales effected
3 by such member or member organization, as a broker or
4 for his own account, of stock of a foreign issuer or debt
5 obligations of a foreign obligor—
6 "(A) with respect to which a validation cer-
7 tificate described in section 4918(b)(1)(A) has
8 been received by such member or member organi-
9 zation; or
10 "(B) with respect to which an acquiring
11 United States person is subject to the tax imposed
12 by section 4911."
13 (h) FAILURE OF NONPARTICIPATING FIRMS TO FILE
14 CERTAIN INFORMATION RETURNS.—
15 (1) Section 6680 is amended to read as follows:
16 **"SEC. 6680. FAILURE TO FILE INTEREST EQUALIZATION**
17 **TAX RETURNS.**
18 "In addition to the penalty imposed by section 7203
19 (relating to willful failure to file return, supply information,
20 or pay tax)—
21 "(1) RETURN REQUIRED UNDER SECTION 6011
22 (d)(1).—Any person who is required under section
23 6011(d)(1) (relating to interest equalization tax re-
24 turns) to file a return for any period in respect of which,
25 by reason of the provisions of section 4918, he incurs no

1 liability for payment of the tax imposed by section 4911
2 and who fails to file such return within the time pre-
3 scribed by section 6076, shall pay a penalty of $10 or
4 5 percent of the amount of tax for which he would
5 incur liability for payment under section 4911 but for
6 the provisions of section 4918, whichever is the greater,
7 for each such failure unless it is shown that the failure
8 is due to reasonable cause. The penalty imposed by this
9 paragraph shall not exceed $1,000 for each failure to
10 file a return.
11 "(2) RETURN REQUIRED UNDER SECTION 6011(d)
12 (3).—Any person required to file a return under section
13 6011 (d) (3) who fails to file such return at the time
14 prescribed by the Secretary or his delegate, or who
15 files a return which does not show the information re-
16 quired, shall pay a penalty of $1,000, unless it is shown
17 that such failure is due to reasonable cause."
18 (2) The amendment made by paragraph (1) of
19 this subsection shall apply with respect to returns re-
20 quired to be filed after the date of the enactment of this
21 Act.

Passed the House of Representatives August 7, 1969.

Attest: W. PAT JENNINGS,

Clerk.

Senator ANDERSON. The first witness this morning is the Honorable Paul Volcker, Undersecretary of the Treasury for Monetary Affairs. Mr. Volcker, you may proceed.

STATEMENT OF HON. PAUL A. VOLCKER, UNDER SECRETARY FOR MONETARY AFFAIRS; ACCOMPANIED BY JOHN R. PETTY, ASSISTANT SECRETARY, INTERNATIONAL POLICY, AND JOHN S. NOLAN, DEPUTY ASSISTANT SECRETARY, TAX POLICY, DEPARTMENT OF THE TREAURY

Mr. VOLCKER. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before this committee to urge your approval of H.R. 12829 extending for a further period, through March 31, 1971, the interest equalization tax.

This bill follows a recommendation of the President in his April 4, statement on the balance of payments.

As the President made clear at that time, this administration aims to relax and dismantle as soon as possible the various selective controls over capital exports. But he also indicated that this must be done with prudent concern for the realities of our balance-of-payments situation. Consequently, while he reduced the rate of the tax he found it necessary to request the extention of the legislation.

This tax does not in any way reduce the necessity to pursue the fundamental measures needed to correct the underlying causes of the balance-of-payments problem. Most importantly, we must eliminate the overheating and inflationary pressures that have characterized the economy in recent years. However, this approach requires time. In the interim, we need the balance-of-payments protection afforded by the interest equalization tax.

There is no denying that our balance-of-payments position continues to be a subject of concern.

The source of this concern is the disappearance of our formerly large trade surplus. From an annual average of about $5 billion in the early 1960's, from a peak of about $6.8 billion in 1964, this surplus has rapidly evaporated. Consequently, our total current-account position, including net investment income, other service transactions and transfers as well as trade, has shown a large deterioration.

Even excluding military expenditures abroad—inflated since 1965 by the Vietnam conflict—our current-account surplus which averaged around $5.7 billion per year in the early 1960's is now running somehow under $3.5 billion per year, notwithstanding the growth in investment income. While we look forward to a reversal of this trend and an improvement in our current account position, this is not a short-term process.

Fortunately, our overall payments position has been supported by capital inflows. Permitting the IET to lapse—with a consequent increase in capital outflows—would hurt our position on capital account at a time of deterioration in our current account. This could clearly result in increased pressure on our reserves.

The IET has substantially supported our payments situation since its inception. In addition, this tax has played a significant reinforcing role in connection with two other capital restraint programs cover-

ing (1) loans to foreigners by U.S. financial institutions; and (2) direct investment outflows of U.S.-source funds. The design of each of these programs was such that their effectiveness and their administration would be facilitated by the IET.

There is ample evidence of the continued need for this tax measure at this time:

1. Lower interest costs for bond issues by foreign borrowers in the U.S. capital market, as compared with alternative sources, is largely what prompted this measure in the first place. These differentially lower U.S. rates persist today.

This fact may come as something of a surprise to those who cite the U.S. bank price rate of 8.5 percent and read about Eurodollar borrowings at 10 percent, 11 percent, or even 12 percent. However, comparison of rates on long-term bonds show that even though the differential between borrowing costs, here and abroad, did narrow this spring, it continues to be cheaper, apart from the IET, for foreigners to borrow in the United States.

2. Countries and institutions exempt from the IET—which can choose between the United States and foreign markets—have continued to place an increasing amount of issues in the U.S. market.

3. The foreign direct investment program has encouraged borrowings overseas by U.S. companies as a means of financing investment abroad, thereby reducing the balance-of-payments impact on the United States. Many of these issues have had especially attractive features. The IET has deterred U.S. residents from purchasing these securities—purchases which would negate the benefit of the direct investment program. The very substantial volume of these attractive issues now outstanding would certainly occasion an intolerable outflow of capital from U.S. residents if the tax were to lapse now.

Supported by this clear evidence of its effectiveness and the continued need dictated by our payments position, the proposed extension of the IET is the minimum insurance necessary to guard against the risk of potentially large capital outflows.

Secretary Kennedy has recently written to Senator Javits, relating this request for extension of the interest equalization tax to our balance-of-payments policy and to President Nixon's April 4 statement. The occasion was a letter from the Senator which emphasizes the desirability of dismantling our direct balance-of-payments controls as soon as possible, and he asked for the Secretary's views and the Secretary replied as follows:

> On April 4, 1969, President Nixon purposefully began just exactly this type of process consistent with our balance-of-payments position. At that time he announced a relaxation of the capital restrictions on foreign direct investment and lending abroad by bank and non-bank financial institutions. In addition, he pledged that "we shall find our solutions (to our economic problems) in the framework of freer trade and payments".
>
> The President also pointed out that "The distortions created by more than three years of inflation cannot be corrected overnight. Nor can the dislocations resulting from a decade of balance-of-payments deficits be corrected in a short time." It was against the background of these actions, this pledge and an appreciation of the time it takes to restore balance to the economy that the President announced his intention to seek an extension of the Interest Equalization Tax. The extension legislation now before the Senate has a new provision which would provide to the President the authority to have a lower tax rate on new issues from that which would pertain to outstanding securities. The purpose of this provision is to provide that degree of flexibility which could be useful in

reducing the reliance upon this tax as a selective restraint on our overall balance-of-payments program. For example, if this authority is employed, a low or no tax on new issues could permit greater access to our markets for new projects without according this benefit to outstanding issues.

The willingness of this Administration to vary the IET tax rate so that it will be as low as possible consistent with monetary stability was demonstrated first on April 4 when President Nixon reduced the IET rate from approximately one-and-one-quarter per cent p.a. to three-quarters per cent p.a. on debt securities. It is my intention to recommend to the President further use of this authority as circumstances permit, and in this regard I will be specially mindful of the opportunity to employ the additional flexibility we are now seeking from Congress which hopefully will advance the time when our reliance upon this tax can disappear.

It is also my intention to recommend as soon as possible in the light of balance-of-payments developments, additional steps in the gradual relaxation of the capital restrictions imposed under the foreign direct investment program.

I would emphasize the fundamental fact that our efforts to further reduce reliance upon selective restraints will be greatly facilitated by the evident effectiveness of our program of general restraints in reducing inflation, restoring better balance to our economy, and creating the conditions that make it possible to rebuild our trade position. As inflation is so much the cause of our international payments problem, it is vital that we pursue the fiscal-monetary restraint which will foster our balanced growth.

I am providing for the record, as an annex to this statement, an updated summary of the main statistics relating to this subject.

I think that you are also aware that there is a series of technical amendments that have been proposed to this legislation and incorporated in the House bill, and some material has been provided to you on those.

Thank you.

(The statistics submitted by Mr. Volcker follow:)

STATISTICS RELATING TO REQUEST FOR EXTENSION OF THE INTEREST EQUALIZATION TAX

Interest rates.—While the gap between long-term interest rates on U.S. and foreign capital markets has narrowed in recent years, a significant differential favoring an outflow of U.S. long-term loan capital still remains.

The data below summarize the situation during recent months and during the same months two years ago for U.S. and foreign corporate issues.

YIELDS ON OUTSTANDING BONDS IN DOMESTIC MARKET AND ON INTERNATIONAL STRAIGHT-DEBT ISSUES ABROAD (AVERAGE OF END-OF-MONTH RATES)

	May–July 1969	May–July 1967
U.S. corporate bonds (domestic)	7.16	5.66
Dollar issues abroad by:		
U.S. companies	7.47	6.40
Foreign companies	7.58	6.67
Margin by which foreign yield exceeds U.S. yield:		
U.S. companies	.31	.74
Foreign companies	.42	1.01

On long-term Government issues, the differential also continues to be significant in the case of many major countries, as the following table shows:

YIELDS ON U.S. GOVERNMENT AND VARIOUS FOREIGN GOVERNMENT LONG-TERM BONDS, JUNE 1969

[Percent per annum]

	Yield	Differential over U.S. bond yield
Western Europe (average)	6.95	0.89
Belgium	5.94	-.12
Denmark	9.46	3.40
France	6.37	.31
Germany	[1]6.50	[1].65
Italy	6.00	-.06
Netherlands	6.83	.77
Sweden	[1]6.82	[1].97
Switzerland	[1]4.58	[1]-1.27
United Kingdom	9.46	3.40
Other developed countries:		
Canada	7.68	1.62
Australia	5.87	-.19
New Zealand	5.55	-.51
U.S. Treasury bonds	6.06	

[1] May.

New issues.—New issues in the United States by countries subject to the tax have virtually disappeared in recent years, whereas issues here by tax-exempt countries have increased.

NEW ISSUES OF FOREIGN SECURITIES PURCHASED BY U.S. RESIDENTS, 1962 THROUGH MID-1969

[In millions of dollars]

	Annual rate			
	1962 and 1st half 1963	2d half 1963 through 1966	1967 and 1968	1st half 1969 estimate
Total new issues	1,384	1,065	1,639	1,494
Countries subject to IET	466	89	8	
Countries exempt from IET	919	976	1,631	1,494
Including international institutions of which—				
Canada	711	690	977	1,028
Latin America	88	96	142	466 (Latin America, Other countries, International institutions combined)
Other countries	64	115	194	
International institutions	56	75	318	

The decline in new issues in the United States by countries subject to the tax has been accompanied by an increase in their international issues abroad, according to the following estimates compiled by Morgan Guaranty Trust Co.

ESTIMATED NEW ISSUES OF FOREIGN SECURITIES SOLD OUTSIDE NORTH AMERICA, 1962 THROUGH MID-1969

[In millions of U.S. dollars]

	Annual rate			
	1962 and 1st half 1963	2d half 1963 through 1966	1967 and 1968	1st half 1969 estimate
Foreign borrowers, total	393	928	2,116	3,002
Western Europe	247	559	948	1,498
Japan	33	81	97	240
Canada			123	336
Other countries	68	140	511	412
International institutional (including minor unallocated)	45	148	437	486

Outstanding issues.—The tax has also discouraged U.S. purchases of outstanding foreign securities from foreigners. In the three and a half years preceding the announcement of the tax in mid-1963, U.S. residents were net purchasers of foreign outstanding issues at an annual rate of about $270 million mostly from foreigners in countries later subject to the tax.

For several years following announcement of the tax U.S. residents were net sellers of foreign outstanding issues. Since 1967, however, U.S. residents have again become net purchasers of outstanding foreign securities, as the following table shows.

Net transactions in outstanding foreign securities by U.S. residents, 1960–68

[In millions of dollars] [1]

1960	−$309
1961	−387
1962	−96
1963, 1st half annual rate	−302
Average annual rate, 1960 to June 1963	−274
1963, 2d half annual rate	204
1964	194
1965	225
1966	323
1967	−116
1968	−102
1969, 1st half annual rate	−414
Average annual rate, July 1963–June 1969	70

[1] Minus means net purchases.

IET collections.—Collections under the IET legislation are shown below. The bulk of the collections results from U.S. purchases of outstanding stocks.

Tax Collections Under the IET

[In millions of dollars]

1964	8.0	1967	40.4
1965	20.7	1968	91.7
1966	25.3	1st half of 1969	71.2

The CHAIRMAN. Mr. Volcker, you spoke, on page 2 of your statement, of the disappearance of our trade surplus. Do you expect our foreign trade position to improve materially in the next 2 years?

Mr. VOLCKER. Materially, yes, sir; as we regain control over the overheating of the economy and the inflationary pressures that have been responsible for the rapidity of the deterioration of our trade surplus, I would expect that we would find a trade surplus reemerged.

I think there is a question as to how large an increase we can get over this period of time. I would be hopeful that we would get a reasonably prompt response to our restrictive action in terms of the internal economy, that we would be moving back into surplus, but I think it is going to take a considerable length of time to regain the kind of surpluses that we became used to in earlier years.

The CHAIRMAN. In what commodity areas do you think there might be an improvement?

Mr. VOLCKER. I think you will see the improvement most noticeably in a broad range of imports. The problem lies primarily on the import side. We have had a very rapid increase in imports during recent years, an increase that ran, for instance, over 20 percent last year, and this included, actually, an increase in proportion of consumer goods im-

ports. This is typical of what happens in an overheated economy, not only for the United States but this is characteristic of the experience of other countries in a similar position, too, so I think the pronounced effect would come in terms of a broad range of manufactured imports, including consumer goods and also as manufactured goods that are further processed in the United States.

The CHAIRMAN. Do you have in mind the application of quotas as to a means to help control or moderate the imports coming into the country?

Mr. VOLCKER. No, sir; I would look forward to this prospect without relying upon that kind of device.

The CHAIRMAN. Does the administration have any plans to provide export tax incentives or to seek moderation of our imports by a small border tax such as the Europeans have?

Mr. VOLCKER. Well, the question of the impact of our tax structure on the export effort and whether this might be reshaped in some degree to provide incentives to exports is a matter that we have reviewed and are reviewing. It is a difficult, complex area.

We have reached no conclusions at this stage that measures might be useful in that area consistent with the general framework that guides matters in this area financially.

We have no plans for instituting border taxes specifically at this time.

The CHAIRMAN. I have some questions for Mr. Petty, but I will reserve them until later.

Senator Anderson?

Senator ANDERSON. No questions.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Volcker, just how effective do you think that this interest equalization tax has been as far as controlling the outflow of American capital?

Mr. VOLCKER. This is a matter upon which I do not think it is possible to give you precise dollar estimates, but let me refer you to the table on page 3 of the annex to my statement, if you have that before you, Senator Williams.

I think it makes an interesting comparison here between the purchases of new issues of foreign securities by Americans when securities are subject to the IET and when they are not. As you can see in this table, before the introduction of the interest equalization tax in the middle of 1963, purchases from countries exempt from the tax were running a little over $900 million, and they have continued to increase. These purchases are not impeded by the tax, whereas purchases from countries subject to the tax have pretty well dried up.

I think this suggests very strongly that in the absence of the tax, you would have had a trend from countries subject to the tax somewhat similar to the trend that you see here for countries not subject to the tax, and you can see that many hundreds of millions of dollars are involved.

Senator WILLIAMS. Under this bill and under existing law, Canada, to a large extent, is exempt.

Mr. VOLCKER. That is right, under an Executive order it is exempt.

Senator WILLIAMS. To what extent do you think that this exemption has resulted in abuse or evasion of the law. For example, I notice that in the March 5th issue of the Wall Street Journal they

reported that a considerable amount of what they called "hot money" was taking a circuitous trip; going to Canada, then moving to Europe, and then being brought back as Eurodollars perhaps sometimes by the same banks?

Mr. VOLCKER. I think there are two, perhaps separable, problems here, Senator, neither of which I think is a major problem at the present. The kind of potentional of hot money flows to which you refer would presumably, be very short term flows of money that would not be subject to the interest equalization tax in any event, but the evidence seems to be—and we work quite closely with the Canadians on this matter—that this has not been an important channel for the shift of short-term money through a triangular route into the Eurodollar market. We have watched this quite carefully in terms of statistics, and there are certain understandings with the Canadian authorities that, in effect, provide that Canadian banks or financial institutions generally will not become a so-called "pass through" for this kind of money.

As you can see, in the same table that I referred to earlier, in connection with the longer term issues the volume of Canadian borrowing in our market has been well maintained, and, in fact, in recent years, has increased; but, again, the Canadian reserve position in general has not increased by large amounts, and I do not think that this borrowing by Canada is an indication of abuse of this exemption.

I think it conforms, again, with the understanding that they have access to our markets, reflecting the close trade and financial ties between our two countries, but that they will not take advantage of this access to simply borrow in the United States and relend in other countries.

Senator WILLIAMS. Do I undertand that this movement of what is referred to as hot money has not concerned the Treasury? You do not think it is important?

Mr. VOLCKER. Let me draw a clear distinction, Senator, between the amounts that may be flowing to Canada—and I do not deny there may possibly be some—and the more general problem.

I think it is the case—although the evidence is not clear-cut in terms of availability of all relevant statistics that one might like, nevertheless, there is evidence—that the Eurodollar market is directly or indirectly receiving funds, either partly from the United States or, I think, more largely, funds that otherwise would have come to the United States in another form.

Now, at present, with money as tight as it is in the United States, there are very strong incentives for American banks to borrow on the Eurodollar market. What is happening is that these funds, this money, start out in the Eurodollar market and then are brought back to this country through the banking system. The net result is a distinct distortion of our balance-of-payments figures, particularly in the so-called liquidity basis as that is published, because when the money comes back in very short term form into our banking system it is counted below the line, so to speak, in those statistics as part of the deficit, it is being counted as a financing item rather than as a true capital inflow.

This is a more or less arbitrary decision, and if you look at the balance-of-payments statistics on the so-called official settlements basis,

where they count this money coming in from the Eurodollar market essentially as a capital inflow rather than as a financing item, we actually have a surplus at present, though it is a surplus which is heavily dependent upon very short term capital inflows, and, therefore, not the kind of equilibrium, not the kind of sustainable position that we would like to see.

The point I guess I am making, in response to your question, Senator, is that I am concerned about it, but at present this money goes out and comes in again. So, it is not really undermining our financial position, although it makes the statistics look very peculiar.

Senator WILLIAMS. To what extent would it be possible to use this pattern by some American companies or individuals to hedge against the American dollar, should the time come when the dollar was threatened with devaluation?

Mr. VOLCKER. This money is not being put into the Eurodollar market to hedge against any concern about the dollar, and I do not think the Eurodollar market can be used for that. These are dollars, and if you were to be concerned about dollars, you would not hedge by putting your money, in dollar form, in another place.

Senator WILLIAMS. But the point is that by getting them out, would it be possible to convert them into other currencies, either Canadian dollars, or something else?

Mr. VOLCKER. I do not think any more easily than you can convert other dollars. The dollar is fully convertible.

Senator WILLIAMS. That was my question, whether it could be used.

Mr. VOLCKER. I suppose one could argue that in some circumstances money in the Eurodollar market is less subject to controls of one kind or another that foreign countries, as well as the United States, might impose.

I do not think that is a consideration of any importance in the current flows. This is a matter that the Eurodollar rates are highly attractive, ranging from 10 to 12 percent recently. This is well in excess of the rates that can be obtained either from bank deposits or from other forms of short-term investments in the United States. So, the money takes the form of Eurodollars, and then the banks buy it back in that manner; but I think it is an interest-rate matter. There is no concern about the dollar reflected in these flows.

Senator WILLIAMS. I was not suggesting that that is a concern today, but I was wondering prospectively.

How do the rates compare in deposits for American banks as compared with the interest rates that they get when they send them abroad?

Mr. VOLCKER. Well, in the Eurodollar market, at various maturities and at various times—the rates are a little volatile—but in recent months they can get 10 to 12 percent as I suggested.

Now, in American banks, if you are an American corporation, let's say, the return you can get is limited by regulation Q to the 6-percent area or a little higher. So, you have a very large differential.

So, the real alternative is investing, I suppose, in Treasury bills or commercial papers and other forms of open-market instruments, where the rate levels recently have, typically, been between 7 and 8 percent. So, there is a substantial margin in favor of these Eurodollar investments.

I would suspect, Senator, that to the extent this has happened, it has been largely a diversion of money by U.S. corporations operating abroad, or money that otherwise might have flowed into our stock market temporarily being lodged in the Eurodollar market as a kind of a short-run haven that provides a very attractive rate of return at the moment.

Senator WILLIAMS. Let me just read an excerpt from a recent article in the Economist. It says:

According to the best but incomplete figures, over $37 billion of Euro-currency loans are outstanding at this moment, a huge pool of convertible international liquidity, subject to (virtually) no central bank controls of any sort. Both central and commercial bankers alike, in quiet moments, are appalled by the dimensions of the monster they have created. . . . Vast sums can sweep in or out of the domestic money supply on exchange rate hunches or other factors that governments cannot control.

No further questions at this time, Mr. Chairman.

I suggest we have this article of the Wall Street Journal of March 5 and the Economist's article of August 30 printed in the record.

The CHAIRMAN. It is so ordered.

(The articles referred to follow:)

[From The Economist, Aug. 30, 1969]

BUSINESS BRIEF: EURODOLLARS GO HOME

Eurodollars are here to stay. Scarcely a day passes without some mention of them in the financial press. Yet hands up those who can define a Eurodollar. What and where is this thing, the Eurodollar market?

The short answer is simple. This market consists of banks borrowing and lending dollars partly to each other, partly to outsiders. But these banks have one essential characteristic. They are outside the United States. The Eurodollar market is operated by "non-resident banks" (NRBs), including (for most purposes) the overseas branches, subsidiaries and associates of American banks. The Eurodollars themselves cannot be seen or touched. They consist of outstanding bank balances: dollars deposited, predominantly short-term, with an NRB, or owing to one. If you own a Eurodollar, it means that you are owed $1 by some bank, somewhere in the world, not necessarily in Europe, but outside the United States. This is true, even if you yourself live in the United States.

Besides Eurodollars there are Euro-sterling, Euro-francs, Euro-marks, and Euro-yen. One day there may be Euro-rubles. In every case the principle is the same. Euro-marks are D-marks deposited with a bank outside Germany, and lent to an ultimate borrower either inside or outside the banking system. Of the Euro-currencies Eurodollars are by far the most important, accounting for some 80 percent of the total.

The Eurodollar market began to materialise in the late 1950s, but really took off in the early 1960s. Its main *raison d'être* was that interest rates in America have been traditionally lower than in Europe. London banks (which still dominate the market) found they could offer overseas borrowers loans of dollars at cheaper rates than sterling and other currencies. These dollars they solicited from non-American holders, keen to earn more than they could get by depositing in New York. The movement got a fillip, as, from 1957 on, sterling became less available for financing international trade, and a further boost in 1960, with convertibility of the major European currencies.

SOURCES AND USERS

Normally therefore Eurodollar interest rates hover between American and European money rate levels. And apart from the interest rate factor, Eurodollars are a useful medium for those with a preference for dollars, but an aversion to investment opportunities in America. East European governments were among the first to accumulate such balances.

Other important sources are those avoiding various exchange controls. A Congolese might export to the United States for dollars. He might then transfer the dollars to a dollar account with his Belgian bank.

But Communist governments and exchange control avoiders are not the main providers of Eurodollars. The two main traditional sources have always been international corporations with spare cash, and European central banks, stuffed with dollars, the reflection of American balance of payments deficits. The central banks do not usually lend in the Eurodollar market directly. Usually, they have encouraged their commercial banks to do it. The commercial bank buys the dollars from the central bank (simultaneously selling them back for delivery three months ahead), and then lends out these dollars for three months. In this way the central bank (e.g., lately the Bundesbank in Frankfurt) still carries the risk that the dollar might be devalued or the mark upvalued, just as if it were lending out the dollars directly. Recently a new source of Eurodollars has appeared: American residents attracted by the unusually high interest rates.

These are the sources. The users are equally varied. They range from commercial firms financing foreign trade to, say, local authorities in Britain. These might borrow short-term sterling from an intermediary who, in turn, had obtained the funds from the Eurodollar market and switched them into sterling for the period of the loan. And whereas sterling was once the main source of financing for export credits, this function has been increasingly assumed by the Euro-currency market, and at one stage represented the most important end-use for Euro-currencies.

Thus a Swedish company requiring 1mn krona for six months would go to its bank, which in turn would proceed to find $193,000 (the equivalent). It might have this sum available already deposited with it, and lent out on a day to day or 7-day basis. Otherwise it would contact one of the several Euro-currency brokers, probably in London, to secure a deposit. The bank would then sell the dollars for krona. It might, at the same time, purchase forward exchange cover, to guarantee the rate of exchange at which it would acquire dollars again at the end o fthe loan. Or it might carry the exchange rate itself.

In theory all Euro-currency interest rates are the same, after adjusting for the cost of forward exchange cover (the so-called forward currency swaps). But in practice exchange rate doubts and fears can distort the relationships a great deal. When, Swiss (or American), borrowers foresee early revaluation of the D-mark they are reluctant to raise Euro-mark loans. Euro-mark interest rates fall. Conversely, in 1967, when borrowers were expecting a sterling devaluation they would pay over 35% for Euro-sterling loans, while at the same time holders of Euro-sterling (the potential lenders), rapidly disappeared, preferring to hold their assets in a currency that was not a devaluation risk.

Thus Euro-currencies are used for financing foreign trade, by international companies, and by other domestic borrowers as a supplementary source of finance over and above the local money markets. There is one final type of borrower: banks themselves.

A Belgian bank for example might use some of its Eurodollar deposits to back its general operations in Belgium, by converting them into Belgian francs, rather than lending them out again as Eurodollars. Recently this is precisely what the American banks have been doing on a huge scale. They have been borrowing back the Eurodollars. This is the result of intensifying American credit restrictions. By pegging domestic American bank deposit rates, the American government has induced American bankers to replenish their depleted deposits by seeking deposits from the Eurodollar market, and indeed becoming the main force behind the growth of this market in the past 12 months. The chart shows how this new pressure has driven Eurodollar rates up even above normal European money rates. Wherever possible of course the American banks have tried to borrow from their own branches and subsidiaries, rather than other NRBs. Their borrowings from this source, as another chart shows, have amounted to some $7 bn in the 7 months to July bringing the total liabilities to their overseas branches etc. to $14 bn.

To this activity the American authorities have replied in two ways. For some while American banks have been urged (by persuasion), not to let their overseas branches etc. take dollar deposits from American residents. And two weeks ago direct action was announced against American banks' borrowing in the Eurodollar market. Starting in October, American banks will have to deposit with the Federal Reserve Banks 10% of their net intake of Eurodollars since Many.

On present figures, this would mean they would have to deposit some $400 mn. which would earn no interest, although they themselves are currently paying 10% or more on these dollars. The Fed clearly hopes in this way to push a chunk of these Eurodollars back to Europe. If it fails, it might well call for a further $400 mn. But it is unlikely to damp down Eurodollar borrowing by big American-based

corporate borrowers. These normally and conveniently, have foreign subsidiaries that are not American residents.

In general British residents (unlike most other west Europeans) are not allowed to borrow Eurodollars as such, any more than they are allowed to own foreign currency bank deposits. Sometimes the Bank of England will give special permission. Thus a British company may be allowed to borrow Eurodollars to buy foreign plant, if it will repay the borrowing out of export earnings derived from the plant. Or an importer who can get a discount from his supplier by offering pre-payment (but who, as is normal, cannot draw his foreign exchange until the goods are shipped). Or a British resident may break the regulations by borrowing Eurodollars from a non-British bank abroad.

EUROBONDS

Fortunately exchange controls are less restrictive in other developed countries. As a result, there has grown up not the Eurodollar market (plus the smaller Eurosterling, etc. ones), but also, some years behind the Eurobond market. Eurobonds are Eurodollar loans of five years or more. They are drawn up in such a form that they can be traded on major stock exchanges around the world (including London and New York). The Eurobond market is thus related to the Eurodollar market in the same way as a country's capital market is related to its money market. In practice nearly all the loans have been in dollars (81% of new issues of $2.2 bn last year) with some in D-marks. Eurobonds first appeared after President Kennedy slapped on the interest equalisation tax in 1963, to discourage Europeans (corporations, municipalities and governments) raising long-term loans in New York, and so forcing them to turn to the Eurodollar pool instead. President Johnson gave the movement a further boost in 1968 by prohibiting big American borrowers from financing overseas expansion with domestic capital.

Nobody is yet worried that Eurobonds might get out of hand. Eurodollars are another story. According to the best but incomplete figures, over $37 bn of Eurocurrency loans are outstanding at this moment, a huge pool of convertible international liquidity, subject to (virtually) no central bank controls of any sort. Both central and commercial bankers alike, in quiet moments, are appalled by the dimensions of the monster they have created.

Enormous sums are borrowed or on-lent in a complicated maze of transactions, in which each participant is as strong as the weakest link in the chain. To be sure it is standard banking practice, and borrowers generally have the highest credit rating. But in the Eurodollar market there is no lender of last resort: banks often borrow short to lend long and the amounts involved are incomparably greater than the average banker ever places on such slender security. Because the banks do not tell each other what they are doing, the market as a whole could become over-committed to one country, or one borrower. Because banks use their own discretion about appropriate liquidity levels in Euro-currencies (rather than having these fixed for them by national regulations), individual banks can make occasional misjudgments.

The central bankers' worries are different. Vast sums can sweep in or out of the domestic money supply on exchange rate hunches or other factors that governments cannot control. So suppose a country hits balance of payments difficulties. The government then moves to stem inflation, and *inter alia* raises interest rates. Eurodollars flow in. Thus they provide useful temporary relief from payments troubles. But unless effectively neutralised (e.g. by a parallel reduction in the domestic money supply) they would swell the total credit base and thus, according to money supply theory, add fuel to the flames of the local inflation. Eventually talk switches to devaluation. At this point the Eurodollars would surge out—with disastrous consequences.

Central bankers will have to live with the Eurodollar market. This means they must learn to adapt their credit squeezes to allow for hot money flows: an old problem, after all, though by no means an easy one when key exchange rates are suspect on both revaluation and devaluation hopes.

[From the Wall Street Journal, Wednesday, Mar. 5, 1969]

'HOT MONEY' IS TAKING CIRCULAR TRIP IN QUEST FOR A HIGHER RETURN: DOLLARS FLEE TO CANADA FIRST, THEN TO EUROPE, WHERE U.S. BANKS BORROW EURODOLLARS

(By ROBERT D. PRINSKY, *Staff Reporter of* The Wall Street Journal)

OTTAWA.—International "hot money," funds that flow across borders at the drop of an additional quarter percentage point of yield, is going around in circles these days.

It's widely known that U.S. banks have been actively bidding for U.S. dollars held in Europe to replace domestic funds withdrawn since last December because of the Federal Reserve Board's credit clampdown. But it's far less widely known that a major part of these Eurodollars represent "flight" money from U.S. corporations and other knowledgeable investors trying to squeeze some extra return from their investments.

All Eurodollars originate in the U.S., as only the U.S. can create dollars. But normally they find their way abroad through the usual tourist and trade channels.

MAZE OF TRANSACTIONS

Because foreign investment by U.S. corporations is sternly restricted by the U.S. under its balance-of-payments program, "hot money" must thread its way through a maze of transactions before reaching Europe and returning to the U.S. A key stopover in the circular trip is Canada, which is generally exempted from the U.S. foreign-investment controls.

Canadian banking sources estimate that perhaps as much as $500 million of U.S. corporate funds have taken the round trip since mid-December in quest for the higher interest rates available abroad. Such funds thus would account for almost 50% of the more than $1.1 billion new Eurodollars large U.S. banks have borrowed abroad during the period.

Monetary authorities here and in the U.S. are aware of what's going on but have never taken an official stand. This is because they haven't any direct evidence that the nations' foreign-investment guidelines and regulations are being violated, particularly as a series of unlinked transactions are involved.

Basically, the circular flow of hot money from the U.S. might look like this:

A U.S. corporate treasurer has, for example, $1 million the company won't be needing for a couple of months. He could invest the funds in commercial paper (short-term promissory notes) issued by either U.S. or Canadian corporations. In both cases, the stated rate of interest on 60-day paper would be about 6¾%. But because of differentials in the foreign-exchange rates between U.S. dollars and Canadian dollars, the actual yield on the Canadian investment could work out to as much as 7½%.

The treasurer, after making his decision, immediately sells his $1 million for Canadian dollars in order to buy the Canadian paper. To guarantee he will be able to return to U.S. dollars when his investment matures, he simultaneously contracts to buy back the U.S. dollars in 60 days. In terms of the Canadian dollar, U.S. dollars are cheaper for future delivery than for immediate transactions. Thus the Treasurer will get back more U.S. dollars than he originally put up, without even considering the interest earned on his investment.

HIGH RATES IN EUROPE

With this hedging operation complete, the U.S. dollars used to buy Canadian currency will wind up in a Canadian bank, which in turn will seek to invest it for the best yield. A lucrative investment can be found in Europe, where rates on dollars are garnering as much as 8½%, because of the demand from U.S. banks. Like the corporate treasurer, the bank must hedge its investment to make sure it will wind up with its own nation's currency. Such hedging might cost the Canadian bank as much as one percentage point in yield, but even so the effective 7½% would still be relatively attractive compared with what's available at home.

Thus, the Canadian bank sends its funds to London, where branches of U.S. banks are among the most active bidders for these Eurodollars. The London branches, in turn, relend the money to their head offices in the U.S., who use them to make loans domestically.

Money has been flowing this way since last December, when U.S. banks began to feel pinched by the Federal Reserve's move toward tight credit, money-market sources say, adding that Canadian banks currently are among the largest

suppliers of Eurodollars. The banks send abroad sums for clients as well as their own money; some wealthy Canadians deposit money directly in London.

CD'S OUT OF FAVOR

The U.S. banks have been eager buyers of Eurodollars abroad because the Federal Reserve's taut-credit policy has effectively cut off a key domestic supply of lendable funds—negotiable certificates of deposits. CDs represent large deposits left with the banks for a specific period of time. Interest rates the banks may pay on such CDs are regulated by banking authorities. The maximum rates permitted currently are well below those available on other money-market instruments, and thus investors have been massively turning away from CDs.

The circular "hot-money" flow from the U.S. has buffeted foreign-exchange transactions. The Canadian dollar has experienced unusually large daily swings in recent weeks though it's still relatively close to the maximum exchange rate of 93.24 U.S. cents for each Canadian dollar.

The flow of funds is apparently being tolerated by authorities because individual steps in the circuit are unlinked and don't violate national guidelines. But one Canadian investment dealer who sought to act as agent for a clearly linked transaction was advised against it by Canadian authorities. In that case it was obvious there was an attempt to send money halfway around the world so that a U.S. investor could get a higher return than a U.S. bank could pay directly.

But in separate transactions, the flow continues. "It all goes to show," says one banker, "that if anything flows faster than water, it's money."

The CHAIRMAN. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Volcker, while we are running a deficit in our balance of payments, that means other countries are running a surplus. These surplus countries are western Europe and Japan. What have they done to eliminate their surpluses?

Mr. VOLCKER. As a preliminary, I think I should say, Senator Miller, that with the complexities of balance-of-payments accounting it does not always turn out that what we report as a deficit appears as a surplus in some other country. This is one of the peculiarities of this area, although the straightforward logic should be exactly what you say. The peculiarities of the accounting mean that it is a little hard to identify this as straightforwardly as one would like to identify it. In fact, as I suggested in replying to Senator Williams, by one of our methods of calculation, which in a way, conforms more fully to the ways used by most foreign countries, we are now running a surplus and have been for more than a year.

The trouble with this surplus is, as I said, it is very heavily dependent upon the short-term capital inflows induced by tight money, and it is not solidly based for that reason.

But, more basically, we have faced this continuing problem. We have seen our trade deficit disappear while we have seen large improving trade surpluses in a number of countries in Europe and in Japan.

Senator MILLER. Are you telling us that these countries do not recognize that they have a surplus and that we have a deficit?

Mr. VOLCKER. People are a bit schizophrenic on this subject.

Take the case of Germany, that has had a lot of discussion this year. They have a very large trade surplus and are, basically, considered a surplus country for that reason. But, actually, for a time this year, they have had a deficit in their overall balance of payments, because they have had very large capital outflows, particularly long term.

Now, whether you call Germany, this year, a deficit or a surplus country I am not quite sure, because it depends upon which aspect of their operations you look at.

Italy is another country that has had in recent years a consistently large current-account surplus reflecting a strengthening trade position, but they have also had some persistent capital outflows and this year have had an overall deficit, although, basically, I think that they would be considered a surplus country.

Senator MILLER. As far as we are concerned, we have, at the most favorable evaluation a marginal—or, in fact, a neutral trade picture?

Mr. VOLCKER. That is right.

Senator MILLER. And we certainly have a balance-of-payments deficit.

Mr. VOLCKER. Well, I do not want to be technical here, Senator. Whether we have one at the moment depends on what definition you use. It is perfectly clear, and I am sure we can agree, that we have a balance-of-payments problem, and a serious one.

Senator MILLER. And we have a balance-of-payments problem because we have a balance-of-payments deficit. Isn't that what we are here about, on this pending legislation?

Mr. VOLCKER. Yes, sir; we are here because we have a serious balance-of-payments problem. We have a very large deficit by the traditional liquidity calculation. We happen to be having a surplus at the moment, in terms of the alternative calculation, and that is the only reason I am hesitant here. I do not want to dispute at all that we have a serious balance-of-payments problem whether or not we count these short-term capital inflows above or below the line, and however they affect the overall results at the moment. We have an unsatisfactory situation.

This has its counterpart, as you stressed originally, in a basically strong balance-of-payments position of a number of other countries—however they define their technical surplus or deficit position at the moment—and that we must all the time work toward a situation where partly through an improvement in our trade balance we work to a better equilibrium. I am not resisting the general thrust of your question at all. But, technically, it is a little difficult.

Senator MILLER. It seems to me that what you are really saying is that when people like you are negotiating with countries of Western Europe and Japan to try to get them to open up their markets and remove some of their protectionist activities——

Mr. VOLCKER. I agree with that formula.

Senator MILLER. That you are faced with an argument: "Why should we do that? You do not have a problem with the balance of payments."

Mr. VOLCKER. I think they recognize that we have a problem. They are not under any illusions on that score. I accept fully your conclusion that this is important in those countries that are in a basically strong trade position. Some of them still have trade restrictions. Some of them still have certain preferences. It is important that we press them, and I assure you we are pressing them, to move in a direction of liberalizing their trade restrictions, so that we have, and other countries have, fair access to their markets when they are in a basically strong position.

Senator MILLER. I am in full sympathy with our pressing, but what bothers me and what bothers many people is that the pressing does not seem to be achieving any results at all, and, if anything, we seem to be going backward.

I was going to draw Mr. Petty's attention to something I am sure he is very familiar with, and that is the recent statement entitled "Technology and Neo-Mercantilism in International Agricultural Trade," by H. B. Malmgren and D. L. Schlechty.

Mr. Chairman, I would like to have permission to have this statement included in the record at this point.

The CHAIRMAN. Without objection.

(The statement referred to follows; testimony continues on p. 43:)

TECHNOLOGY AND NEO-MERCANTILISM IN INTERNATIONAL AGRICULTURAL TRADE

(By H. B. Malmgren [1] and D. L. Schlechty [2])

While developments in agricultural trade in this decade have been reasonably favorable, the underlying trend and some recent developments suggest a very difficult and dangerous period ahead in the 1970's. The results of the Kennedy Round trade negotiations were clearly beneficial for certain commodities. Agricultural trade has generally been increasing. Amongst the OECD countries, which are the major trading countries, it increased by 6½ percent per annum from 1960 through 1967. (5) But in spite of this overall progress, some of the general problems raised by other writers in the recent past are even more threatening now (2) (4); and there are technological and policy developments which add new complex dimensions.

All countries were aware of the need to provide for expanding trade opportunities for agriculture during the course of the Kennedy Round. However, the real, substantive negotiating sessions in agriculture came too close to the end of the Kennedy Round talks to allow time for negotiating fundamental changes in access to markets or in national farm policies. The liberalization which took place was therefore modest in character.

THE NEW MERCANTILISM

During this period the general level of protection in the Common Market rose as a result of the implementation of the Common Agricultural Policy (CAP). The degree to which that protection has risen for some of the major farm commodities has not been fully realized. If the total charges of the variable levy system at the EEC border are converted into ad valorem equivalence, some interesting comparisons can be made between the pre- and post-CAP protection levels (see Table 1): For BTN Chapter 1, live animals, protection rose from 14 percent in 1959 to 49 percent in 1968. For meat, the rise was from 19 percent to 52 percent. For dairy produce, there was a rise from 19 percent to 137 percent. Though not shown separately, in the case of butter alone, the increase was from 30 percent, pre-CAP, to 350 percent, post-CAP. In cereals, the protection rose five times from around 14 percent, pre-CAP, to 72 percent, post-CAP. In contrast with these phenomenal rises in the level of protection for major commodities, there have been some modest declines, mostly in complementary, non-competitive imports, or in products where there has not yet been applied a common price policy or variable levy system. For the principal nonvariable levy commodities, like soybeans and soybean products, tobacco, and canned fruits and vegetables, the U.S. and other countries hold negotiated tariff concessions and the introduction of the levy system would constitute an impairment of exporters' rights. Nonetheless the EEC has recently contemplated breaking its undertakings and introducing the levy system, or introducing other protective devices which might have a major protective effect.

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[1] H. B. Malmgren is former Assistant Special Representative for Trade Negotiations, Executive Office of the President. He is presently a Senior Fellow, Overseas Development Council, Washington, D.C.; and D. L. Schlechty is International Economist, Office of the Special Representative for Trade Negotiations, Executive Office of the President, on loan from the Foreign Agricultural Service, U.S. Department of Agriculture.

[2] Footnotes appear at end of statement.

Because of these dramatic increases in the level of protection in the EEC, the Community is the most highly protected area for agriculture in the world. With the variable levy, the protection level is about triple what it was eight or nine years ago prior to the CAP and many times above that in the other major developed countries.

There has been an argument often used by defenders of the CAP that the level of exports from the U.S. and other major traders would continue to rise, regardless of the "system," because of the rising demand for both food and feed. Until 1965–66, U.S. agricultural exports to the EEC did indeed continue to rise. But since then, there has been a reversal, and we now appear on a downward path. In the fiscal year just ended, total U.S. agricultural exports to the EEC were $1.3 billion, seven percent below that of fiscal year 1968. This represents a 19 percent drop ($300 million) in the past three years. The items subject to variable levies rose each year until the 1965/66 peak, when they totaled $736 million. The level for these same export products for 1968/69 is $441 million, a decline of nearly 40 percent in three years, while nonvariable levy items remained about the same. The rise until 1966 is also worthy of comment: Until that time, there was no CAP for many products—only certain transitional price ranges. Towards the end of the Kennedy Round the EEC, in a series of marathon sessions, reached internal agreement on common price levels, which tended to approach the highest individual country level. Consequently, the new import protection levels had also to move up dramatically. Thus, the real bite of the protective mechanism of the Community's CAP was not really felt until the common prices began to be reached in 1966 and 1967.

This is not the whole picture, however. While increasing its import protection, the EEC has simultaneously been raising its level of domestic production. Both yields and total production of the major commodities have been rising rapidly (Table 2). The rapid growth in output has been encouraged by high support prices and protected by a levy system which essentially converts imports into residual supplies. The support prices for cereals, for example, are about double the average world market level. Total EEC grain production has risen 20 percent in this decade, largely on the strength of a 34 percent improvement in yields which also reflects new technologies. Total coarse grain or feed grain production rose 37 percent since 1960 and yields increased by 38 percent. The rising internal production in turn results in pressures to expand exports. With the high internal market prices, exports would not be possible without some special export assistance mechanism. The so-called restitution system of export payments was designed to carry out this function. Initially, the concept of the Common Agricultural Policy was that of a system with high prices, like an island in the sky, with a bridge up to that island in the form of the variable import levy system, and a bridge back down to the world market level via restitutions. Restitutions were theoretically to be established at a level equivalent to the import levies. On a feed product, such as poultry, exported chickens would theoretically benefit from a restitution payment equivalent to the import levies on the feedgrain incorporated in the exported birds plus a standard amount. In practice, however, the restitution system has lost this theoretical tie to the import levies in many cases, and the restitution payments are often simply set at levels sufficient to make the export competitive in any market of destination. In other words, the payments have no technical limit in some cases, designed as they often are now, to beat the best price of the lowest competitor.

These restitution payments, or subsidies, have been especially troublesome in certain commodities: poultry generally, barley and wheat into the Far East, lard into the U.K., dairy products to all destinations. The outlook is that these subsidies will be even more aggressively used in grains generally, as EEC surpluses begin building up to serious levels in coming months.

The poultry problem is a good example of the dangers that can result from this system. Import protection was tripled through the introduction of the variable import levies. This brought about a substantial drop in imports ($33 million in one year from the U.S. alone). On the other side, as EEC subsidies necessarily affect the position of all poultry exporters, the Danes, who are major exporters, have been encouraged to continue and expand their own subsidy system (known as the "Home Market Scheme"). Importing countries in turn, having some home production of their own, are under pressure to increase the level of import protection if their markets are relatively open to imports. The Greeks established their own variable levy system to protect against such abnormally low-priced imports, and the Austrian Government recently introduced a minimum import price scheme of its own. In reaction to this highly distorted

situation, the U.S. Government resumed its own poultry export subsidy into Switzerland in 1968, to make our exports competitive and at the same time dramatize the absurdity of the subsidy policies of other countries.

Thus the dimensions of the protectionist, mercantilist aspects of the CAP go far beyond the question of the import levy system itself. The CAP system could have been operated in a less damaging manner. For example, the import levies could have been used to limit distress selling, or abnormal pricing by state trading nations. But the Europeans seem in practice to have opted for a much more import-protective and export-aggressive-usage of the system. Because of excessively high protection, exporting countries find themselves competing more intensively in other markets to which they are diverted. Compounding this problem, EEC subsidies put heavy downward pressure on market prices for exports into third markets. The CAP has thus become truly mercantilist: its workings result in reduced imports, increased home production, artificially assisted exportation, and discouragement of exports of other countries into third markets.

These developments would be harmful enough by themselves. But there is the real likelihood that the practice will spread. Both political parties in the United Kingdom are advocating increased self-sufficiency in agriculture. The minimum import price scheme, which was introduced in 1964 for grains, is highly protective. The Economic Development Committee for Agriculture was established to develop import-saving policies. The Ministry of Agriculture has followed its general proposals to stimulate home production and has agreed to pursue policies to cut back imports of agricultural products to save about $400 million annually by 1972–73. In the next year or two, the nature of import protection will be reviewed if the U.K.–EEC negotiations take place, leading toward the entry of the U.K. into the Common Market. The likely result of U.K. entry will be adoption of the variable levy system, and an alignment to high support prices. This will raise the level of protection on agricultural imports into the U.K., encourage home production of cereals and meat, encourage purchase of French and German wheat and feed as a substitute for imported wheat and feed from third countries such as the United States, and thus further increase competition in the remaining markets. Moreover, the costly accumulation of surpluses within the EEC could be greatly relieved by this opening of the U.K. market, especially for grains, dairy products (real butter), and sugar. With a reduction of the pressures on the member countries of the EEC resulting from costly stockpiling, there is less likelihood of a fundamental change in the EEC's own internal policies.

In Japan, a major agricultural importer and the largest market for U.S. agricultural products, the trend was good until about 1966. But Japan also is now suffering from the consequences of high support prices, mainly in rice (the rice support being nearly triple the world price level). There must soon be domestic diversion of production to other commodities to relieve the indigenous rice surplus being acquired by the government at great cost. This could easily result in increased pressures for new protection measures, or at least maintenance of existing agricultural quota restrictions which are contrary to Japan's GATT obligations. The implications of the rise in rice supplies alone could be broad. First, there is currently consideration of a curtailment of wheat imports, as recommended by the Japanese Federation of Agricultural Cooperatives. Second, imports of rice, which dropped to insignificant levels in 1968–69, will tend to remain very low, weakening the world demand for the increased rice production of the developing countries. Third, Japan will seek to grant some of its food aid commitments under the International Grains Arrangement of 1967 in the form of rice, which will detract from the development of intra-LDC trade in rice.

The developments in other major producing and trading countries are also in the same direction, particularly in grains generally. The one positive sign in terms of changing public attitudes toward production restraint is in wheat, in the cases of Australia and Canada. The change here is rapidly becoming necessary because of shortages of storage capacity and rapidly increasing world surpluses of wheat.

Even in the United States, there have been growing pressures for increased agricultural protection. Existing protective systems have been used more actively in the last two years. In the case of dairy imports, emergency quota action was taken against certain dairy products, including some types of cheeses in addition to those already under quota. The main reason was the extraordinarily low price levels for some of the imports, resulting from large subsidies by the EEC and certain other countries. Given the enormous surplus of butter in Europe, it is not surprising that the EEC was tempted to try to

move butterfat in various forms with the use of unusually large export aids. Nonetheless, in spite of the reasons for the U.S. actions, it can be said by other countries, with some justification, that our overall quota levels for dairy imports are excessively restrictive, holding imports to about one percent of domestic production. In beef, the present quota legislation, introduced in 1964, does not formally apply, since imports have not reached the so-called trigger levels which would bring quotas into effect. However, imports have recently been very close to the trigger levels. Consequently, the Executive Branch was forced to warn exporting countries in 1968 that they would bring quotas into place unless they restrained exports below certain specific levels. In this way, an informal, voluntary quota system came into effect in 1968, and is still operating. The result has been significant restraint on the levels of exports from both traditional exporters (Australia and New Zealand) and from a number of developing countries in Latin America.

ECONOMIC REGIONALISM

These forces are working themselves out in conjunction with another set of mercantilist forces arising out of economic regionalism. Clearly, when nations join together in a trading bloc, there is the danger of trade diversion as well as the prospect of trade creation. The effects of the CAP on world trade have been changing. As already suggested, the odds are great that U.K. entry will exacerbate the difficulties. There will consequently be considerable incentive for other neighboring countries to become part of the system, opening these markets more directly to the EEC member states, while closing them to third country exporters, like the United States. The costs will be high to such new members, but those countries seem willing to pay the costs. Moreover, if the political decision is put frankly, it is a question of accepting a heavy price for agricultural readjustment in exchange for greatly improved industrial access and exposure to the kinds of competition which ought to stimulate industrial growth. Since countries like the U.K. are necessarily faced with major agricultural adjustment needs anyway, and those adjustment programs which are being given consideration are already protectionist in character, there is doubt that the agricultural costs will ultimately deter entry.

Economic regionalism has had its bad effects felt in agriculture elsewhere. The increasing preferential tendency between the EEC and other countries is having a diversionary effect in a number of commodities. The preferences of Greece and Turkey, unjustified by any reasonable construction of the allowed types of association in the GATT rules, have an adverse effect, as do the special relations with African and Mediterranean countries. Just within the last few months, for example, the EEC has arranged for new preferences on citrus products from Tunisia, Morocco, Spain, and Israel, which results in discrimination against numerous other suppliers, including the United States.

The developments among the developing countries have not been favorable to third countries either. One of the effects of the Latin American Free Trade Area has been to raise the protection against certain agricultural products from outside the group while providing preferred access to those within. Of course, if the LAFTA were a true customs union, preferential access among the members would be acceptable. But it is not a customs union, and there is little prospect of it becoming so in the reasonably near future. In the meantime, outsiders have been harrassed by a variety of problems. For example, U.S. exporters of fresh fruit face increasingly high, or prohibitive, import barriers into the Latin American economies, while some of these same countries export to the U.S. in increasing quantities, as well as to each other.

This tendency toward regionalism is growing. It need not necessarily result in damaging distortions to third country trade, but it has tended to do so thus far, in agriculture.

THE ROLE OF TECHNOLOGICAL CHANGE

Past improvements in technology, leading to steadily improving yields, have played a significant role in the rise in world production. But those developments have been orderly until recently. In the next few years, world grains production, particularly in Asia, will be greatly affected by the recent introduction of the new high-yielding varieties of wheat and rice. The area planted to these high-yielding varieties in Asia, for example, have increased substantially from 4 million acres for the 1966–67 crop year to 27 million acres for the 1968–69

crop year. (7) The impact of these new varieties will be great, though the exact dimensions are as yet uncertain. (3), (8) The developing countries are not only hoping that use of these varieties will bring about a quantum change in their economic position: they are actually planning on major changes. A number of them expect not only to reduce imports drastically, but to become self-sufficient and to begin exporting on a large scale. The change from net importer to net exporter position for some of them is part of their over-all economic development plan.

Questions immediately arise: What will be the effect in terms of adding to the world commercial grains surplus? Will the increasing self-sufficiency of some of the larger developing countries mean the reduction of world market potential, instead of the rise some had hoped for in previous years? Will world trading prices, already subject to the pressures of export subsidies and production stimulation policies in the developed countries, be further depressed by the rising commercial position of the developing countries. If so, will this bring about the same kind of mercantilistic policy reactions in the developing countries as has been seen in the developed countries, with all the consequent heavy costs of export subsidies and income support programs?

Another set of problems arises out of the international transmission of new technology. One of the best examples is again the case of poultry. The newer methods of chicken production were first introduced in the U.S. Americans then provided technical assistance to Europeans with a view to increased sales of feed and chicks. The improved efficiencies in European production might have reduced the pressure for higher levels of protection as a result of the declining cost of production. But this did not happen. Instead, increased capability to produce at home simply added to the pressure to substitute for imports. The less efficient producers who were subjected to increased competition from internal EEC competition insisted on increased protection against somebody—and the somebody had to be the outside world since the internal market of the EEC had to be free of restrictions. In some smaller countries, the improved technology provided increased incentives to shift over to, or remain in, poultry production. With the advent of increased production and heavy export subsidies from the major exporting countries, such countries found themselves with a semi-efficient industry suddenly challenged by artificial prices and in need of protection. Thus the steady transfer of technology from the countries originating new methods to other countries has often simply added further protectionist incentive.

A third set of problems now facing us is the changing technology of animal feeding. Much of the change has, of course, been spurred by the changing price differentials amongst various feeds, which in turn were brought about by national policies. Countries are increasingly feeding wheat (and even recycling milk products back to cows). New feeds are also able to make inroads. Fishmeal has been making major gains. The use of urea, a new development in synthetic feeding, is taking hold.

The combined effects of these three developments cannot be gauged at this time. But is is clear that major readjustments in trade patterns are likely to arise out of these forces of changing technologies.

INTERNATIONAL ADJUSTMENT PROBLEMS

The technological developments, both those of longer term, steady improvement character, and the more recent quantum changes such as those made possible by the new varieties of food grains, should theoretically have reduced protectionist pressure. As efficiency improved, it might be expected that the need for individual product protection would be lessened. Events have not unfolded in this way, however. One response in Europe to increased efficiency and increased production has been to seek to raise the level of protection and of export aids. Another response to the production rise has been the conscious restructuring of price differentials between food and feed grains. The objective in Europe is to make corn expensive and wheat relatively more cheap for feed, so as to substitute wheat for imported feedgrains.

The general improvement in agricultural production coupled with a less rapid rise in demand will mean increasing supplies available for export. A recent OECD study indicates that the major developed countries have the prospect of expanding food production well beyond their own needs, without any changes in policy. For example, the net export availability of grain of the OECD countries plus Oceania would rise from 20 million tons in 1961–63 (6 percent of produc-

tion) to 90 million tons in 1975 (19 percent of production) and 121 million tons in 1985 (21 percent of production). (6)

Against this background, the consequence of the interaction of conflicting national and regional agricultural policies will be to create a major world trade and production adjustment problem. The present crisis in world dairy trade, characterized by heavy surpluses and extensive subsidization, is not an isolated problem. It is simply an example of the adjustment problems to come in other commodities. Particularly in wheat and rice, the increased self-sufficiency objectives of many countries, both developed and developing, will limit the opportunities for unloading domestic surpluses of those countries which traditionally export. The developing countries, who have put so much of their hopes on the Green Revolution, may confront a very difficult market. Moreover, the possibilities for relieving their difficulties through regional arrangements with other developing countries are endangered. One of the major incentives for regional cooperation would have been sale of agricultural commodities; but if these nations become more or less self-sufficient, they may have substantially reduced incentives to work more closely together.

One of the major adjustments will be a consequence of the slowly changing relationship between food and feedgrains, as foodgrains are increasingly utilized as feed ingredients because of the rapid rise in wheat and rice production. One of the interesting analytical questions on which there has been little work, is the relationship between rice and wheat, and the relationship amongst rice, wheat, and feedgrains taken together. Looking at the adjustment problem generally, some countries are tending to see their salvation in increasing production of animals, and increasing demand for animal proteins in the diet. There is room for maneuver here, but countries may well follow again the patterns of the past and attempt to make the adjustments behind increasing protection, thus starting a new cycle of major adjustment problems.

A major force which eventually ought to push countries toward consciously planned and economically efficient adjustment policies is the rising cost of the domestic production policies and export subsidies. But the costs can continue to rise for a time in some countries. In the EEC, the home costs are far higher than they appear. The national programs are additional to the Community programs, and many of the national programs are buried in the budgets of many ministries in addition to the agricultural ministry. Moreover, consumers pay a significant portion of the costs through the very high level of prices. A not unreasonable estimate done informally within the U.S. Government sets the cost of the Common Market agricultural program at about $15 billion a year.[1] Of course, any such estimate of cost does not reflect the cost of diversion from alternative resource allocations which could have higher social and economic returns. So long as the costs are diffuse and difficult to pin down, there will remain room for further rises. Moreover, taking into account the political objectives of the European Community, there are many who argue that the farm costs are simply part of the political cost, and that an appropriate mercantilistic use of the CAP mechanism will relieve much of the burden. Since export subsidies are at least in part financed by import levies, they argue that further room for increased subsidization exists. Others argue that it is cheaper to subsidize almost to any level, rather than build storage and incur storage costs where surpluses exist. For a time, the U.S. can step up the cost pressure on other countries by lowering its export prices, either by increased use of subsidies or by decreased support prices in the U.S. This indeed is a necessary ingredient in the search for an easing of the conflict in national policies, because the costs to other countries will probably have to rise somewhat further before they will be politically prepared to make major policy changes. But this means that the world faces a kind of trade and adjustment problem which is most difficult; a problem which ultimately the major powers can cope with, at great cost, but with which the developing countries and the smaller developed countries cannot, unless there is some new international discipline introduced.

THE NEED FOR COORDINATION OF NATIONAL POLICIES

There is, then, urgent need for some new kind of approach to international negotiation, and coordination, of national adjustment policies in agriculture.

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[1] The direct budget expenditures at all levels of government amounts to about $8 billion, and the cost to consumers in prices above world levels, about $6–$7 billion.

There are many complex analytical questions which must be faced up to in the search for any international principles, guidelines, agreements, or understandings. Countries will continue, as they have in the past, accusing each other of maintaining systems which provide greater protection, production incentives, and export aids. There can be no progress unless better measurements can be found for the economic impact of the various national policies. The EEC suggested the montant de soutien technique during the Kennedy Round, as a means of measuring the margin of support.[3] While this particular approach proved unworkable there is a need to find some technique of quantifying the level of agricultural support, and of the degree of price distortion from one country to another, and from one product to another, are needed.

One interesting analytical question has come up in the context of proposals to limit or eliminate subsidies. Naturally, the question arises in debate amongst countries as to what levels to set for limiting subsidies, taking into account the effects of home production and marketing incentives. What is an efficient international price?[3]

Although there will be many who have difficulty with the idea, it will be necessary to examine in some detail whether some types of access commitments and price arrangements, or subsidy limits, are necessary, at least for a transitional period; and whether levy systems might be put under international discipline, and if so, how.

Agricultural economists are badly needed to turn attention to these trade questions, so as to lay the basis for sensible international discussion.

It is thus no longer sufficient to say that the international agricultural market will somehow take care of itself, and that the best trade policy is one of minimum intervention. Governments have already committed their economic systems too far to allow abrupt adjustment to free trading principles. Given the present world technological adjustment problems, the seriously conflicting national policies, and the resurgence of mercantilism, there is urgent need for governments to intervene to restrain themselves, and to restrain each other. At this time it is not a question of free trade based on open commercial competition, because governments have so heavily intervened. So long as governments play such a dominant role, any solutions must be related to government actions, require government commitments, and provide meaningful international guidelines for governments to live by. Without some breakthrough of this character many countries will face extremely costly adjustment problems. For some countries, particularly the developing ones, there will be even broader implications for their economic development and political stability.

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[3] This question is even more complex when trade from Eastern European, nonmarket economies, is considered; and the trade from these countries is increasingly important in world markets.

TABLE 1.—COMPARISON OF PRE-CAP AND POST-CAP LEVEL OF IMPORT PROTECTION (TARIFFS AND OTHER DIRECT CHARGES) FOR AGRICULTURE IN THE EUROPEAN ECONOMIC COMMUNITY[1]

[In percent]

BTN[2] chapter	Commodity	Common external tariff	
		Pre-CAP	Post-CAP
	Live animals, animal products:		
1	Live animals	14.4	48.5
2	Meat, edible meat offals	19.0	52.1
3	Fish, crustaceans	16.6	13.3
4	Dairy produce; birds' eggs	18.6	137.3
5	Products of animal origin	.1	.1
	Vegetable products:		
6	Live trees, other plants	13.6	10.8
7	Edible vegetables, roots	12.0	12.8
8	Edible fruit, nuts	15.9	14.5
9	Coffee, tea, mate, spices	16.3	9.8
10	Cereals	13.5	72.4
11	Products of the milling industry	22.8	20.9
12	Straw, fodder, miscellaneous grains	.6	.6
13	Vegetable dyeing material	1.1	1.1
14	Vegetable plaiting materials	1.1	.4
15	Animal and vegetable fats: Animal and vegetable fats and oils	8.3	9.5
	Prepared foodstuffs:		
16	Preparations of meat, fish	20.1	20.4
17	Sugars, sugar confectionery	75.8	41.9
18	Cocoa, cocoa preparations	10.3	7.8
19	Cereals, flour, or starch	28.8	27.8
20	Preparations of vegetables, fruits	25.5	25.9
21	Miscellaneous edible preparations	21.4	19.9
22	Beverages, spirits	21.6	37.7
23	Residues and waste	2.4	3.9
24	Tobacco	35.5	22.9

[1] Data for pre-CAP protection (1959) taken from report by Committee on Economic Development, "Trade Negotiations for a Better Free World Economy," Library of Congress catalog card No. 64-20846, p. 79 Post-CAP protection estimated from pre-Kennedy round tariffs adjusted to include 1968 import levies. Post-Kennedy round tariffs would be somewhat lower for certain nonvariable levy commodities.
[2] Brussels tariff nomenclature.

Source: Estimated from unpublished data in the world trade and tariff computer tabulations developed by the Office of the Special Representative for Trade Negotiations, Executive Office of the President, Washington, D.C.

TABLE 2.—INDEX OF EEC PRODUCTION AND YIELD OF SELECTED AGRICULTURAL PRODUCTS BY YEAR[1] (1959-60 EQUALS 100)

Item	1959-60	1960-61	1961-62	1962-63	1963-64	1964-65	1965-66	1966-67	1967-68	1968-69
Total grain:										
Production	100	92	86	100	98	103	104	101	117	120
Yield	100	102	96	109	110	115	116	113	132	134
Wheat production	100	94	89	114	94	113	118	102	120	125
Yield	100	95	96	114	103	114	120	109	134	132
Total coarse grain:										
Production	100	109	99	105	120	113	111	118	138	137
Yield	100	109	96	106	117	116	115	117	132	138
Barley production	100	113	106	126	139	136	137	183	177	177
Yield	100	109	93	111	112	115	112	108	132	127
Corn production	100	116	112	90	133	107	119	139	143	164
Yield	100	110	98	87	122	103	119	135	125	150
Milk production	100	107	110	113	113	113	117	121	125	128
Yield	100	104	105	106	109	110	113	116	119	120
Butter production	100	113	108	111	125	124	132	132	141	150
Nonfat powdered milk production	100	202	236	291	362	416	570	696	939	1,180
Poultry meat production	100	114	126	139	148	174	193	207	218	225
Grain/meat ratio[2]	(3)	(3)	3.5	(3)	(3)	(3)	(3)	(3)	(3)	2.2

[1] Grains production figures shown for crop year (July-June); all other figures on calendar year.
[2] Pounds of grain required to produce 1 pound of poultry meat, 1962 figure represents approximate grain/meat conversion ratio in the Netherlands. 1968 figure estimated on basis of trade information.
[3] Not available.

Source: U.S. Department of Agriculture, "Grain Developments in the Common Market," FAS M-202, December 1968 and various Foreign Agricultural Service commodity circulars.

Senator MILLER. Malmgren and Schlechty point out on page 2 of the statement:

For Brussels Tariff Nomenclature, chapter 1, live animals, protection rose from 14 percent in 1959 to 49 percent in 1968. For meat, the rise was from 19 percent to 52 percent. For dairy produce, there was a rise from 19 percent to 137 percent. Though not shown separately, in the case of butter alone, the increase was from 30 percent, pre-Common Agricultural Policy, to 350 percent, post-Common Agricultural Policy. In cereals, the protection rose five times from around 14 percent pre-Common Agricultural Policy, to 72 percent, post-Common Agricultural Policy.

Then, they go on to say:

Because of these dramatic increases in the level of protection in the EEC, the Community is the most highly protected area for agriculture in the world. With the variable levy, the protection level is about triple what it was 8 or 9 years ago prior to the CAP and many times above that in the other major developed countries.

I am in sympathy with the President, but we do not seem to be making any progress, and it seems as though we are going backwards.

Mr. VOLCKER. You are putting your finger on a very serious and continuing problem, in the agricultural area specifically.

Senator MILLER. So, what are we going to do about it? Continue to press and continue to go backward?

Mr. VOLCKER. I hope we are not going to continue to go backwards, and I think this has to be brought to a head. I think they have to appreciate the seriousness of this problem for us in a number of directions. I think, so far, at least, they have not taken some of their still more defensive actions, still more restrictive actions that had been contemplated. I would not present that as a great victory on our side.

Senator MILLER. Mr. Volcker, let me assure you that I was one of the first and one of the loudest complainants of the outcome of the Kennedy round negotiations. I said it was a sellout on agriculture, and it was. And I think even the testimony of our former chief trade negotiator will bear that out.

Now, I am in sympathy with pressing, and I am in sympathy with trying to work things out on a negotiated basis, but there comes a time when negotiations apparently are not proving fruitful at all.

Things are getting worse, and I do not need to point out to you that we have a number of quota bills here, and those of us who are sponsoring some of them are not at all affected by some so-called free traders who say that this is going to lead to a trade war.

We are not interested in taking the offensive at all. We are only on the defensive, but when some countries go on the offensive and keep making things worse, it does not seem to me that we can continue to talk about free trade as though it were a one-way street with Uncle Sam at the end of a deadend street. We have got to take some action.

I must confess my disappointment that the administration has, so far at least, indicated that they are going to continue to press and negotiate without giving any indication that—with perhaps the exception of the Secretary of Commerce—we are going to have to take some defensive action ourselves.

So much for that.

I would like to ask Mr. Petty this question:

You come before us advocating this legislation, which is a 20-month extension. It was put on the books back in 1963 as a temporary measure.

I might tell you that I voted against it, because I thought that the administration at that time was engaged in deficit spending and inflationary activities, and I felt that that was the heart of the problem and I could not see that this was going to be more than a palliative, that we had to go at the basic problem.

I understand that the administration is trying to go at the basic problem of inflation which Mr. Volcker has highlighted, but how much longer are we supposed to have this temporary tax? Do you think that 20 months is going to get the job done?

If you think that it is, does that imply that you think that in 20 months, with the cooperation of the Congress, of course, that we are going to be able to do a job on inflation?

Or is that the only underlying problem you are after?

Mr. PETTY. I think, Senator Miller, I might have Secretary Volcker come back on that. It is certainly our objective and desire to have the 20 months extension that we are requesting be the terminal date.

It is difficult to make predictions on this. Secretary Volcker has quoted in his statement Secretary Kennedy's letter to Senator Javits which emphasized the necessity of having some evidence of the success of our anti-inflationary program.

I think Secretary Volcker might speak to that point, because it relates exactly to your question.

Senator MILLER. Pardon me?

Mr. PETTY. Secretary Volcker might pick up on this point, because I think the effectiveness of the anti-inflationary problem is the key point in your question.

Mr. VOLCKER. I would answer the inflationary part of your question, Senator Miller, by saying that we certainly do expect results within 20 months. I think that lies at the heart of our balance-of-payments problem—though I do not want to say, it certainly is not, the whole of our balance-of-payments problem. This has been a persistent matter over a period of years. As I indicated earlier to Senator Long, I think it is going to take a long period of time before we can get our trade balance back to the kind of level we had earlier, and it is partly dependent upon some of the matters that you were just referring to.

Senator MILLER. We are talking here now about the interest equalization tax.

Mr. VOLCKER. Right.

Senator MILLER. And a 20-month extension.

Mr. VOLCKER. Right.

Senator MILLER. And hoping that the underlying problem of inflation——

Mr. VOLCKER. Right.

Senator MILLER (continuing). Will be pretty well taken care of——

Mr. VOLCKER. Right.

Senator MILLER (continuing). By the administration. But, simply, it must be with the cooperation of the Congress.

Mr. VOLCKER. That is right.

Senator MILLER. If the Congress does not cooperate, then all bets are off.

Mr. VOLCKER. Right.

Senator MILLER. I am assuming that Congress is going to live up to its responsibility and will cooperate with the administration, and if it does, that the administration believes that within 20 months this inflation problem can be pretty well knocked down to our original target of zero inflation. Now, if that is all, can we expect that there will not be a request for a continuation of this temporary interest equalization tax again about 20 months from now?

Mr. VOLCKER. I hope so. But this is a complex world, Senator. I think the best answer I can give you to that question and the best expression of our intent is that we have already, shortly after this administration took office, moved to relax some of the selective controls, and this is not the only one. But we have moved to reduce the rate on the interest equalization tax.

We moved to relax to some degree the controls on direct investment and on bank loans. This, I think, is symptomatic of our intentions in this matter.

This is not a risk-free process in undertaking this relaxation at this time, when our balance of payments is still not in a situation in which we would like to see it. We were willing to take those risks.

Senator MILLER. Could I ask you this at that point?

During the first half of 1969, the administration moved to relax, as you say——

Mr. VOLCKER. Right.

Senator MILLER (continuing). And I note that in the first half of 1969 there were apparently no new issues by countries subject to the IET, according to the table on page 3.

Mr. VOLCKER. Yes, sir.

Senator MILLER. So that although we moved to relax, this did not have any impact, as far as the countries subject to IET?

Mr. VOLCKER. For these particular new issues included on this table, that is right. This relaxation also applied to outstanding issues, and I think there may have been some increase in the purchases of outstanding issues that are not reflected on this particular table.

Senator MILLER. That did not cause a problem.

Mr. VOLCKER. They do not cause a major problem.

Senator MILLER. The relaxation.

Mr. VOLCKER. The more important relaxation moves, Senator, I think quantitatively, were certainly those in the direct investment program and with respect to the banks.

Now, one factor which affects the length of time we need the interest equalization tax and the phasing-out process will be, as I very briefly alluded to in my statement, the fact that as part of the direct investment program very large amounts of securities of subsidiaries of U.S. firms have been sold in Europe and elsewhere, and there is, therefore, a large overhang of these securities in foreign markets, securities that could—potentially—flow back to the United States.

The interest equalization tax is a barrier to that, because these securities are subject to the interest equalization tax. In that sense it is complementary to that program, but, in reducing our reliance on this tax, we have to keep in mind that this stock of potentially attractive securities does exist in Europe, and if we free too suddenly and too quickly we could get a surge of American purchases of these securities. That is essentially the reason why we are proposing in this ex-

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tension that we be given the flexibility to reduce the rate on new foreign issues and to differentiate that rate from the rate on outstanding issues, to permit us to move as rapidly as possible in certain conditions toward minimizing the burden of this tax while retaining that essential protection relating to these past transactions.

Now, whether this problem is not going to be an important one 20 months from now, I do not think anyone can tell. I hope it is much less important.

Senator MILLER. I appreciate that answer very much..

I would like to ask one more question, Mr. Chairman.

Looking at the table on page 3, it appears that Canada is the one that has the largest chunk of the investment in the United States.

Is there any feasibility in doing something about the countries exempt from the IET as a matter of helping this problem?

Mr. VOLCKER. As I suggested, we do review this situation with the Canadians, and particularly focusing on the question of whether this access to our market by Canada has resulted in any leakages of funds elsewhere. I think we are satisfied on that point, Senator, and do not see this as a major source for additional——

Senator MILLER. I am not talking about hot money or leakage. I am talking about proper investments.

Mr. VOLCKER. Right. I think we are left still with the same problem that we had initially here. The ties between Canada and the United States are so close, the general position of the Canadian economy and the Canadian balance of payments does not suggest that this exemption should be eliminated at this time, and I think it would create great problems if it were.

Senator MILLER. Could you furnish for the record a brief statement on that point?

Mr. VOLCKER. We certainly could. I think one of the key elements here, if I might just add—we will provide a statement for the record—is whether Canada, not whether it passes on funds elsewhere but whether it is, itself, in such a strong position that it is both borrowing in our market and building up vast amounts of reserves itself, and that has not been the case.

Senator MILLER. Thank you, Mr. Chairman.

(The statement submitted by Mr. Volcker follows:)

The status of Canada in our balance of payments program, including the Interest Equalization Tax, reflects the unique financial and economic relationship between our two countries which have a common border over 5,000 miles long. The flows of trade and capital across that border are important to the economic life of both countries. Access to the U.S. market for a wide range of capital transactions enables Canada to continue the usual pattern of helping finance its current account deficit with the U.S. It also permits financial institutions on both sides of the border to operate flexibly. In this way, the arrangement is of mutual benefit to both countries and has assisted the operation of the international monetary system.

In order to ensure that the exemption would not occasion unnecessary borrowing in the U.S., the Canadian authorities agreed that it would not be their intention to increase Canada's reserves as a result of this access to our markets. In addition, the Government of Canada took specific steps to prevent Canada from becoming a "pass-through" channel for the outflow of capital from the U.S. These steps include the issuance of investment guidelines to Canadian investors.

Canadian financial institutions were requested not to increase their net foreign currency claims on residents outside North America, in order to prevent net

movements of funds to Europe and other parts of the world. In addition, Canadian banks, which are free to borrow in the U.S. to the extent that the proceeds are needed for use in Canada, may not raise U.S.-source funds for the purpose of investing the proceeds in the U.S., because such transactions are of no foreign exchange benefit to Canada but hurt the U.S. payments position by increasing U.S. liquid liabilities to Canadians.

On securities, all Canadian investors have been asked not to acquire offshore issues of U.S. companies (or their Canadian subsidiaries) which would be subject to the I.E.T. if purchased by a U.S. resident. Foreign mutual funds have been discouraged from selling to Canadians unless the proceeds are invested appropriately in Canada or the U.S., and foreigners have been discouraged from floating new issues on the Canadian market, if such issues would have been subject to the I.E.T., if floated in the U.S.

On direct investment, Canadian companies have been told that the flow of investment overseas should not be increased as a consequence of the access of Canadian business to the U.S. capital market.

Canada has cooperated in the supervision of these guidelines and they have served the purpose for which they were designed.

These arrangements are kept under continuing review.

The CHAIRMAN. Senator Jordan?

Senator JORDAN. Mr. Volcker, what effect do you anticipate the French currency devaluation will have on our balance of payments?

Mr. VOLCKER. As I recall, Senator Jordan, the direct trade between France and the United States accounts for 4 percent, or less, of our imports and exports, so that the direct impact I do not think is substantial. Nor would I think the indirect impact in third markets is really significant in terms of our balance-of-payments problem. The fact is, of course, that France has been suffering from intense inflationary pressures.

Senator JORDAN. Yes.

Mr. VOLCKER. And that their trade position has been deteriorating, and that this devaluation was designed to arrest that deterioration and permit them to reestablish a stronger position. But in that particular kind of a situation, I do not think we have to be concerned about any direct impact on our trade or on the dollar.

Senator JORDAN. Part of the reason why the balance-of-payments situation has not been as disastrous as it might have been is because of capital inflows, as you have said in your statement.

Mr. VOLCKER. That is correct.

Senator JORDAN. To what extent is that capital inflow a repatriation of U.S. funds, and to what extent is it foreign investment?

Mr. VOLCKER. Basically, this is foreign investment.

Now, recently, with the Eurodollar rates very high, there may have been some of this kind of circular flow, where is it is essentially a kind of repatriation of American money that goes out through one channel and comes back through another or it comes in through this channel instead of coming in, in some other form.

Basically, the improvement in the capital position recently I think reflects an inflow of foreign money for a variety of reasons.

One is, I think, a basically increased trend of interest in our equity markets, a recognition of the great advantages of liquidity, marketability and the terms available in that market in recent years; and another even more immediately, is the great tightness of credit and the great demand for funds in the United States which has tended to reduce incentives to send American money out and has attracted some foreign capital.

Senator JORDAN. How long do you expect that this favorable inflow of foreign investment capital either in equities or in fixed investment is likely to continue?

Mr. VOLCKER. I think we have to recognize that the short term capital inflow and to a lesser extent perhaps the equity movements are potentially volatile sources of funds, and this is why our balance of payments is not in a satisfactory position, that these are, particularly the short-term inflows that have loomed so large in——

Senator JORDAN. And, in a sense, this was a windfall that we could not count on when it came and can't count on for its continuance.

Mr. VOLCKER. I think, to a considerable extent, that is the right attitude toward the short term capital inflows. I do not think that is entirely true with the stock by any means.

Senator JORDAN. No.

Mr. VOLCKER. On the stock market investment, it so happens that in very recent months that has dropped off very sharply, but I would suspect that may be a temporary aberration on the the downside.

I think, basically, there is a widespread and greatly increasing interest in U.S. equities in increasingly affluent countries abroad. There has been a great effort to attract this money by the American financial community.

They have established, essentially, the institutional apparatus, to go out and sell American securities to Europeans and to others, either through the mutual fund device or through the expansion of brokerage offices and the dissemination of information. One of the great advantages that we have, for instance, is the availability of information on our markets and on our companies.

Senator JORDAN. What favorable factors do you see that might be working for us, aside from the ones you have mentioned in getting our own fiscal house in order?

Mr. VOLCKER. That I think by all odds is the most important one. the quantity of inflation in the United States. We also have, basically, a long term factor working in our favor in terms of the increasing income on foreign investments, which gives us a fairly steady and predictable increase from year to year that accumulates to a larger amount of money over a period of time.

I think we have, apart from the special incentives on capital now, reached a stage where capital market availabilities, capital market capacities, are in a better balance now between Europe and the United States than they were at the time this tax was imposed, partly because this tax was imposed. The Europeans were forced to develop their capital markets, and I think this will have some continuing longer range advantages in diminishing the relative pressures on foreign borrowing in the United States.

Senator JORDAN. Isn't it true that this interest equalization tax is, in a sense, for the long range, self-defeating?

Had it been in force and effect 20 years ago, might it not have dried up some foreign investment from which we are now getting substantial returns?

Mr. VOLCKER. In very general terms, I think that is certainly a fair statement, Senator, but this applies to portfolio investments which were not particularly large 20 years ago. Our major income has been from direct investments which are not directly affected by this tax.

But certainly the fewer foreign securities we buy now, or 5 years ago, the less income we have in the future. In that sense, that statement is certainly correct.

I do not think it is unimportant or insignificant that, partly under the pressure of this tax, the Europeans, in effect, have had a forced development of their own capital markets which, in the longer run, I think, is a healthy thing, rather than a self-defeating kind of thing. But, certainly, in terms of this kind of selective or artificial restraint, if you will, it cuts down our potential for income in the longer run, and to some extent we sacrifice the longer run for the shorter run.

Senator JORDAN. We used to enjoy a very favorable balance-of-trade position partly by reason of our wheat exports.

Now, we have gone about the business of introducing new wheat varieties and better farming practices in countries that need foodstuffs.

At the same time, we have increased our production at home until now we face substantial surpluses in addition to a deterioration in the amount of out wheat exports. The people whom we have been helping are now more nearly self-sufficient and require less of the excessive production here at home. Do you see any possibility that wheat exports are likely to show any improvement?

Mr. VOLCKER. I am aware of the problem to which you refer. This has been a factor in the deteriorating situation. I am not enough of an expert in that particular area to give any kind of a reliable forecast of what the outlook is for wheat exports, in particular, over the next year or two.

This has been a deteriorating situation, as you say, and I do not think there is room for a lot of optimism here, but I just do not want to be too precise in an area in which I am not an expert.

Senator JORDAN. One way we could improve our balance of trade position would be to bring some troops home. Do you have any crystal ball on that?

Mr. VOLCKER. No, sir, I do not. We have made an effort in the past—we have made continuing efforts to encourage those countries where we have troops to recognize the mutual responsibility here and to offset the cost of those troops through suitable arrangements of one kind or another.

I wish these arrangements, from our point of view, were more satisfactory than they were, and the net of it is that the stationing of these troops overseas, of course, does put a burden on our balance of payments. They are there for overriding security considerations, and I think so long as those security considerations exist all we can do is again to attempt to get these countries to recognize that this does place not only a budgetary but a balance-of-payments burden upon us and to encourage them just as fully as we can to share this responsibility.

Senator JORDAN. Have you had any response from them other than their willingness to buy some U.S. securities to offset——

Mr. VOLCKER. I think we have had some response. We have recently concluded a new agreement with Germany, which is the largest single factor here by all odds. That agreement again includes a larger proportion really than I would like to see, of security purchases, which partly defers the problem instead of meeting it straight-on, but I think in a number of respects the current agreement is a considerable improvement over what we have had in the recent past.

They are purchasing a considerably larger amount of American equipment, which is a straight offset to our expenditures there, and they have agreed to provide funds in the form of either securities, lending to us, or in the form of purchases of certain assets that we hold under terms that are quite favorable, in terms of the interest rates involved.

Senator JORDAN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. I notice that one of our big problems has to do with Canada, and, according to these charts you have here, a large amount of our capital outflow is to Canada, and when that money comes back in, it comes back in at much higher rates than when it went out.

Why is this interest equalization tax not extended not to apply to Canada, in one respect or another?

Mr. VOLCKER. I do not think it is fair to say, Senator, that this money reflected in that table comes back at higher rates. This is money largely borrowed by Canadian provincial authorities and Canadian industry, and employed in Canada.

I think a large part of it comes back in other forms, including traditionally the favorable trade surplus we have normally had with Canada; but, basically, again, I think the answer to your question is that this exemption reflects the very close linkages between our economies and the very close linkages in our capital markets and the fact that Canada historically has been very heavily dependent upon outside capital to maintain a reasonable equilibrium in its own accounts. This combination of close financial ties and their heavy dependence upon foreign capital means that if we impeded this flow in a decisive way, then Canada is very hard-pressed to find alternative means of balancing its accounts. The experience has been, certainly when this tax was introduced and at a later date when certain direct investment controls were extended to Canada, that very heavy speculative pressures developed that aggravate the adverse effect on Canada. So, in our judgment as well as in the Canadian judgment, the application of the tax to those flows is therefore not conducive to economic stability internationally.

The CHAIRMAN. Thank you.

Now, I would like to direct this towards Mr. Petty.

I have an article here that appeared in the U.S. News and World Report, and I will ask that it be printed in the record at this point.

(The article referred to follows:)

Interview with Maurice H. Stans, Secretary of Commerce[1]

IS U.S. BEING SQUEEZED OUT OF WORLD MARKETS?

Why the worsening balance between what Americans sell abroad and what they buy? Which lines of business are hurt most? Is the foreign-trade problem tied closely to inflation at home? For answers to these and similar questions, editors of "U.S. News & World Report" invited Secretary Stans to their conference room for this interview.

Question. Mr. Secretary, are you worried about what's happening in U.S. foreign trade?

Answer. Yes, I am. In the early 1960s, this country was going blithely along

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[1] Maurice H. Stans, 61, an authority on finance and business, came to the Commerce Department from the presidency of an investment banking firm. He was Budget Director from 1958 to 1961, earlier served on federal task forces.

with a trade balance in its favor of 5 billion to 6 billion dollars a year—that is, the U.S. sold that much more abroad than it bought.

Now, quite abruptly, that favorable balance has almost disappeared. In 1968, it fell to less than a billion dollars, and there is no present sign that it will be any better this year, or even in 1970.

Question. Is that because sales of U.S. goods abroad are lagging?

Answer. No, that isn't the real problem. Exports have done fairly well in recent years. They have been increasing at a rate of 8 or 9 per cent a year. But imports have been growing far faster than that. Last year, for instance, they rose by 24 per cent, while our exports rose only 10 per cent.

Question. Does this have an impact on business and jobs in the United States?

Answer. Yes. Take the textile industry as an example. Some studies I have seen show that if imports of textiles and apparel continue to grow at the present rate there could be a loss of 100,000 jobs a year in this country. That would be serious, particularly because many of these displaced workers would be from the black minority. So we would face not only economic problems but social problems, too.

Question. Why has the gap been narrowing between what we buy from other countries and what we sell to them?

Answer. There are several reasons:

One, of course, is the inflation we have had in the U.S. the past few years. This has made it more attractive to import goods from countries where wage rates—and thus selling prices—are lower.

For another thing, Americans seem to like the idea of buying imported things. There is a little touch of glamour attached to products made abroad.

Also, other countries have modernized their manufacturing capabilities to the point where they can compete with us rather well in world markets.

Question. But aren't U.S. industries modernizing, too?

Answer. Yes. We are ahead in technology in some areas, but not significantly ahead in such products as radios, TV sets, typewriters and some household appliances.

A great many consumer items, and some industrial products—including machine tools—are made as efficiently and as well in other countries as they are here, and often other countries have the advantage of lower wage costs.

There are only a few industries in which our technology is so far ahead of that of other nations that we can still outdistance them in world trade. Those fields include aircraft, computers, some chemical products. But on the broad range of manufactured goods, exporters in other countries have the edge on us, not only because of lower wages but because of tax and credit advantages.

Question. What about farm products—can we still compete on those?

Answer. Yes, to a great extent—but competition is getting stiffer. Agricultural products make up approximately 20 per cent of U.S. foreign shipments each year. That is certainly important to our farm population in terms of jobs and income. In recent years, the rate of agricultural exports has not been increasing.

Question. Are we losing our over-all position in world markets?

Answer. Yes, to some extent. It has been a slow downward drift.

Over the past eight years, the U.S. share of world export trade has fallen from a level of 21 percent of the total to about 19 per cent.

Question. Does this whole trade problem threaten to get out of hand?

Answer. No, I don't see it getting to the stage of crisis. But we don't want it to get any worse.

In the Department of Commerce, we are taking steps to restore our trade balance, and we hope that over the next four or five years we can rebuild it significantly.

Question. Will that be done by boosting exports—selling more goods abroad—or by asking Americans to cut down on what they buy overseas?

Answer. By increasing exports. We do not believe that the answer to the trade gap is to hold back on imports of foreign products into this country, except in highly unusual cases where special factors apply.

We must induce more American companies to realize that there is profit to be made by exporting, and that the feared difficulties of language, foreign exchange and differing trade customs are easily surmounted. The Department of Commerce and the State Department are both able to be of real help in guiding our producers into foreign markets.

Question. Do we have to control inflation as a first step?

Answer. That is vitally important, of course, but it is only one element in the

picture. If we can slow down the inflationary spiral, that will automatically help to keep imports in check, because domestic prices will be more competitive. This would also help to widen our range of exports.

But we need to do much, much more than that. For example, this country needs a better means of financing exports. U.S. exporters today are not at all competitive in the financing terms they can offer buyers in other countries—and it is essential that they should be competitive. In our Department, we are spending a lot of time on this problem, working with Henry Kearns, the president of the Export-Import Bank, and with the Federal Reserve Board.

Question. What are other countries doing to help increase their own foreign trade?

Answer. Among other things, they are providing larger amounts of credit for their exporters for longer periods of time, and often at lower interest rates than are available to exporters in the U.S.

Question. Does this mean that governments of some countries subsidize exports?

Answer. Yes, in some cases. There is a tendency abroad to hold down interest rates on money that finances exports, regardless of the movement of money rates in their domestic economy.

In the U.S. we don't do that. Export-financing costs here follow the movement of our interest rates, so at a time like the present, when interest rates are the highest in years, U.S. companies that want to sell abroad are at a deep disadvantage.

Question. Should we follow the pattern set by our competitors and subsidize interest rates for American firms that sell things abroad?

Answer. I think we have to be competitive with other countries, and if that means subsidizing interest rates, then we should find a way to do it.

Question. Should we also provide tax credits for exporters?

Answer. That is a matter we are studying. There are several ways in which our Government could help exporters through direct tax credits or tax deductions. Some of these steps could be taken without any new laws; others would require action by Congress. We are not prepared to say yet which might be the most feasible. Before the end of the year, however, we are hoping to find ways in which the tax system can be used to benefit exporters.

HOW BORDER TAXES HURT—

Question. Do U.S. exporters run into problems from taxes in foreign countries where they sell goods?

Answer. Yes. A particular problem is the growth of border taxes abroad—taxes on goods moving into a country. An American company that wants to market its products in a country with a border tax has to pay that levy if it wants to make the sale.

In many European countries, these border taxes are a reflection of value-added taxes, imposed at various stages of the manufacturing process. There are plans now in the Common Market to get those European countries together on a uniform value-added tax on all manufactured goods, at about 15 per cent of the total price of the goods. That tax would apply to citizens of the countries involved. But U.S. exporters who wanted to sell within the Common Market would have to pay the same 15 per cent when their goods entered a member country, even though they already were priced to include our domestic taxes.

The disadvantage faced by an American producer is even more evident in dealing with a third country. A competitor in a country with a 15 per cent border tax receives a refund of that tax from his government on all exports to another country. The American company gets no such refund of the domestic taxes it pays.

All of this is the result of a major difference between tax systems. In the U.S., we collect most of the taxes by direct levies on corporations and individuals. In Europe, a high proportion of revenues is collected on merchandise, and it is these so-called indirect taxes that are reflected in the border-tax rates that are assessed on imports and rebated on exports.

We in the Commerce Department are coming to the conclusion that there should be serious study of a value-added tax in the U.S. as a partial substitute for other types of excises and income taxes.

Question. Have you made such a recommendation?

Answer. We have not as yet. But we want to study this possibility further with the Treasury Department to be able to make a recommendation, pro or con, at an early date.

OTHER HURDLES FOR U.S.—

Question. Besides taxes, are there other things that cut the flow of U.S. goods into foreign countries?

Answer. Yes, besides tariffs there are a great many kinds of nontariff barriers that restrict trade.

Question. What are some of them?

Answer. One example is the restrictions other countries put on the purchases of products by their government agencies or by nationalized industries. These tend to effectively shut out American goods.

Then, in addition, many countries put difficult technical requirements on imports for the purpose of regulating health or safety. In some cases, foreign governments actually subsidize exports by one means or another. And there are hundreds of other nontariff barriers that impede our exports.

Question. Do we in the U.S. have some of these nontariff barriers, too?

Answer. Yes, we have some restrictions on imports that are highly criticized by other nations. The "Buy America" law is one. But this Act specifies very clearly the exact measure of disadvantage a foreign company has in selling to the U.S. Government or its agencies. No other country has the equivalent of this law, and in most countries such transactions are foreclosed to American producers by local administrative procedures.

By and large, we do not have anywhere near the trade restrictions that other countries have, and that makes for a lack of reciprocity in our trading relationships.

Question. In your recent travels abroad trying to get trade barriers lifted, what attitudes have you found?

Answer. Governments of most countries agree that these bars to trade ought to be eliminated, or at least considerably reduced.

On behalf of the U.S., I have proposed what we call an "open-table policy"—a suggestion that we put all the facts about trade barriers and restrictions out in the open and try to find ways to reduce their number and their impact. In almost every case, this proposal has been welcomed, and steps are under way now to set up meetings at which these things can be explored.

Question. What about the Japanese? Are they co-operating?

Answer. The Japanese Government has not endorsed the principle as wholeheartedly as some other countries. Japan has more than 120 different quantitative restrictions on imports. Those restrictions are in violation of their commitment under the General Agreement on Tariffs and Trade—the so-called GATT agreement.

On the other hand, our own trade difficulties with Japan have been related in large measure to timing. We have been pressing them for some time to cut trade barriers and to make it easier for our people to invest there. They have set up a timetable, but it is much too slow, particularly since our trade balance with Japan last year was a negative 1.1 billion dollars, and probably will rise to a negative 1.5 billion this year.

On the positive side, for the long term, I believe the Japanese are slowly coming to the conclusion that their position as a major world power requires them to assume a greater degree of international reciprocity, and thus to modify some of their trade restrictions.

Question. Since a major trade worry now centers on textile imports from Japan, are you proposing some special kinds of voluntary import restraints?

Answer. Yes. We have proposed that an international agreement be negotiated with key exporting countries as a solution of this problem. Our concern over textile imports involves not only Japan but a number of other countries in the Far East and elsewhere. President Nixon and his Administration recognize it as a unique type of problem that requires a special approach. The situation is this:

For certain kinds of textiles and apparel, mostly from synthetic fibers and wool, the U.S. is the only open market in the world. Every other major nation has put restrictions on imports of those items. As a result, the producing countries all are directing their output toward the U.S., and are increasing their capacity at an outstanding rate. This has brought a tidal wave of imports that the domestic industry simply hasn't been able to combat. Just on apparel from synthetic fibers, U.S. imports from Japan were up 51 per cent in the first six months of 1969, compared with the same months last year.

Question. Has this posed a critical problem for textile manufacturers here?

Answer. Yes. The labor organizations are greatly exercised at the loss of employment and the necessity for closing plants in some communities. And produc-

ing companies are finding their profit margins shrinking. Wage rates here are several times as high as those of our large overseas competitors.

Question. What can be done about it?

Answer. We think it can be handled by an orderly system of marketing. We are telling textile producers in Japan and elsewhere: "We do not ask you to reduce the level of your shipments to the U.S. We are willing to accept the 1968 level and even permit an increase, year by year, as our total market grows. No one in your country need lose a job and no one in the U.S. need be forced out of work."

In other words, we are seeking to hold imports to a moderate rate of growth, rather than permitting the massive increases that have been taking place in the past few years.

Question. Why not work through GATT and get the countries that have put barriers on imports of textiles across their own borders to reduce those barriers, so the U.S. doesn't have to absorb the whole flood?

Answer. None of the countries we have talked to is willing to do that. They feel that a degree of protection is necessary for their own industries.

Here, obviously, is a perfect example of the unworkability of an absolute free-trade policy. There is no really free-trade country in the world. Every nation has some barriers to trade, over and above tariff walls, to protect what it considers its long-term interests.

So the U.S. has to face the textile problem on that same basis, and find a way to moderate the rate of imports. This unusual situation does not contradict President Nixon's basic belief in a freer trade policy.

Question. Are there other products besides textiles where manufacturers are demanding protection from foreign products?

Answer. Yes. Congress has been getting complaints from producers of shoes, steel, electronics, flat glass and other items. In some of these instances, adjustments to the import problem might be made by the industries concerned. But I believe that we need better legislation than now exists to help companies that are clearly harmed by excessive imports.

Question. Isn't there an "escape clause" in existing law that is supposed to help companies that are being hurt?

Answer. Yes, but that provision is ineffective. The law is so tightly written that no company up to now has been able to qualify for aid.

Question. What changes do you propose?

Answer. The President should be given more authority to adjust tariffs in such cases, and access to financial and other assistance should be liberalized for a company and its workers who are clearly being harmed by excessive imports.

Question. More and more American companies are setting up plants in other countries to manufacture goods for the foreign market. Doesn't income from those subsidiaries help offset a falling-off in exports from the U.S.?

Answer. Yes, to a degree—and this source of income will grow increasingly significant as time goes on.

However, many American companies with subsidiaries overseas that were originally created just to supply foreign markets now are finding it profitable to send some of their merchandise back to the United States. In the future, it may be necessary for more U.S. companies, in their own interest, to move into the low-wage areas of the world and produce for the U.S. market. This is a matter of great concern to us, because it means exporting jobs to other countries.

Question. How much has that meant so far in taking jobs away from American workers?

Answer. There is really no way to document that or quantify it. We are in an expanding economy with high employment, so it is difficult to measure this kind of loss. But, as a result of more and more U.S. companies moving into the low-wage areas of the world, we do know that we are suffering a definite loss of job opportunities—now and for the future.

WHERE EXPORTS WILL GROW—

Question. In what fields of U.S. industry do you foresee the greatest growth of exports in days ahead?

Answer. We have identified 17 categories of American manufacturing in which we see the greatest opportunity for export growth. At the top of this list is commercial aircraft, in which the U.S. has pre-eminence in the world. Next are computers and high-technology components in electronics. Chemicals are high on

the list, and there are others, such as nuclear power plants, telecommunications systems, instrumentation and measuring devices, materials-handling equipment, and so on.

Question. What else is our Government doing, in addition to trying to increase exports, to improve our balance of payments with other countries?

Answer. The Commerce Department has the responsibility in two other areas which directly affect our payments balance. One has to do with travel, the other with investments by U.S. companies overseas.

In the case of travel, the U.S. presently has a "travel gap" of about 2 billion dollars a year. That is the amount that Americans spend in other countries in excess of what people from other countries spend here.

We are pushing an active campaign to induce more people abroad to visit the United States. We are expanding the program this year to induce travel agencies to offer flat-price package and group tours to foreigners to visit the U.S., and we are trying to get business and professional groups from other countries to hold conventions in this country.

In the case of direct control over foreign investments, we recognize that this is not a desirable long-range program. We want to eliminate it. We are continuing it now only because of the current stringency in the balance of payments.

Under present controls, the amount of American investment that will be permitted overseas in 1969 is about 3.35 billion dollars. That is in terms of actual net investment, but will be augmented, of course, by money that can be raised by American companies in foreign markets.
by American companies in foreign markets.

This limit is not a severe impediment to business in the present economic climate. As soon as the balance-of-payments situation permits, the Administration will want to remove the remaining controls on overseas investment.

Question. In the meantime, should measures be taken to restrict American travel abroad?

Answer. As you know, the Johnson Administration proposed some restrictive measures, and even taxes on spending by U.S. travelers abroad. President Nixon has decided against any proposals of this type.

We would very much like the American people to see their own country first. But, beyond exhortations of that type, we have no plans to make it more difficult for Americans to travel to other countries.

The CHAIRMAN. Secretary Stans, in that article, indicated that he is hopeful that before the end of the year there will be found ways in which the tax system can be used to benefit U.S. exporters.

Is the Treasury Department actively cooperating with the Commerce Department in seeking to improve our balance of payments by means of tax incentives for exports?

Mr. PETTY. The short answer to the question is: "Yes, sir." There is a subcommittee of Secretary Stans' Export Strategy Committee, which is directing its attention specifically to the issue of export tax incentives, and this is a matter currently under review.

The CHAIRMAN. Now, I believe it was also indicated in the same article that border taxes by European countries have an adverse effect on U.S. commerce, both exports and imports. You were a member of the U.S. team trying to negotiate border taxes with foreign countries. Why has there been such little progress in this critical area?

Mr. PETTY. I think, Senator, this is primarily a commentary on the complexity of the problem. The negotiations and discussions which have been going on for over a year at the GATT have, I think, achieved one step. It is unsatisfactory because of the pace, but it is a necessary preliminary for progress, and that is to demonstrate successfully that a problem exists, to educate the other parties that the present system of GATT on border taxes is not trade neutral, and this is, as I say, a necessary precondition to progress.

The talks are now at the specific stage of seeing what administrative, definitional and procedural aspects in the border tax situation can be agreed to. The provisions within the GATT have evolved without a great deal of predesign. We had a mass of procedures by which countries employ their own border taxes. We do not agree on what the definitions are, and the working party is currently addressing itself to this aspect of the problem.

On the broader question, which I think is also behind your question: What is the ultimate solution to the border tax problem when the existing GATT rules are not trade neutral? This is a matter which is currently under examination within the administration.

The CHAIRMAN. You made a speech in Toronto on November 20, 1968, which I will place in the record at this point.

(The document referred to follows; testimony continues on p. 64:)

BORDER TAX ADJUSTMENTS AND THE GENERAL AGREEMENT ON TARIFFS AND TRADE BY HON. JOHN R. PETTY, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, U.S. TREASURY DEPARTMENT

INTRODUCTION

Introducing my subject has been made immeasurably easier as a result of a recent article in the September–October issue of *The Canadian Tax Journal*.[1] Mr. Robert Latimer, the author, has done an admirable job in defining "The Border Tax Adjustment Question," and lucidly pointing up the issues. His article provides an added timeliness to the need I see for a discussion of this subject.

At the outset, let me say that the importance the United States attaches to the issue of border tax adjustments was signaled by President Johnson in his 1968 New Year's Day Balance of Payments Message, when he declared:

"In the Kennedy Round, we climaxed three decades of intensive effort to achieve the greatest reduction in tariff barriers in all the history of trade negotiations. Trade liberalization remains the basic policy of the United States.

"We must now look beyond the great success of the Kennedy Round to the problems of non-tariff barriers that pose a continued threat to the growth of world trade and to our competitive position.

"American commerce is at a disadvantage because of the tax system of some of our trading partners. Some nations give across-the-board rebates on exports which leave their port and impose special border tax charges on our goods entering their country.

"International rules govern these special taxes under the General Agreement on Tariffs and Trade. These rules must be adjusted to expand international trade further."

I believe it would be useful to provide the background for this passage. First, let me review the history of the border tax adjustment problem, and then go on to bring this subject up to date by discussing the multilateral negotiations now under way in GATT.

BACKGROUND

The General Agreement on Tariffs and Trade was intended to institutionalize the system of international trade much as the International Monetary Fund was designed to provide rules and order to the international financial system. Both sprang forth from the despair of war and the hopes kindled by the prospects of peace. Each has made a substantial contribution to economic growth, trade and prosperity that exceeded expectations.

However, the world of 1968 is a different world than that of 1946. New demands are now being made of these tried institutions and some are being met. We are now in the process, for instance, of amending the articles of the IMF to make provision for Special Drawing Rights which will better meet the international monetary needs of the future. A fresh look at the GATT is called for, too.

Highest on the priority list for this fresh look are those provisions pertaining to border taxes. The problem here, in brief, is this:

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[1] Robert Latimer, "The Border Tax Adjustment Question," *The Canadian Tax Journal* (September–October 1968).

The GATT permits member countries to provide a full rebate for *indirect* taxes levied on their exports and to impose equivalent border taxes on imports. On the other hand, GATT prohibits any rebate or import levy for *direct* taxes.

The basic premise underlying these provisions is now being widely questioned. At one time, theorists argued that the burden or incidence of indirect taxes was *entirely* passed on to consumers, while direct taxes were *wholly* absorbed by producers. The GATT rules reflect this supposition. However, it is increasingly recognized today that this is not the case in actual practice and that as a result the border tax adjustment rules of GATT bestow trading advantages on countries which employ multi-stage indirect taxes.

HISTORY

The provisions in GATT relevant to border taxes, basically Articles II, III and XVI, are drawn from the Havana Charter of the 1940's which was intended to found the International Trade Organization. These provisions were themselves either a comprise (for example, Article XVI) or were adapted from provisions of numerous bilateral trade treaties, including especially the U.S.-Canada reciprocal trade agreement of the mid-thirties.[2] There is no unified section of the GATT which deals exclusively with border taxes and it is quite clear that the provisions of the GATT which cover border tax adjustments were not the product of a carefully reasoned theory, or of experience molded in the crucible of extensive usage. The lack of precise or concentrated thinking about the border tax problem is illustrated by the absence of explicit definitions of key concepts.[3]

In view of the symmetry implied in border tax adjustments, an interesting historical note is that the provisions on the compensatory tax on imports and the relief of indirect taxes on exports developed quite separately. The GATT rules concerning these two elments of border tax adjustments are found in several articles of the General Agreement and in related interpretive notes and Working Party reports. The basis for the application of compensatory taxes on imports is found in Articles III:2 and II:2(a), which deal primarily with the relationship between internal taxation and imports. The provision with respect to exports is found in Article XVI, which deals with subsidies. This is hardly the handiwork of a drafter intent upon transcribing the destination principle of taxation into a permanent international agreement.

Import Tax Burdens.—Article III:2 limits the imposition of internal charges on imported goods to the amount of those charges applied directly or indirectly to like domestic products. By reference to Article III:1, provision is made that such charges on imports shall not be applied "so as to afford protection to domestic production." Article II:2(a) explicitly provides that a limitation on increasing the tariff on goods bound through international agreement does not prevent the imposition or increase of compensatory border taxes.

Export Tax Relief.—The 1946–47 version of Article XVI only contained a notification and consultation procedure in cases where the trade effects of subsidies are considered to be serious. It did not define subsidies nor how to limit them.

It was not until the GATT Contracting Parties reviewed the various articles of the General Agreement in 1954–55 that a partially successful effort was made to answer these two questions. In reaching partial agreement a rule with respect to export tax relief was made by the following interpretive note:

"The exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not to excess of those which have accrued, shall not be claimed to be a subsidy."

While the focus of this change limited the definition of an export subsidy there was, however, no elimination of subsidies.[4] Instead it was agreed that

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[2] 49 Stat. 3960 (1936). Effective May 14, 1936.

[3] For example, the meaning of the phrase linking the import charge at the border with "charge . . . applied, directly, or indirectly, to like domestic products" was not given.

[4] Although no attempt was made to define what was meant by duties or taxes borne by the like product, examination of the discussion at the Review Session related to Article VII (dealing with customs valuation) provides some clarification. During these discussions it was agreed that the note to Article XVI would permit the exemption from, or remission of: "Only (i) internal taxes of the kind which are levied directly on the goods exported (or directly on the materials going into the manufacture of such goods), as distinct from (ii) other taxes (income tax, etc.)". Although this provides some guidance on the question of direct and indirect taxes, it does not indicate the status of "hidden taxes" (i.e., those not imposed on the exported product itself or on the materials incorporated in the product).

there would be no introduction of new, nor extension of existing, subsidies on manufactured goods.

The long negotiation to find language to limit the use under GATT of export subsidies achieved a breakthrough in 1960 when the United States and the other industrialized countries in the GATT agreed in a Declaration to cease granting export subsidies on manufactured products.[5] The Working Party report which constituted the basis for the Declaration contained a list of measures considered as forms of export subsidies. By indirection, this extended the interpretive note to Article XVI by excluding from the definition of an export subsidy the rebating or exemption of multi-stage indirect taxes. Clearly, the implications of this Declaration were not adequately considered by the United States. Part of the reason was, perhaps, due to political considerations: the U.S. did not want to appear to be raising obstacles to the tax harmonization objectives of the European Common Market. Nevertheless, there must have been some concern with the interpretation of this article because a special provision for review of the operation of the provisions of Article XVI were inserted at the Review Session. The drafters did not seem content to rely on Article XXX which provides for the review and amendment of all of the GATT Articles.

CONCLUSIONS ON HISTORY

This brief review of the GATT articles demonstrates that there is no consistent rationale behind the GATT rules on border tax adjustments, nor clear-cut guidance on the meaning of the GATT provisions. Articles II and III were incorporated almost in their entirety from existing practices, probably modeled after a U.S.-Canadian commercial treaty.[6] The separate treatment of the import duties and the history of clarifying the status of export remissions confirms that no consistent consideration was given to this subject; certainly no specific economic theory was used as the underpinning for the treatment of border tax adjustments. Instead, it would appear that the matter of "border tax rules" was not even a contentious issue. Rather, these rules simply codified certain practices.

It is not surprising that the drafters of the GATT were willing to accept the status quo. Problems quite apart from the question of border tax adjustments demanded the attention of the drafters. In a postwar, exchange-control world, where fixed exchange rates were at best approximations of reality, concerned voiced about the discrimination that would arise if the world shifted to a buyer's market would probably have been met by some retort such as "we'll worry about that problem if and when it ever arises." Little wonder. In the late 1940's and early 1950's, border tax rates were low—in the range of 2–4 percent—and limited to around one-sixth of the goods traded—and then only in the case of a few nations. Furthermore, a seller's market existed in which demand was highly unresponsive to small price variations. Finally, the $10 billion commercial trade surplus of the United States in 1947 must have had an effect on the attitude of the U.S. negotiators. This is best illustrated by the then prevalent and understandable U.S. policy of deliberately encouraging a transfer of financial assets to Western Europe in order to facilitate European reconstruction.

1953 OEEC REVIEW

As early as 1953 there began to be some recognition of the fact that border tax adjustments could create advantages for nations using them. The likelihood of this occurring tended to grow as other barriers to trade fell, and the adjustments were substantially increased. This recognition came in the Working Party on Artificial Aids to Exporters, part of the OEEC Steering Board for Trade. This

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[5] The 1960 GATT Working Party on Subsidies Report stated that the governments prepared to accept this Declaration agreed that, for the purpose of that Declaration a list of certain enumerated practices "generally are to be considered as subsidies in the sense of Article XVI: 4." This Report, which contained the direct/indirect tax dichotomy in the list of practices was adopted by the Contracting Parties, the most important representative body within the GATT organizational structure. However, the Contracting Parties did provide for a review of the provisions of Article XVI, Paragraph 5 of Article XVI states:

"The Contracting Parties shall review the operation of the provisions of this Article from time to time with a view of examining its effectiveness, in the light of actual experience, in promoting the objectives of this Agreement and avoiding subsidizaton seriously prejudicial to the trade or interest of Contracting Parties."

[6] During the 1930's, when this treaty was written, exchange rates fluctuated. There was probably little concern about the price effect of the import adjustments as such effects would be absorbed by exchange rate changes.

Working Party discussed the possible trade diversionary effect of the introduction of the French value-added tax. Some opposing views existed and one of the participants (and then committee chairman) offered a proposal designed to limit the distortion to trade from full tax remissions. The proposal was an attempt to reach a compromise between divergent views and to prevent a disastrous race between OEEC countries in the area of fiscal incentives. The basic provisions of the proposal were:

(1) Full relief of exported goods from a single-stage indirect tax would be permitted;

(2) A *limitation* would be placed on the total amount of relief exported goods could obtain from *other forms of indirect taxes and from direct taxes.* The limit would be set as a percentage of the value of the goods at the point of export;

(3) A transition period would be established in order to permit nations to reach the common limit; and

(4) A consultation procedure would be established.

It is interesting to note that this proposal explicitly recognizes a divergence of views concerning (a) the effects of remissions of direct and indirect taxes; (b) the difference between single-stage and multi-stage indirect taxes; and (c) the need for some limitation to these adjustments. The suggested solution presented a pragmatic and arbitrary solution to a difficult theoretical and political problem. Unfortunately, there was not enough awareness of the significance of the proposal, and other members of the Working Party were unwilling to moderate their positions.

OECD BORDER TAX CONSULTATIONS

In 1963, U.S. concern about the trade effects of border taxes was further aroused by the decision of the member states of the EEC to harmonize their tax systems, by adopting the value-added tax (TVA). The U.S. Government requested the OECD to undertake a careful and comprehensive study of border tax adjustments. In making the proposal, the U.S. stated: "A study of this subject is particularly timely at the present moment. A number of countries which impose turnover tax adjustments at the border are contemplating changes in the level of such compensatory adjustments, others are considering a change in the method of applying the tax (e.g., a change from the cascade to a value-added type) and some countries which heretofore have not employed a general sales tax by the central government are considering introducing it . . ."

In order to create a better atmosphere in which to review border tax adjustments, the U.S. sought agreement in the OECD for a *standstill* (i.e., a temporary agreement not to make border tax changes). The Common Market countries opposed the idea, arguing that agreement on a standstill would interfere with their objective of attaining a harmonized tax system by 1970. They were, nevertheless, prepared to agree to a notification procedure which would keep the OECD countries informed about actual and contemplated changes in border tax adjustments. They also were prepared to agree to consultation in the OECD on these changes. This notification procedure was adopted as a second best solution.

In 1967, at the request of the United States, an *ad hoc* group of the OECD undertook a consultation with Germany on the general trade and payments effects of the German Government's announced switch to a value-added tax system scheduled for January 1, 1968. A series of carefully prepared meetings followed. The discussions in this OECD group revealed a considerable difference of opinion on the effects on trade of border tax adjustments. The German delegation not only argued that the TVA was perfectly trade neutral but also that the shift from the then existing cascade type indirect tax to a TVA system would not appreciably improve German's competitive position. This contention was supported by German's EC partners. This is curious, because during this same period three of these countries—France, Belgium, and the Netherlands—were simultaneously moving to increase the level of their own border tax adjustments *for the publicly acknowledged purpose of combating the impact on their trade of the German changeover.*[7] Ironically, the notification procedure worked best for those countries which felt no necessity for it.

[7] See e.g., (a) French Finance Minister Debre's speech to the OECD Ministerial Meeting, November 30, 1967; (b) Dutch Finance Minister DeBlock, Memorandum to the Dutch Parliament, October 4, 1967; and (c) Belgian Cabinet Communique following their meeting

This explicit and public recognition by Common Market governments of the trade effects of the German changeover of their indirect tax systems destroyed the German contention that the shift was of no significance to international trade.

Testimony of European businessmen further demonstrated the true picture. The Business and Advisory Committee (BIAC) to the OECD, gave practical evidence of the serious limitations of the theory underlying border tax adjustments.[8] Briefly, the essence of their views was that "in a strongly competitive situation the prices obtainable—and hence the degrees of tax shifting—are substantially determined by the market itself." If this report is correctly interpreted, they hold that there are a great variety and interdependence of factors which influence tax shifting, but primary importance is attached to the market situation. Of course, if economic conditions are buoyant, there may be a greater possibility of tax shifting than in a depressed and declining economy, just as there is a greater possibility of increasing profits. It seems to me that even though it is extremely difficult, if not impossible, to measure the degree of tax shifting, it is grossly inequitable to maintain, as the GATT rules do, that indirect taxes are *always fully* shifted forward into product prices. By the same token it is wrong to hold that no direct taxes are ever shifted—forward—to any degree. Perhaps most significant, and for the economist most difficult to measure, is the fact that today we have much more of a buyer's market than existed during World War II and immediately thereafter when the GATT rules were drafted. Not only is there increased competition among firms, but the freer trading world fostered by GATT advances substantially the size and number of competitors. Moreover, the development of competitive products (e.g. steel and aluminum) expands the range of competition.

MOUNTING CONCERN IN THE UNITED STATES

In the United States, concern about the adverse trade effects of border tax adjustments has been mounting steadily, not only in the Executive Branch of the U.S. Government but in industry and the Congress as well.

Individual companies have spent considerable time and effort analyzing the effect of changes in border tax adjustments on their exports. Industry associations, such as the Manufacturing Chemists Association (MCA) and the National Association of Manufacturers (NAM), to name but two, also have taken a hard look at the problem.[9] And the key Congressional committees concerned with this problem have looked into this subject. In statements recently submitted to the House Ways and Means Committee the two trade associations mentioned above pointed to the increasing awareness that United States exporters clearly face a competitive disadvantage arising from the GATT rules on border tax adjustments.[10] In another indication of concern, the Action Committee on Taxation of the National Export Expansion Council, early in 1966, expressed the view that the GATT rules on border taxes "are discriminatory against the United States" [11] and specifically called for a renegotiation of GATT.

As for America's position at intergovernmental meetings, the U.S. representative to the OECD Consultations on Germany repeatedly voiced concern about the trade effects of the changeovers in indirect tax systems occasioned by the EC tax harmonization. He pointed out that increases in border tax adjustments

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at Knakke. To illustrate the nature of these comments the following is an excerpt from DeBlock's statement:

"They (ed.: the government) feel, however, that Dutch industries are right in fearing that they will be adversely affected as a consequence of such a change (ed.: adoption of German TVA) in the situation in Germany. . . . there is sufficient reason to take legislative measures ensuring that international competitive position of Dutch industry does not deteriorate too much."

These related actions demonstrate the tendency towards proliferation inherent in the present GATT rules. The absence of a limitation invites other countries to take similar action.

In a recent official paper, the German government has in fact admitted that the changeover to the value added tax had a substantial effect on export prices.

". . . in contrast to earlier Government expectations, the changeover to the value-added tax system after all turned out to favor exports from the point of view of prices. At any rate, average export prices declined by 2.2 percent from January to September."

Ministry of Economics, "The Necessity for Protection Against External Economic Influences," Section 1, informal translation by U.S. Embassy, Bonn, Germany, November 29, 1968.

[8] Unpublished report dated June 1967.

[9] The Logic of the Border Tax Mechanism, Government Finance Division, National Association of Manufacturers, October 1965.

[10] Hearings before the Committee on Ways and Means, House of Representatives, 90th Congress, Part 10, p. 4489.

[11] Taxation and Exports, Action Committee of the NEEC, February 1966, p. 17.

would compound the trade advantages gained by the indirect-tax countries. Moreover, he said, for a country with a large balance of payments surplus to undertake a changeover at that time was directly contrary to its responsibility to the better working of the process by which international balance of payments adjustment is achieved. The August 1966 report of working Party 3 of the Economic Policy Committee of the OECD recognized the responsibility of balance of payments surplus countries, and on this particular issue it said:

"It was noted that on occasions when the national structure or level of indirect taxation was being reformed, the accompanying change in export rebates or import levies or other adjustments can have an impact on international trade, and that further consideration might be given to the question whether countries could undertake to take account of their prevailing balance of payments situation in deciding on the timing of such changes in 'border tax' adjustments." [12]

Germany's January 1, 1968 changeover from a cascade type turnover tax with a rate averaging 4 percent on each turnover to a value-added tax of 10 percent on most commodities perhaps did more than any other single act to solidify a U.S. Government attitude that more equity must be achieved in the GATT rules as they pertain to border taxes.[13]

Therefore, the U.S. pursued the issue in the GATT forum itself. Ambassador Roth, the President's Special Trade Representative, called attention to our serious concern over non-tariff barriers in his statement at the GATT Ministerial meeting on November 23. These measures adversely affected our trade, and he asked GATT to press ahead and organize itself for a timely resolution of this problem. This initiative resulted in the GATT Ministerial Meeting agreeing to the formation of groups to deal with:

(1) Non-Tariff Barriers
(2) Border Taxes
(3) Subsidies and Countervailing Duties

It was believed that with these groups working concurrently, each at a pace suited to its own purpose, a framework conducive to achievement would be established.

On January 1, 1968, President Johnson called attention to the disadvantage to U.S. trade posed by the provisions of the GATT rules on border tax levies and rebates and called for adjustment of these rules. In March of 1968, the United States reviewed the problem with the GATT Council and established the terms of reference for a Working Party to examine the problem of border tax adjustments. On April 30, this Working Party began discussions. It is now under way in its task.

GATT NEGOTIATIONS

At the initial meeting of the Working Party, April 30–May 2, the U.S. raised three general problems which we believed should be corrected. First, the GATT border tax rules are inequitable. We questioned whether there should be any border adjustments to compensate for differences in taxation. If there must be border adjustments, then they should be designed to equate the price effect of all taxes—direct as well as indirect. The current GATT rules on border tax practices, limiting adjustment to indirect taxes (and then 100%) do not reflect adequately this principle.

The second general problem concerns the trade diversionary effect of changes in border adjustments; in addition, it is concerned with the relationship of the timing of such changes to the balance of payments adjustment process.

The third area of concern is the ambiguity in the present rules which allows protective national practices to be justified by interpretations that are at times self-serving. This ambiguity illustrates the need for more precise definitions and a code of practices.

Elaborating on the first general problem associated with the GATT, the present border adjustment rules apply the origin principle to direct taxes and the destination principle to indirect taxes.[14] Under the destination principle pro-

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[12] Organization for Economic Cooperation and Development, *The Balance of Payments Adjustment Process,* A Report by Working Party 3 of the Economic Policy Committee (Paris: OECD, 1966), pp. 23–24.

[13] See U.S. Treasury Department, "Maintaining the Strength of the United States Dollar in a Strong Free World Economy" (Washington: Government Printing Office, 1968), p. 74.

[14] For a brief discussion of the destination and origin principles, see Carl S. Shoup, "Indirect and Direct Taxes and Their Influence on International Trade, a paper submitted to the House Ways and Means Committee, June 1964.

ducts are taxed at the point of consumption. Since exported products are consumed abroad they should not pay the indirect tax that would pertain if the goods were consumed at home. Therefore, exports are relieved of the indirect tax burden. Imported goods, on the other hand according to the destination principle, should carry the same indirect tax burden to avoid a "privileged position" over goods produced domestically. Accordingly, tax frontiers are established at the border. On the other hand, it is argued that regardless of the rate of direct taxes, the sales prices of the products are unaffected. Consequently, border adjustments would not be justified, even if the destination principle were employed for direct taxes because the direct tax is presumably not passed on to the point of consumption.

In contrast, the origin principle states that goods should be taxed at the point of production; thus, border adjustments are not permitted. It is the origin principle toward which the Common Market is moving for transactions between member states. Interestingly, the Common Market decision to harmonize tax systems and eventually to adopt a common tax system was based on the desire to eliminate tax frontiers. The argument was advanced that such frontiers constitute both a psychological and a real obstacle to a truly free exchange of goods and services.

The origin principle must not be overlooked in seeking a solution to the border tax problem. Adjusting for indirect taxes mean that one aspect of government policy is singled out for special treatment. There are no adjustments for a wide range of other government measures which directly affect prices. Nor are there adjustments for many forms of taxation which affect prices. Frequently, government economic policies affect private industry and trade but they are not necessarily accompanied by offsetting action. Moreover, many of the governmental services financed by indirect taxes may be provided through the private sector in other countries. To this extent, the border tax adjustment rules have an influence on the distribution of activities between the government and private sector. This is a wholly inappropriate by-product of the GATT rules. Only in the case of indirect taxes is there an institutionalized provision for offset.

Modern economic theory suggests that the distinction implicit in the GATT treatment of direct and indirect taxes is an extreme and arbitrary assumption which does not stand the test of economic reality.[15] While economists and businessmen may disagree on the extent of the forward shifting of indirect and direct taxes, they do agree that the extreme assumptions which are necessary to make the present GATT rules trade neutral are an inadequate approximation of reality. Therefore, a border adjustment equivalent to the full internal indirect tax tends to stimulate exports and provide protection against imports.[16] In brief, the present provisions of the GATT divert trade and thereby disadvantage countries such as the United States and Canada which rely primarily on direct taxes.

Not only are the GATT rules unfair, they are illogical and unreasonable. There is a contradiction between the way in which direct taxes are treated in the provisions relating to subsidies and in the provisions relating to border tax adjustments on the import side. If the remission of direct taxes is considered a subsidy, this is presumably because it is felt that this would have an effect on the price of the exported products. But if direct taxes had an effect on price, it could be argued that adjustments should be made in respect to them at the border. Furthermore, there should be no presumptions about the administration of direct tax remissions being more difficult than indirect tax remissions and thus no additional concern about the price effects of the former due to administrative problems.

The second general problem concerns changes by a nation in its border tax adjustment practices. There are three categories of changes: (1) When the level of the indirect tax within the country and at the border is changed by the same amount. Germany's 1% increase on July 1 is a case in point; (2) When the amount of adjustment at the border is different from the domestic level of the tax and this difference is "corrected". (A level of adjustment lower than the

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[15] The material on shifting of general taxes has become quite extensive. For a review of the debate, see John F. Due, "Sales Taxation and the Consumer," *American Economic Review* (December 1963), pp. 1073–84.

[16] Stanley S. Surrey, "Implications of Tax Harmonization in the European Common Market," a speech before the National Industrial Conference Board, New York (February 1968).

tax is "under compensation"; a higher level of adjustment is "over compensation"). Belgium's increase in border adjustments in 1967 and 1968 are examples of a country moving from "under compensation" to "full compensation". The German border tax change in November 1968 is an example of a move from "full compensation" to "under compensation". It is argued that the German change on January 1, 1968, included a few cases of "over compensation" going to "full compensation"; (3) The third involves the changeover resulting from the adoption of a new type of indirect tax. Germany did this on January 1, 1968 and the Netherlands will do it a year later.

Within the three categories mentioned, changing the degree of adjustment at the border without commensurate changes in the relevant indirect tax brings about the most striking effects on trade. Other changes are considerably more difficult to measure—but frequently no less significant in their impact upon trade.

The increasing use of border adjustments suggests, however, that governments actually believe there are trade effects. In any case, changes in border tax adjustments to eliminate "under compensation" clearly have favorable trade effects on the country making the change. The increase in the export rebate and import surcharge can be looked at as having exactly the same effect as a devaluation on the trade account—it improves the competitive position of the country making the change and thereby strengthens their trade account. Such actions by a trade surplus country exacerbate the problems of countries working toward balance of payments equilibrium and are directly counter to the surplus countries' responsibilities to assist the international adjustment process.

The third general problem with the GATT border tax adjustment rules concerns the extent to which the lack of trade neutrality is aggravated by techniques used in the administration of border tax adjustments. For example, (a) the necessity of using averaging techniques to determine the amount of adjustments, as is the case in any Cascade System[18]; (b) by the inclusion of secondary indirect taxes (taxes occultes) which are not "borne by the produce", in border adjustments; and (c) the arbitrary assumption of tax and subsidy allocation on grain sales within the EC on agricultural products. These technical determinations are left open to national judgment because of the lack of precision in the GATT rules and by the complexity of the issues. Assumptions employed by fiscal and trade technicians are not likely to err on the side of trade neutrality.

Due to the complexity of manufacturing processes, the difficulty of cost accounting and the varying tax systems of the countries making border adjustments it is impossible to accurately determine the indirect tax acually borne by domestic goods. The "real number" is a changing number in any event—by product and in response to market factors. This is likely to be more true of a multistage turnover tax than a single stage retail tax. As products undergo varying stages of production, the tax burden will vary between commodities. In order to avoid the task of ascertaining the tax burden on each commodity, averages are used to determine a mean rate for a commodity class and the appropriate border adjustment. By their very nature, averages result in trade distortion as some commodities receive adjustments in excess of the domestic tax burden while other commodities are "under compensated."

The GATT rules permit adjustment for taxes levied on or borne by goods. Although there is not much confusion about the fact that GATT, as presently drafted, classifies corporate income taxes as direct, there is a large controversy about the status of other taxes. Many countries adjust for taxes on such items as gasoline, general overhead expenses, capital, etc., taxes which are difficult to consider as levied on a specific product. We believe the arbitrary adjustment for such taxes, often referred to as *taxe occulte*, is contrary to the GATT rules and trade diversionary in effect.

The combination of erroneous shifting assumptions, taxe occulte, averaging and changes in border tax adjustments combine to make the present GATT rules far from trade neutral; in fact, they are damaging to your trade and ours.[19]

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[17] This was the case for integrated companies.

[18] In a cascade system, the tax burden on a product depends in part on the number of transactions it undergoes. As this will vary from product to product, and even for different units of the same product, there is no single estimate of burden which can be universally applied. Therefore averages are used.

[19] For a theoretical discussion of the trade effects of border taxes, see Richard Musgrave and Peggy Richman, Allocation Aspects, Domestic and International, in John Due, editor, The Role of Direct and In-Direct Taxes in the Federal Revenue System (Princeton: Princeton University Press, 1964).

The obvious next question is what alternatives exist which are more neutral and less discriminatory.

APPROACHES TO SOLUTIONS

One approach that has been suggested is that the U.S. not seek a change in the GATT rules but, instead, adopt its own Federal indirect tax system.

Here, I concur with Mr. Latimer's statement in his article in the Canadian Tax Journal which I referred to at the outset of my remarks. He said:

"The essence of the border tax debate is that, countries should be at liberty to choose the structure and level of taxation consistent with their notions of economic growth and tax equity, without at the same time prejudicing their international trading position." [20]

As a second approach, there have been some who argue that the U.S. should disregard the GATT and make similar border adjustments, with or without reference to our direct taxes. GATT is too vital a multilateral institution for such a course of action to recommend itself.

A third approach involves multilateral negotiations to reduce the inequities in the present rules, while harmonizing international tax practices as they pertain to trade between nations. In the last analysis, what is needed is a sane, simple and practical way to resolve this problem. A workable set of rules can be devised and these rules could promote the objectives of the GATT. Such an approach would be in the greater interests of the whole trading community in serving to avoid practices prejudicial to the trade of any contracting party.

Within this framework, the use of the origin principle in trading has definite attraction. It would eliminate an unnecessary barrier to trade, remove a discriminatory feature of the rules governing trade, and provide a consistent treatment for the trade effects of government tax and economic policy. Whatever its attractions—and I think they are many—the origin principle poses serious problems. The most prominent of these is how do you implement the principle in the fixed exchange rate system we now have.

Other approaches, of course, could be based on the destination principle. However, under the present rules we have seen broadly increased uses of border tax adjustments resulting from changeovers in tax systems. The present rules have encouraged the adoption by other countries of indirect taxes permitting border tax adjustments. The proliferation of "adjustable" indirect tax changes is startling, and in trade terms frightening. Moreover, present rules provide no limit whatsoever to the degree of "adjustment" permitted for indirect taxes. If allowed to continue unrestrained, this proliferation will work to undo much of the progress towards freer international movement of goods, services and capital.

In conclusion, the GATT rules must be improved in such a way that they do not permit nations to achieve a trade benefit through the adoption of one domestic tax system over another. A pragmatic and equitable solution must emerge from the GATT negotiations now in progress. Our trading partners did not agree to a "standstill" on new border tax adjustments while the existing rules were under discussion. The result has been that adjustments have continued to mount, rewarding protectionist sponsors and arousing the envy of others who might be tempted to take similar trade restrictive actions. There is no longer time for drawn-out deliberations. The proliferation of changes and new border taxes gives great urgency to the GATT work.

The CHAIRMAN. It seemed to me a very good speech.

One of your conclusions was:

"There is no consistent rationale behind the GATT rules on border tax adjustments, nor any clear-cut guidance on the meaning of the GATT provisions."

You went on to state:

"Not only are the GATT rules unfair, they are illogical and unreasonable."

Now, in the light of your position, how do you explain that the U.S. negotiators remain wedded to GATT commitments which are "illogical and unreasonable" in your own words, and which, in the eyes of the

[20] Op. cit., p. 400.

Congress, are not binding on the United States since they have never been approved by the Congress?

Why don't we just impose a border tax and export rebate system of own, irrespective of the unfair, illogical and unreasonable GATT restrictions?

Mr. PETTY. If we accept that they are illogical, do we emulate them by adopting our own border tax and take the implications of the illogical aspects of it, or do we proceed through multilateral negotiations to resolve our differences, to improve the trading rules as they pertain to border taxes and indirect taxes?

That is the issue we are grappling with.

The CHAIRMAN. Doesn't it work out as sort of a heads-they-win; tails-we-lose situation? And, if that is the case, why don't we simply change our way of doing business and remove the unfair disadvantage we now suffer from?

Mr. PETTY. I think, agreeing to that summary would be to prejudge the results of the current talks at GATT, Senator.

I think I am as frustrated and perhaps more frustrated at the pace at which they go ahead. I have no illusions that we can quickly evolve a group of rules that is perfectly trade neutral in a short time or perhaps even ever. I say perfectly neutral.

That does not mean that we respond by adopting an indirect tax system which would permit within the GATT rules border taxes. I think there are a lot of related implications for the United States in a turnover tax which should be considered other than its international trade effect.

The CHAIRMAN. What incentive is there for them to change a rule or a practice which they make unilaterally which is in their favor?

Now, if you want to change it, why shouldn't we change to a basis that is in our favor, and then proceed to negotiate from there?

If they are getting the best of all worlds on both ends, then why should they be willing to change it?

It sounds to me like some of those negotiations with regard to some of the Japanese imports, where the Japanese would talk to us just as a matter of courtesy, feeling that we were not going to do anything about it and they were going to keep it just the way it is, where they had adopted rules all to their advantage, and our people did nothing to protect our interests.

Mr. PETTY. I suppose, in the last analysis, there is no such thing as international relations. I think there was a philosopher, whose name I do not remember, who made the statement that there are only international interests and international interests are resolved by finding a mutuality which is the precondition for agreement.

I think, in this case, the arguments that are telling consist of one, the one of equity. I think it is a fact that they are not immune to that argument, and, second, that they understand that a mulilateral world trading and payments system, cannot persist if it is a heads-I-win; tails-you-lose situation, and, I think, making this argument, and relating it to the international monetary system, which Secretary Volcker handles, is the factor which will prompt the ultimate solution.

The CHAIRMAN. It seems to me that with the prodding that some us on the Hill have been trying to bring to bear, and with various other

groups also recognizing the economic realities of the situation, that both this administration and the previous administration have moved gradually toward doing some of the things that need to be done to protect American foreign trade interests. We are gradually beginning to get some progress in that respect, but it seems to be discouragingly slow when the answer appears to be so obvious.

Take the chicken war some years ago. There was an agreement which they just broke, and that is how I understand they often do business under the GATT. When the rule no longer serves their purpose, they just break it. But it took us a long time to get around to saying: "If you are going to do that to us, by denying us fair access to a market that we can compete in, we are going to have to retaliate against some of your exports to the United States."

So, eventually, we got around to placing some sort of duty on certain VW trucks being imported into this country, and a few other selected commodities.

My thought was that they must have considered us awfully stupid to waste all that time getting around to retaliate. We should have retaliated the next day. By doing so we would have indicated OK, if that is how you are going to do business, we will retaliate.

Why would you want to spend all that time soulsearching, pursuing the argument that some people pursue in some branches—and I think the State Department is supreme in this regard—saying, "No matter what they do to you; no matter how badly they kick you in the face, that you should do nothing about this matter, because you ought to pursue the theory of turning the other cheek and setting the good example," whereby, hopefully, that it would prevail as a concept of justice, conscience, and brotherhood and they would be compelled to do the right thing. But it never seems to work that way in business.

In business, it seems that if you do not respond to the other fellow, to show that it is bad business to give you the worst of it, he will just keep right on taking advantage of you.

Mr. VOLCKER. May I just make two comments on this, Senator?

I think there is a distinction between reacting when they break a rule, which I agree that we should be alert to, and going ahead and, in some sense, attempting to break rules ourselves.

I think we do carry a special responsibility in trade areas as in monetary areas, that we do happen to be the biggest country in the world by all odds and with the largest trade, and I think that does imply a special responsibility to try to work within this kind of orderly framework and set the right kind of example, recognizing all the frustrations of this process in many areas.

The defense area is another area where we have recognized the security obligations, but then we are forced to try to get these other countries that are our basic partners here to recognize some share in the burdens. I think there is an analogy in all these areas, and I think the mere fact of our size, our influence, our position in the world, gives us some responsibilities of leadership that do tie our hands in some respects.

The CHAIRMAN. It would seem, in view of the fact that we have the biggest market in the world, that others ought to be cautious about violating agreements with us——

Mr. VOLCKER. I agree, when they violate the agreement we——

The CHAIRMAN (continuing). Or trading unfairly with us when shipping into this market.

Mr. VOLCKER. I think we ought to be alert that they, at least, follow the rules and that we be as aggressive as we can in trying to negotiate new rules where they seem to be palpably unfair, but I draw a distinction, again, between those actions and unilaterally going out and setting some rules of our own.

The CHAIRMAN. Senator Miller?

Senator MILLER. No further questions.

The CHAIRMAN. Senator Jordan?

Senator JORDAN. No further questions.

The CHAIRMAN. Senator Javits, would you care to ask questions of these witnesses here?

Senator JAVITS. No.

The CHAIRMAN. Thank you very much, gentlemen.

Mr. VOLCKER. Thank you.

The CHAIRMAN. Our next witness is the Honorable Jacob K. Javits, Senator from New York.

We are pleased to have you here.

STATEMENT OF SENATOR JACOB K. JAVITS, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator JAVITS. I should like to file my statement, and, as exhibits with my statement, I should like to file an exchange of correspondence which has already been referred to.

The CHAIRMAN. We will print the entire statement.

Senator JAVITS. And, then, I would like to submit a memorandum submitted to my office by the Director of the Office of Foreign Direct Investments which shows the interrelationship of the interest equalization tax and the foreign direct investment program.

(The documents referred to follow; testimony continues on p. 73:)

PREPARED STATEMENT OF SENATOR JACOB K. JAVITS

I appear today as a long-standing opponent of the Interest Equalization Tax—but considering the fact that it is on the books instead of the voluntary Capital Issues Committee, which I considered far preferable, and that we are in no position to be caught with neither the tax nor the Committee—I must, with reluctance, support another interim extension of the tax. However, in doing so I must make certain important reservations.

I am encouraged in this position by an exchange of letters with the Secretary of the Treasury to which I will later refer. The reservations I propose are (1) that the IET be extended for only one year and continue to be phased out; and (2) that the Japanese $100,000,000 exemption be repealed. These reservations stem from factors which have supported my traditional opposition to the tax.

Not to extend the IET at this time, for reasons which I shall explain, could result in severe strains on this country's balance of payments. Therefore, I do not believe I can responsibly advocate that this tax be done away with immediately. However, the IET, which represents a significant departure from the long-standing U.S. commitment to the freedom of capital movements, should not be allowed to become a permanent fixture of the Code, and my reservations are directed toward insuring that this does not happen.

As the Committee knows, I speak from a double vantage point. First, I represent the state in which the principal financial markets of the country are located. I use these words advisedly, because it is not necessarily the principal source of money or the richest in the country. It is the principal financial market of the

country, which has a certain asset value to our nation, as it develops the overwhelmingly largest amount of domestic and foreign financing marketed to investors in the United States.

Second, I have spent a great deal of my life as a lawyer in financial work and have had considerable experience in the banking business.

It was from this vantage point that I strongly opposed the introduction of the IET back in 1963 and 1964. At that time I proposed as an alternative the formation of a Capital Issues Committee, in which the Government and private sector would establish an optimum level of borrowing in this country, and then seek voluntarily to keep such borrowing at that level. In making this recommendation, I was not attempting to downgrade the severity of our balance of payments problems, and I do not attempt to do so now. It was in fact the severity of the problem which led me to believe that this approach would work as effectively and without the drawbacks of the IET, as it is now working in the Federal Reserve Program and as similar voluntary controls worked during the Korean War.

The imposition of the IET was characterized by the Administration in 1963 as "fully consistent with . . . free capital movements," in that it still allowed market forces to determine the price and amount of foreign issues in this country—taking the IET into consideration, of course. By the same token, however, one would have to say the same thing about protective tariffs, about illegal export subsidies and rebates, about complicated licensing requirements and about other devices which impede, but do not actually bar, international transactions.

The IET also was described as a tax whose purpose was to eliminate the interest rate differential being paid on U.S. versus European securities. This argument can give a vague ring to authenticity when applied to debt issues, whose attraction to investors is often based upon the interest rate they pay. However, equity securities—which presently carry an IET rate of 11.25%—are not sensitive to differential interest rates. Purchase of equities is made primarily with the expectation of capital appreciation. At least so far as equities are concerned, therefore, the IET is a protective tariff on imported securities, pure and simple.

Let us also remember that one of the purposes of the IET was to keep borrowing costs in the United States down, by removing from our capital markets much of the foreign demand for money. One alternative to the IET—a substantial increase in our long-term interest rate structure—was explicitly considered and rejected by the Administration in 1963. Now, of course, we have both the IET and high interest rates, and Government leaders are telling us that both together are necessary to cure the economic ills which afflict the country. This only demonstrates still further the basic weakness of the symptomatic approach to our balance of payments problems: the approach epitomized by the IET.

My final objection to the IET—then as now—has been that it would not accomplish its purpose. Loopholes still exist by which hundreds of millions of dollars have leaked out of the country into foreign securities. More important, the IET does not prevent the widespread purchase of foreign paper—and the consequent drain on our balance of payments—when market factors themselves overcome the deterrent imposed by the tax. Many investors might be willing to pay more than the 11.25% premium on, say, a gold stock during a period of international monetary uncertainty. In 1967, when our worsening balance of payments eventually prompted the Johnson Administration to establish the Office of Foreign Direct Investments, this was apparently exactly what happened. Transactions in outstanding foreign securities rose in 1967 at an alarming rate, resulting in net purchases in this sector of $116,000,000, compared with net sales the previous year of $323,000,000. This state of affairs might have been avoided if Congress had adopted the idea of a Capital Issues Committee. It was against this background that the Foreign Direct Investment Program—another symptomatic treatment—was called into being.

That Program, incidentally, represented an even more serious departure from the traditional U.S. commitment to free capital movements. Established under the same emergency authority which enabled President Roosevelt to close the banks in 1933, it imposes direct restrictions on the movement of U.S. investment capital abroad.

In short, I believe that the IET has been a bad and ineffective way of approaching our balance of payments difficulties. By attempting to stop up only one of the many holes in our balance of payments, it has merely increased the flow out of the others, and forced the adoption of even more direct controls on our economy. By treating symptoms rather than causes, it has put off the day when the Ad-

ministration can come to grips with the underlying causes of our payments imbalance and formulate responsible, long-range programs for putting our own and the international accounts of others on a better and more realistic footing.

Yet, I recognize that the IET has regrettably become an integral part of the system of barriers established to deal with the balance of payments. Its removal at this time would not only suddenly depreciate those securities which had been purchased by Americans paying the tax, but would also seriously weaken other efforts to reduce net capital outflows. Immediate removal of the IET could possibly stimulate wholesale purchases of foreign securities and aggravate an already precarious balance of payments picture for 1969. It would vitiate the strength of the Foreign Direct Investments Program, since the security issues made abroad by U.S. firms under constraints imposed by that Program could immediately be brought up by Americans.

I also believe that removal of the IET at this time would cast the United States in a poor light with the international financial community. Our balance of payments position is poor—dropping to a record annual rate of a $3.79-billion deficit during the second quarter of this year—and is not likely to show significant improvement in the near future. To remove the IET at this time would subject us to the charge of irresponsibility: of claiming to be in a better position than we actually are.

However, I also believe that the time has come for the new Administration to correct the mistakes of the past six years and begin the gradual and continuous phase-out of direct controls on international capital movements. This would entail the simultaneous adoption of policies designed to strike at the roots of our balance of payments problem: at inflation, at deteriorating export performance resulting in part from inadequate export incentives, and at excessive demand in our economy. In this regard, I commend the President for his balance of payments message last April, wherein he emphasized that this approach would characterize the balance of payments efforts of the Administration.

For these reasons, I have sought to obtain assurance from the Administration that the President would utilize his authority under the proposed extension of the IET to keep the tax rates on both new and outstanding issues as low as possible consistent with monetary stability, and that he would gradually relax the restrictions imposed by the Office of Foreign Direct Investments. My request, and the Administration reply, are contained in an exchange of letters with Secretary Kennedy which took place on August 9th. I ask the Chair's permission to include the texts of these letters in the record.

I also requested the Office of Foreign Direct Investment to supply me with an analysis of the relationship between the IET and the Foreign Direct Investment Program. I ask that their reply be made a part of the record.

Secretary Kennedy's letter points out that the President recently reduced the IET rate from approximately 1½% per annum to ¾% per annum on debt securities. The Secretary stated it was his intention "to recommend to the President further use of this authority as circumstances permit, and in this regard I will be especially mindful of the opportunity to employ the additional flexibility we are now seeking from Congress which hopefully will advance the time when our reliance upon this tax can disappear." Of the Foreign Direct Investment Program, the Secretary wrote, "It is also my intention to recommend as soon as possible in the light of balance-of-payments developments, additional steps in the gradual relaxation of the capital restrictions imposed under the foreign direct investment program."

The reply of the Office of Foreign Direct Investment indicates that removal of the IET would require the Office substantially to restrict the ability of United States companies to sell Eurobonds and thus complete their foreign investment plans. It also refers to the recent relaxation in the FDI regulations, part of which would permit U.S. corporations to increase their annual transfers of investment capital abroad.

Mr. Chairman, I appreciate the efforts of the Administration during these trying times to cope with deep-seated imbalances in our economy, and to effect even modest relaxations in the restrictions on capital controls. I also appreciate the complicated relationships which exist between institutions which—however misconceived—have built up vested interests and dependencies. However, the gradual phase-out of these controls requires in my mind a *continuous* phase-out; not merely a token effort. To stop the relaxation of controls at this point would leave us no better off than we have been over the last five years.

Therefore, I propose that the IET be extended for one year only. The IET is still a temporary tax, and should not be accorded the semi-permanent status it would acquire by being extended any longer than is absolutely necessary. A one-year extension would be sufficient to determine whether the Administration's balance of payments program is beginning to yield results, and whether the IET should not be substantially altered or abolished at that time.

I believe that removal of the IET under the circumstances would not result in serious dislocations either of the securities markets or our balance of payments. It is common knowledge that in the more seasoned foreign stocks traded in the United States, there is no lack of American-owned shares. Continual phase-out and eventual removal of the IET might create some leakage owing to annual growths in demand for various securities, but this leakage would not be as serious as what might have occurred if New York were still the only capital market of any significant size. Stimulated by our capital controls, the Eurobond and Eurodollar markets are so well developed that Mexico and some other countries to which the IET does not apply have preferred to float certain issues solely in the Eurobond market. Convertible Eurobonds issued by U.S. corporations are also becoming very popular with European investors, thus reducing the dependence of these corporations on the U.S. markets for financing foreign investments.

Also, the bill gives the President power to reduce the tax or eliminate it in selected categories which are in the nation's interest. In extending the interest equalization tax, under the conditions I have specified, I also feel that we should do away with the $100,000,000 exemption granted to Japanese borrowings in the United States, contained in Executive Order 11211 of April 2, 1965.

It is my opinion that the remarkable progress made by the Japanese economy since 1965, has done away with the need for this special exemption. In this short period of time, Japan has begun to move rapidly towards becoming a significant, capital-exporting nation. Japan's reserve position is presently in excess of $3-billion, a considerable increase over the $1.9-billion reserve position of April, 1968. This reserve position has been increasing at a rate of more than $100,000,000 a month throughout this year. This strengthened Japanese balance of payments position has resulted in the Japanese making very little use of their exemption under the Interest Equalization Tax.

It is for these reasons that I propose that we accept the economic realities of the situation, which clearly indicate that the $100,000,000 exemption for Japan is no longer needed by the booming Japanese economy—a fact that is clearly attested to by the failure of the Japanese to use this exemption over the past years. In 1968 no funds were brought into Japan under the provisions of this exemption and so far in 1969 only $9,000,000 have been brought in.

Memorandum Submitted to Senator Jacob K. Javits, by the Director, Office of Foreign Direct Investments

INTERRELATIONSHIP OF THE INTEREST EQUALIZATION TAX AND THE FOREIGN DIRECT INVESTMENT PROGRAM

The Foreign Direct Investment Regulations (the "Regulations") administered by the Office of Foreign Direct Investments ("OFDI") restrict the amount of direct investment that may be made in a foreign business venture by a person within the United States ("direct investor") owning or acquiring a 10 percent or greater interest in such business venture ("affiliated foreign national"). Direct investment is the sum of (1) the net transfers of capital (including acquisitions of equity interests and debt obligations) made by a direct investor to affiliated foreign nationals during any calendar year, and (2) the direct investor's share of earnings reinvested by its incorporated affiliated foreign nationals during such year. Reflecting the inter-dependence of the balance of payments control programs, the regulations do not apply to any bank or other financial institution subject to the Federal Reserve Foreign Credit Restraint Program. Similarly, the Interest Equalization Tax (IET) expressly does not apply to direct investment transactions meeting certain qualifying tests.

Direct investment is prohibited except to the extent it is generally authorized by the Regulations or specifically authorized by OFDI upon application. Sub-

part E of the Regulations permits each direct investor a minimum investment "allowable" of $1 million for each year, or, in the alternative, annual investment "allowables" calculated on the basis of either (1) the direct investor's share in the earnings of its affiliated foreign nationals during the preceding year, or (2) direct investment made by a direct investor during the years 1965 and 1966.

A direct investor is also permitted to make transfers of capital with proceeds of a "long-term foreign borrowing", and to repay such borrowing, even though a net transfer of capital not authorized by the Regulations would result, provided the direct investor has met certain conditions set forth in the Regulations. A direct investor may also, to the extent permitted by he Regulations, "allocate" proceeds of a long-term foreign borrowing to direct investment in affiliated foreign nationals. Consequently, the Foreign Direct Investment Program (the "Program") has the effect of encouraging direct investors to finance their foreign direct investment with long-term foreign borrowings.

In 1968, direct investors made long-term foreign borrowings in an aggregate principal amount of $3.5 billion. Of this amount, approximately $1.9 billion was made by domestic finance subsidiaries of direct investors "formed or availed of" for the principal purpose of obtaining funds for debt or equity investments in foreign affiliates. Almost all borrowings by such domestic finance subsidiaries were made in the form of sales of debentures (often referred to as "Eurobonds") to foreign persons. In order for the proceeds from the sale of such debentures to qualify under the Regulations as "proceeds of long-term foreign borrowing," the debentures must be subject to the IET if purchased by nationals or residents of the United States.

The reason for this requirement of the Regulations is that in the absence of the IET, the probable place of resale of such debentures would be the United States securities markets. Were the debentures to be resold in the United States, the favorable balance of payments effect of the foreign borrowing would be offset by the consequent outflow of United States funds to the foreign sellers of the debentures. OFDI has been willing to extend "long-term foreign borrowing" treatment to proceeds of these offerings since it considers the IET an effective barrier to resale in the United States. If the IET did not apply in this manner, OFDI might be forced to withdraw its present treatment of debenture offerings, thereby substantally restricting the ability of United States companies to complete their foreign investment plans within the Program.

A recent relaxation in the Regulations allowing direct investors to offset reinvested earnings of affiliated foreign nationals, as well as transfers of capital, places even greater reliance upon direct investors' ability to borrow abroad. It has been the policy of OFDI to continue such relaxations as balance of payments circumstances permit. Removal of the IET protection upon which the Program heavily relies could inhibit this and future relaxations and, more likely, require an increase in the Program's restrictiveness.

The Administration plans an orderly phasing out of both the Program and the IET consistent with the changing balance of payments position of the United States. Any significant relaxation of the IET, which does not take into account the interrelationship of this tax and the structure of the Program, would jeopardize the continuing progress toward the dismantling of direct investment controls.

AUGUST 9, 1969.

Re: Interest Equalization Tax

Hon. DAVID M. KENNEDY,
Secretary, U.S. Treasury Department,
Washington, D.C.

DEAR MR. SECRETARY: The Interest Equalization Tax extension has been slated for floor consideration this coming week, and as you know, I have been following with some concern the reaction which this issue has had in the country. In April of this year, the Joint Economic Committee, on which I serve as senior Minority member, recommended that the IET be phased out as soon as practicable. The Majority noted that suspension of the IET would do little or no injury to the U.S. balance of payments, and that suspension is an appropriate way to begin the elimination of capital export restrictions which "are a direct contradiction of the most fundamental international economic policy objectives pursued by the United States since the end of World War II." The Minority noted the strong and valid arguments which exist for reconsidering the continuation of the IET, and pointed out that significant changes in the structure of capital markets in the

United States and abroad have reduced the danger of the greatly increased outflows which the IET was designed to prevent.

These views accord with my prior opposition to the IET. In 1964 when the tax was being introduced, I proposed a "capital issues committee" for regulating foreign borrowings in the United States on a voluntary basis, which would have kept our capital outflows within manageable levels and preserved the traditional U.S. commitment to the freedom of private transactions. I have since expressed opposition to extension of the tax, and voted in favor of amendments which would have restricted its effect. I continue to have considerable doubts whether extension of the IET would be in the best interests of our country, in the absence of a concrete pledge to begin dismantling this web of capital restrictions at the earliest possible time.

I would therefore like to be appraised of:

(1) your intentions to use the powers which will be given the President to vary the tax rates, so that these rates—for both new and outstanding issues—will be as low as possible consistent with monetary stability:

(2) your actions and intentions which, in your continuing review of the nation's balance of payments program, may result in the gradual relaxation of the restrictions imposed by the Office of Foreign Direct Investment.

Please be assured that I have pledged my efforts to maintaining the strength of the dollar both at home and abroad, and am willing to support any measure which will effect this end and for which no reasonable alternative exists.

With best wishes, believe me,

Sincerely,

JACOB K. JAVITS.

THE SECRETARY OF THE TREASURY,
Washington, August 9, 1969.

HON. JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR JAVITS: In your letter to me today on the Interest Equalization Tax, you have emphasized the desirability of dismantling our direct balance of payments controls as soon as possible.

On April 4, 1969, President Nixon purposefully began just exactly this type of process consistent with our balance of payments position. At that time he announced a relaxation of the capital restrictions on foreign direct investment and lending abroad by bank and non-bank financial institutions. In addition, he pledged that "we shall find our solutions (to our economic problems) in the framework of freer trade and payments."

The President also pointed out that "The distortions created by more than three years of inflation cannot be corrected overnight. Nor can the dislocations resulting from a decade of balance-of-payments deficits be corrected in a short time." It was against the background of these actions, this pledge and an appreciation of the time it takes to restore balance to the economy that the President announced his intention to seek an extension of the Interest Equalization Tax. The extension legislation now before the Senate has a new provision which would provide to the President the authority to have a lower tax rate on new issues from that which would pertain to outstanding securities. The purpose of this provision is to provide that degree of flexibility which could be useful in reducing the reliance upon this tax as a selective restraint in our overall balance-of-payments program. For example, if this authority is employed, a low or no tax on new issues could permit greater access to our markets for new projects without according this benefit to outstanding issues.

The willingness of this Administration to vary the IET tax rate so that it will be as low as possible consistent with monetary stability was demonstrated first on April 4 when President Nixon reduced the IET rate from approximately one-and-one-quarter percent p.a. to three-quarters percent p.a. on debt securities. It is my intention to recommend to the President further use of this authority as circumstances permit, and in this regard I will be specially mindful of the opportunity to employ the additional flexibility we are now seeking from Congress which hopefully will advance the time when our reliance upon this tax can disappear.

It is also my intention to recommend as soon as possible in the light of balance-of-payments developments, additional steps in the gradual relaxation of the capital restrictions imposed under the foreign direct investment program.

I would emphasize the fundamental fact that our efforts to further reduce reliance upon selective restraints will be greatly facilitated by the evident effectiveness of our program of general restraints in reducing inflation, restoring better balance to our economy, and creating the conditions that make it possible to rebuild our trade position. As inflation is so much the cause of our international payments problem, it is vital that we pursue the fiscal-monetary restraint which will foster our balanced growth.

Sincerely,

DAVID M. KENNEDY.

Senator JAVITS. I appear today as a longstanding opponent of the interest equalization tax, but considering the fact that it is on the books instead of the voluntary Capital Issues Committee—which I consider far more preferable and which we used in the Korean war—we are now in no position to be caught with neither the tax nor the committee. Hence, I must, with reluctance, support another interim extension of the tax. However, in doing so, I wish to make a number of points to the committee, and I have already submitted the letters which form a basis for my position.

First, I suggest that the tax be extended for only 1 year and that the flexible authority to continue to phase it out should be contained in the legislation. Second, I suggest that the Japanese $100 million exemption be abolished.

I have heard the discussion here about Canada, and I think what Secretary Volcker says makes a lot of sense with respect to Canada, though it has been a loophole. We must not forget that, as the chairman has pointed out.

Most of the security capital which has flowed out has flowed out into Canadian issues. With regard, however, to the discussion this morning on retaliation for unfairnesses to us, such unfairnesses include not only what the Chair was referring to in the so-called border taxes but also other indirect barriers to trade, which are far more vicious than protective tariffs and are the case in many countries. Japan is probably the prime offender in that.

The answer is, of course, that we have an across-the-board relationship with all these other countries and the various things we can do and should do have to be orchestrated. It is very hard to make any firm rule that if they step on our toes on chickens we are going to hit them on a particular thing. You have got to orchestrate that.

This principal is true in the interest equalization tax area, too. So, I think we should (1) extend the IET for a year, continuing to phase it out—and the administration has promised to do that, from the correspondence—and (2) do away with the Japanese $100 million exemption.

Now, as to testifying, Mr. Chairman, I would not testify, obviously, as a Senator. I can move amendments on the floor, et cetera, but I feel that my reason for testifying is twofold.

First, my State is the principal financial market of the country. I hasten to add, lest Senator Russell take after me, that this does not mean we are the best State or the richest. It just means we have the major securities market; that is all. But it does impose a big responsibility upon the market, and upon me as Senator of the State.

Second, I have spent much of my life as a lawyer in the financial world, and so I do have some personal knowledge and experience in the matters with which we deal.

It is very interesting to me, and it will be remembered—and, of course, Senator Long remembers it—that I opposed the tax on the ground that we would be much better off with a Capital Issues Committee. I was beaten, and realize that the Capital Issues Committee is now a dead issue.

It is very important, as I see it, that the imposition of the tax was characterized way back in 1963—and I quote—"as being fully consistent with free capital movements" in that it still allowed market forces to determine the price and amount of foreign issues in this country, provided naturally that they took the tax into consideration.

Of course, by the same token, you can say the same thing about protective tariffs, about export subsidies and rebates, about complicated licensing requirements and other devices which impede but which do not actually bar international transactions.

There is another thing which gives me a rather wry feeling about this whole matter, and that is: Originally, we were told that the tax would keep borrowing costs down in the United States by removing foreign demands for money. We were told that an alternative to the tax was to increase our interest rates materially, because, at that time, we enjoyed a very distinctly lower interest-rate structure.

Now, of course, we have both the interest equalization tax and high interest rates rivaling anything. As a matter of fact, you can borrow money in Germany today for a lot less than you can borrow it in the United States, without any interest equalization tax. So I thoroughly agree with the feeling of the administration that the tax must be flexible—and we must constantly reduce it—because we may reach a point where we permanently lose our position as a great marketing place for securities.

Nonetheless, as I say, I think you have to extend the tax, because, if you do not, we will be caught very short.

For example, immediate removal of the tax could stimulate wholesale purchases of foreign securities—the Secretary mentioned that—and aggravate an already precarious balance-of-payments picture for 1969. Also, the removal of the tax would vitiate the strength of the foreign direct investments program, since the securities issues made abroad by U.S. firms under constraints imposed by that program could immediately be bought up by Americans.

Also it would put us in a poor light in the international financial community. Our balance of payments is poor. Right now, we are still flirting around with that millstone of $4 billion a year in the balance of international payments, and from what we know about the trade picture and the increase in prices because of inflation in the United States, it does not look as if we are going to have much improvement in the immediate future. This means that if we did remove the tax at this time we could, and I think quite properly, be charged with being irresponsible.

If we give the administration only a year's extension—showing that this is very clearly a temporary tax—and give them the flexibility which they promised to employ, I think they can correct a good many

of the mistakes which have been made in the last 6 years and begin gradually to phase out the direct controls on international capital movements.

Naturally, this assumes correlative policies dealing with inflation and with the excess of demand in our economy; also dealing—as Senator Miller's questioning brought out—with our deteriorating export performance which I think is, in part, attributable to inadequate export incentives.

I might say, in this respect, that the President certainly recognized all of those factors in his balance-of-payments message to the Congress. It is for these reasons that I now favor the extension of the tax for a year under these circumstances and that I have sought assurance, and obtained assurance, from the administration that the extension of the tax would still enable us to gradually bring down tax rates especially on new issues.

One last point, Mr. Chairman, and I will be through, and this is this matter of Japan. Why do I ask that the exemption for Japan be taken out?

There has been remarkable progress by the Japanese economy since 1965, and really that progress has done away with the need for this exemption. Japan's reserve position is presently in excess of $3 billion, which represents a 40-percent increase in only 1 year, so rapidly is it moving forward. This reserve position has been increasing at the rate of more than $100 million a month throughout this past year. This strength in the Japan balance-of-payments position has resulted in the Japanese making very little use of their exemption under the interest equalization tax, and, therefore, I propose that we accept the economic realities of the situation, which indicate that the Japanese $100 million exemption is not needed. It certainly has not been used in the past years. In 1968, no funds were brought into Japan under the provisions of this exemption, and so far in 1969 only $9 million has been used.

In summary, I favor an extension of the tax, because there is no other alternative, as I see it.

I urge the committee to make it only 1 year. I urge the committee to leave in the presidential flexibility for reductions, especially reductions of a qualitative character: For example, applying it only to new issues, as the Secretary said.

Finally, I suggest that the Japanese exemption is now something of an anachronism and that it be eliminated.

The CHAIRMAN. Thank you for your statement, Senator Javits. There is one thought that occurs to me about this overall problem. It would seem to me that if we have complete free flow of capital and complete free trade over a period of time this would necessarily tend to equalize wages all around the world, especially as progressive, enlightened countries, like Japan and European countries, train their labor as we have done with ours. I would be curious to know your reaction as to what problem that might pose so far as a State like New York is concerned, where you have a very high standard of living and very high average wage.

Senator JAVITS. Mr. Chairman, I think that the forces which will make for increases in the wage levels of other countries are world forces, and it is hard to keep anything secret today.

The American standard of living is probably the best advertised commodity on earth, and the aspirations of the people everywhere, whether they are in or outside of Communist countries, naturally has now made this standard their goal. So, I think our work largely is being done for us in that regard.

Where I think we need to do an awful lot of work, Mr. Chairman, is in automation and technology and the tremendous aspects of that, and in merchandising, marketing, styling—call it what you will. I think that all of us who have had experience in the export and import business know that the lowest price does not necessarily sell the item. Many factors enter into it, including not only styling and merchandising but also services and all that this word implies.

It seems to me that the more sophisticated the American exports become, the more we are likely to hurdle the elementary, rather primitive comparisons in hourly rates of pay.

The second thing I think we need to do is to be sure that we are not bested by the rules of the game. The chairman knows—and I am very proud of the fact—that I am a liberal on welfare matters, civil rights matters and other things, but also the chairman has seen me very hardnosed when it comes to business and money, and I feel that way about this.

The only point of difference, if it be one, that I would have with the Chair, is that you have to be more subtle than to hit them on the head with the same chicken that they have barred from Europe. But other than that, I am all for being sure that on balance we are not being taken. There is no reason why we should be, and there is no virtue in being, except your own stupidity.

The third thing that I think is critically important is the length between America's financial capability in terms of financing the world and its exports.

It is undeniable, Mr. Chairman, as the chairman knows so very well, that if you have installed a game or if you have installed a factory, or if you are responsible for a certain entrepreneurship somewhere else, it is very likely that you will have a pretty good customer. The reasons for this are manifold but nonetheless you will have a good customer.

And, so, I think those three factors represent the major demands on our country, and I will be the first to say to the Chair that we have not begun to approach the capabilities which are inherent in all of them. It seems shocking to me that considering the relationship of a $4 billion to $6 billion export surplus—which we aspire to—to the total size of our economy, even the total size of our foreign trade, that we cannot give ourselves the ability to carry on the things which we feel we ought to carry on in the world, through doing better by far than we do in the balance of payments. Even in an elementary field like travel, we do not seem to be able to summon ourselves to some major national effort which will gain this ability.

The CHAIRMAN. I was in Tokyo only once. That was, I believe, about the last time that the International Monetary Fund Conference was held over there, and one of the officers of the Chase Manhattan Bank attending that conference looked abound to see how those Japanese were learning skills, and said: "Just give them a few years, and those people are going to be giving somebody fits around this world."

Now, during the recess I visited relatives in Colorado. My nephew took me out to climb some mountains in a jeep—a Japanese-made jeep. He thought it was the best quality jeep made. It is a real good product.

Now, 15 or 20 years ago, no one would think of the Japanese as manufacturing that kind of quality product, or if they did, including spare parts so that we can get all the spare parts needed immediately, to replace a sparkplug, if it burns out, or something of that sort. I think they are also being made where the parts are almost interchangeable, in so far as they usually are as between automobiles.

Now, those people are moving up in skills like that under a free flow of capital and a free flow of trade.

Capital will go where it receives the highest reward, where it receives the greatest earnings, generally speaking; and labor and industry tend to go where it can get qualified labor at the lowest cost.

Put those two together, and it seems to me that it has some problems for the future. The Japanese will continue to come up in the export of automobiles and a lot of other things. They are really moving in the electronics field, as you know. You have seen a highly developed electronic industry in that part of the world, and I should think that on their part and on the part of the Germans, Italians, the English, those who want to ship into this market, it is to their advantage to ship to us those items where skilled labor achieves a high reward rather than those items where you have depressed wages all around the world, very low wage standards.

Salesmanship, and all that, can hold for a while, but it seems to me over a period of time that free trade would tend to equalize wage standards around the world.

Senator Javits. Technology can do the most for you. In the first place, I thoroughly agree with the equalization factor of wages, but there are other factors which enter into the picture. For example, the disposition of solid wastes is an enormous problem for cities.

There is however, a tremendous amount of experimentation in the United States with self-consuming elements, which are the largest elements of solid wastes, self-consuming paper, self-consuming plastic or whatever one might come up with. I only mention it, because it is one of those Buck Rogers technological breakthroughs which undoubtedly will come and will help us regardless of our wage structure.

We had the original breakthrough in automobiles. The Japanese are still being unfair to us in automobiles. It is still very difficult to get a car into Japan, just as it is very difficult to make an American investment in Japan. They are still treating themselves on a theory which was valid before they reached their present capabilities. So, Mr. Chairman, you have to deal with that on two levels. One is the level of the direct confrontation, as, for example, in cars and investment, using the whole range of opportunities, which is available to you. We must make this confrontation without necessarily being beligerent, because it is a fact that Japan is one of our best customers, just as we are one of theirs, so it is not a matter that can be dealt with lightly.

The other level, which I thoroughly believe in, is the level that the vitality and virility of American technology and science reaches, which we have to watch in many ways. For example—and I hope the Chair will pardon me for saying this, but I know the Chair's deep involve-

ment in the whole patent question, and that has to be thought through. I am not saying the Chair is right or wrong, but your point has to be thought through in terms of its relationship to this competitive posture of the American people.

In a sense, this competition is good for the national morale. I would hope we could make it very vivid in the Congress, because there is nothing more than gamesmanship that inspires people to be alert and on the ball and get some joy and interest in life.

I only mention that because we are dealing with a very, very pervasive national situation upon which this committee, the Finance Committee, can have a very material effect.

The CHAIRMAN. I have noticed that we are welding more steel per man-hour on the job than the Japanese do, but the difference in terms of wage standards is such that if we do not have some kind of a shipbuilding subsidy, why, all our ships will be built in foreign shipyards.

I do not see how, on the long pull, we can overcome the very large wage differential. Of course, their wages will come up. There is no doubt about that. But it seems to me that we will have to lose our industries or will have to go down very much before we ever get on the same basis with them.

Senator JAVITS. Of course, I believe, Mr. Chairman, that we can overcome it. I would not wish to take the tenuous position of ruling out any opportunity for interim adjustments which are required, where you have a sudden economic assault which you are simply unprepared to meet and where you need some assistance. Generally, we have adopted this route. I think a voluntary agreement technique is as good a compromise as any, where you need a little time in order even to muster your technological resources—this has to be done on occasion—but I believe that we must depend essentially upon technology and science.

Second, the merchandising which we have talked of, and, third, the foreign investment or its equivalent—which gives an American presence and invites therefore American support, spare parts, acquaintance with American goods in terms of quality and brand—will help us overcome these wage differentials.

There is a great allegiance by people in the world to brand names: even by people in relatively underdeveloped areas. The same can be said for the United States. These are the areas along which I think we should move, and as to the debasement of wage scales.

That is why I think we have got to lend ourselves, generally speaking, in the world to an enlightened international policy which will provoke more and more peoples to be seeking higher and higher standards of living, because that is the way life ought to be: man should not just be serving the State.

The CHAIRMAN. Senator Anderson?

Senator ANDERSON. You apparently do not like H.R. 12829.

Senator JAVITS. Mr. Senator, I like it a little bit, and only because I have to. I think that is a fair characterization.

Senator ANDERSON. If you do not like it, how about killing the whole bill?

Senator JAVITS. Well, I think you could not now, because we are so deeply in it, and we would have nothing to put in its place, and momentarily it would be too much of a wrench.

Mind you, I am one of probably its prime opponents, but at this time, I really do not see what else you could do. So I do urge that you extend it for the least possible time which I suppose is a year.

Senator ANDERSON. The House act is 18 months.

Senator JAVITS. Yes, they have 20 months. A year and 8 months.

Senator ANDERSON. You spoke of the fact that the top should be done away with for good. Why not kill it?

Senator JAVITS. As I say, Senator Anderson, now that it has been built in as an element in various pockets, like American securities abroad, which, as I have described, have been built up on the strength of it, I really do not think you could just knock it down without suffering some rude shock which would be less if you phased it out over a period of a year.

I think, frankly, sir, if the committee felt that way, I would support extending it for a year and serve notice of the fact that it would not be extended further.

I think I would rather do that than kill it now.

Senator ANDERSON. It will be extended right along.

Senator JAVITS. Well, we will be here next year at this time, if it is extended for only 1 year. The same Congress will still be in. But, as I say, we all have a sense of public responsibility.

When Senator Long and I discussed this on the floor, I had this very attitude, notwithstanding my opposition to it, the fact that I think it was a great mistake; once you embark on this road, you can't suddenly drive off the edge.

Senator ANDERSON. That is all.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. No questions. We have got it started, and I do not think we can stop it at this particular time, even if we wished.

Senator JAVITS. Thank you.

The CHAIRMAN. Senator Gore?

Senator GORE. No questions.

The CHAIRMAN. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

I want to commend my colleague on a very fine statement. He is knowledgeable, and this is based upon experience. He knows I supported him in his opposition to this IET originally, for the reasons as he has outline again, that it would tend to treat symptoms rather than the causes.

I agree that we are in a position right now where it must be pretty carefully handled. There is only one question I would like to inquire about, and that is this proposal to repeal that $100 million exemption with respect to Japan. Would this have an adverse impact on our efforts to get Japan to loosen up for American investments in Japan?

Senator JAVITS. Senator Miller, it is like the tax collector. He has to cut as close as he can to the bone without cutting into the bone. I feel the same way about this matter.

It is my judgment—and yours can be as good as mine—that this will not represent that kind of a casus belli to the Japanese. On the contrary, it will represent a dignified self-confidence in our own belief that this is obviously an anachronistic exemption, and we can eliminate it without any fear that the Japanese will misunderstand.

They are business people, and we are looking them square in the

eye and saying "This has not been used. It does not need to be used. You do not need it. It was put in here to accommodate you. We are entitled to appreciation for that, and now it is no longer needed, and we strike it out." I think this would have a beneficial and not a harmful effect.

Senator MILLER. The point I am making is that if that exemption is repealed, I would think it would make it a little more difficult for American investors to go into Japan in line with the policy we are trying to develop over there, and we have been negotiating and working on this problem and it looks like we may be getting somewhere. If all of a sudden when we are possibly at the threshold of opening up Japan for American investors, we take away this exemption, it might be a rather inopportune time to do that.

Senator JAVITS. Senator Miller, we have so many things with Japan, including Okinawa, the mutual defense treaty, tremendous exports and imports—so many, many problems in the world that, frankly, I do not think this will make any difference either way. I rather like for myself—and I do not think I need to yield to anybody in terms of my being an internationalist in thinking—the dignity and the self-respect which comes from the fact that we are unafraid about the matter.

The Japanese do not use their exemption. On the contrary, Japan was in for this $100 million exemption when she was a less able financial power than other powers. That is why Japan and Canada, for different reasons, were picked out. At that time, she was still very vulnerable. Now, we are recognizing the fact that she is one of the greats of the earth. She ought to be pleased.

Senator MILLER. Yes. Perhaps the reason has changed. We sat up the $100 million exemption for a reason which no longer exists today, but, perhaps, the reason for keeping it on should be to help implement our policy to have Japan open her doors more to American investment in Japan.

Senator JAVITS. We are not only anxious to have Japan open her doors to American investors, we want her to open them to everybody's investments, and so we are showing again that we believe in an across-the-board treatment for everybody.

Japan, after all, has an exception here. We are repealing an exception. We are not imposing one. Japan stands alone, other than Canada, among all the nations of the world in the interest equalization tax. This is a good object lesson. We want to be treated across the board like everybody else, but we want everybody else to have liberal, decent treatment.

I really do not think, Senator Miller, that it will harm our relations with Japan for the reasons that I have stated, and I think you know they gave our man, our Secretary of Commerce, a pretty chilly reception when he went over there to talk to them about various things. I think it is a good thing every once in a while to show that you deal with these things across the board.

Senator MILLER. Suppose the $100 million exemption was left on?

Senator JAVITS. Yes?

Senator MILLER. With the proviso that it be used only in connection with the policy which we are trying to develop?

Senator JAVITS. Well, but that is anticipating a deal when none has been made.

Senator MILLER. That is right, but it lays the foundation for maybe making the deal.

Senator JAVITS. You have already made one concession, and you do not have their card to trade anymore. Suppose you make an investment treaty with the Japanese, it might very well be a provision of that investment treaty, but that is very different from having an a-priori exemption in the law which they no longer need. They have got to admit that. They have not used it.

Senator MILLER. Then, what you are suggesting is that this does have some efficacy. There would be efficacy in terms of negotiating a treaty, which, in time, would require congressional approval; whereas, if we do not remove the exemption by law, it is there for the administration to use as a negotiating tool.

Senator JAVITS. Senator Miller, I am not making a case on that score. I am not being Machiavelian about it. I say: "Here is a law. It has an anachronism in it. You are going to extend the law, take out the anachronism, and let the chips fall where they may." You ask my opinion: Will it help or hurt on negotiations with Japan? At worst, it will not do either; at best, it may help. That is my answer.

Senator MILLER. Thank you very much.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman.

Senator, I think you have made a very fine statement here. It is instructive. If we were to adopt your amendment to phase this out in 12 months, we would have to start immediately a plan for disengagement, would we not?

Senator JAVITS. Yes.

Senator JORDAN. And transition?

Senator JAVITS. But I think that Secretary Volcker has laid that out. They have got a good beginning in the new issues concept. Time has, in a sense, overtaken us on that. When we started, our interest rates were very attractive, whereas, today, we are looking for the business. If you go down to Wall Street you will soon find that out.

Senator JORDAN. How about old business that would not expire in 12 months?

Senator JAVITS. Well, I think you could not absolutely shut your mind. I was really responding to Senator Anderson's question when he said: Why not just eliminate it entirely? I said, rather than just eliminating it entirely, I would rather see you continue it and phase it out in the 12 months. As a practical matter, now that you are in it, unless you do go for some other scheme—and it is too late for that really—you have got to follow through on that line as long as you can.

Senator JORDAN. Thank you.

Senator JAVITS. Thank you very much, Mr. Chairman.

The CHAIRMAN. I think I should put in the record a table that supports the Senator's statement with regard to the $100 million exemption for Japan. It is from the Treasury Department, and indicates that we have a very big deficit in dealing with Japan, and this new securities exemption is being used very little anyway. So it does sup-

port the Senator's statement, and it will therefore be in the record here. There is really no need for it anymore, and, in view of the huge deficit, there is very little logic to it.

Senator JAVITS. I thank my colleague.

(The table referred to follows:)

U.S. BILATERAL BALANCE OF PAYMENTS WITH JAPAN

[In millions of dollars]

	1967	1968
A. Current accounts:		
U.S. exports	2,672	2,959
U.S. imports	−3,017	−4,071
Trade balance	−345	−1,112
Invisibles		
Net military	−500	−550
Income from U.S. investments	318	364
Payments on Japanese investments	−157	−201
Other	96	97
Total	−243	−290
Current account balance	−588	−1,403
B. Capital account		
U.S. private:		
New securities issues, gross	−14	−3
Redemptions of outstanding securities	4	6
Direct investment	−34	−77
Other long term	108	64
Short term	−626	18
U.S. Government	2	101
Japanese capital	278	296
Capital account balance	−282	305
C. Balance recorded transactions (A+B)	−870	−99[illegible]

Source: Survey of Current Business

The CHAIRMAN. I will also include in the record further matter supplied the committee by Mr. Petty on various aspects of the interest equalization tax.

(The material referred to follows:)

THE DEPARTMENT OF THE TREASURY,
Washington, D.C., August 6, 1969.

Mr. TOM VAIL,
Chief Counsel, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR MR. VAIL: In response to your request of July 28, for additional information with respect to six points bearing on the extension of the IET, I am attaching comments and tables.

You had also indicated that an estimate of what the capital outflow would be, given the present tight money situation, without the IET, would be most helpful. Even in the present monetary circumstances, I would think the IET is reducing our capital account outflows by at least several hundred million dollars per year. Although U.S. interest rates in the principal foreign markets has also tended to move upwards, so that the interest-rate gap favoring borrowing funds in the United States has not disappeared; it has only narrowed. Thus, in June, on good quality straight-debt industrial dollar bonds, yields on the international market were roughly 40 basis points higher than in the U.S.

Another indication of the continued importance of the IET to our balance of payments is the fact that those countries and institutions exempt from the IET actively availed themselves of their privileged access to our capital markets. On the other hand, there were almost no taxable issues.

The IET also serves to reduce substantially the attractiveness to U.S. residents of the acquisitions of foreign securities. Many outstanding and new issues would have been acquired but for the tax; for example, the $600 million of convertible securities sold overseas by U.S. companies for which no comparable security was available domestically. Should the tax expire the odds are high that as many as possible would be picked up by Americans. We already have clear indications that this potential threat was being actively anticipated at the beginning of this month—when some brokers considered the extension to be in jeopardy.

In addition to these direct restraining effects on U.S. purchases of foreign portfolio securities, the tax reinforces importantly the effectiveness of payments restraints on direct investment and on lending to foreigners by our financial institutions. While we are looking forward to the day when these selective restrictions may be further relaxed and removed, the IET remains a vital supporting element as long as these payments restraints exist.

Please let me know if some additional information would be helpful.

Sincerely yours,

JOHN R. PETTY.

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1. EXPLANATION OF SPECIAL EXEMPTION FOR CANADA AND JAPAN FROM THE INTEREST EQUALIZATION TAX

Canada

Canada and the U.S. have a unique financial and economic relationship. A common border over 5,000 miles long characterizes this. The interaction of our economies was demonstrated when the announcement of the Interest Equalization Tax on July 18, 1963 precipitated a severe disruption of the Canadian financial market and a sizeable decline in Canada's foreign exchange reserves. Canadian officials expressed their view that a foreign exchange crisis would develop which would make it necessary for Canada to adopt measures which would have a disrupting effect on the trade of both countries and on the international monetary system, unless they were able to give the market some assurance that Canada's traditional borrowing in the U.S. could be maintained. The Canadian authorities felt that this required exemption from the Tax.

After intensive discussions, United States Government officials agreed to the exemption from the Tax of new Canadian securities. In return, the Canadian authorities agreed that it would not be their intention to increase Canada's foreign exchange reserves through unnecessary borrowing in the United States.

That basic principle upon which Canada's I.E.T. exemption rests was reiterated by the Canadian Minister of Finance in December, 1968. At that time, the United States recognized the need for flexibility with respect to the level of Canada's reserves, in order to accommodate the natural consequences of the adaptation of monetary policy to the changing needs of the domestic economy, seasonal factors and other influences of a temporary nature.

In connection with the exemption, the Canadian authorities also agreed that Canada would not serve as an entrepot through which capital might flow from the United States to other countries, and they have undertaken specific measures to this end.

During the period of the I.E.T. exemption the level of Canada's reserves has changed little, while in contrast the volume of her imports and other current payments has substantially increased.

Japan

Had the U.S. Government imposed the Interest Equalization Tax on bank loans to Japan in early 1965, without some measure to mitigate, at least partially, the impact on Japan's ability to continue to refinance its large outstanding foreign debt, the resultant impact directly on the Japanese economy reinforced by consequent psychological reactions would have been far more severe than occurred when the I.E.T. was first announced. Japan's large foreign debt was heavily concentrated in the short-term area, in part due to the fact that Japan had issued no long-term securities in the United States following the imposition of the I.E.T. The ability of the European market to absorb Japanese securities had also decreased somewhat from the previous year. Moreover, U.S. banks were under strong pressure to limit short-term credits abroad. Given the foregoing factors, the opening up of limited longer-term Japanese borrowing in the United States ($100 million annually) helped ward off adverse psychological factors affecting Japan's capital flows and materially helped toward achieving a more balanced foreign debt structure for Japan.

This exemption has not been used extensively indicating that the psychological elements in the market were quieted by the limited exemption.

Major Canadian Borrowers of Long-Term Capital in the United States*—1963–1968

GOVERNMENT OF CANADA

PROVINCES AND MUNICIPALITIES:
- Alberta Government Telephone Commission.
- Alberta Municipal Financing Corp.
- British Columbia Hydro and Power Authority.
- City of Montreal.
- Manitoba Hydro Electric Board.
- Newfoundland and Labrador Power Commission.
- Province of Nova Scotia.
- Province of Ontario.
- Province of Quebec.
- Quebec Hydro Electric Commission.

CORPORATIONS:
- Bell Telephone Co. of Canada, Ltd.
- Canadian Imperial Bank of Commerce.
- Canadian Pacific Railroad.
- Electric Reduction of Canada, Ltd.
- Home Oil, Ltd.
- Intercontinental Pulp and Paper Co.
- International Minerals and Chemical Co.
- MacMillan Bloedel and Powell River, Ltd.
- Massey Ferguson, Ltd.
- Prince George Pulp and Paper Co.
- Shell Oil of Canada.
- Toronto-Dominion Tower, Ltd.

Japanese Borrowers of Long-Term Capital in the United States—1964–1968

Japan Development Bank; Kansai Electric Power Company; Komatsu Manufacturing Company; Metropolis of Tokyo; and Nippon Telephone and Telegraph Public Corporation.

*This list represents Canadian borrowers who have issued substantial amounts of new securities in the United States; it excludes a large number of smaller issues by Canadian corporations and municipalities.

U.S. BALANCE BILATERAL BALANCE OF PAYMENTS WITH CANADA

[In millions of dollars]

	1967	1968
A. Current account:		
U.S. exports	7,302	8,141
U.S. imports	−6,854	−8,594
Trade balance	448	−453
Invisibles:		
Net military	−180	−246
Income from U.S. investments	1,595	1,758
Payments on Canadian investments	−337	−402
Other	−495	−268
Total	583	842
Current account balance	1,033	389
B. Capital account:		
U.S. private:		
New securities issues, gross	−1,007	−946
Redemptions of outstanding securities	226	190
Direct investment	−403	−594
Other long term	−129	−27
Short term	−84	12
U.S. Government	−33	24
Canadian capital	368	427
Capital account balance	−1,062	−914
C. Balance recorded transactions (A+B), apart from special Canadian Government investment	−29	−525
Special Investment in U.S. Treasury securities by Canadian Government	200	1,050
D. Total balance on recorded transactions	171	525

Source: Survey of Current Business.

GOLD AND FOREIGN EXCHANGE RESERVES, AND ANNUAL IMPORTS

[In millions of dollars]

Year (end of period)	Canada				Japan			
	Foreign exchange	Gold	Total	Imports	Foreign exchange	Gold	Total	Imports
June 30, 1963	1,946	755	2,701		1,613	289	1,902	
1963	1,786	817	2,603	6,636	1,589	289	1,878	6,737
1964	1,658	1,026	2,684	7,554	1,495	304	1,799	7,938
1965	1,523	1,151	2,674	8,713	1,569	328	1,897	8,170
1966	1,199	1,046	2,245	10,170	1,469	329	1,798	9,524
1967	1,260	1,015	2,275	10,966	1,453	338	1,791	11,664
1968	1,972	863	2,835	12,482	2,261	356	2,617	12,988
June 30, 1969	1,773	866	2,639		2,285	363	2,648	

Source: IMF, International Financial Statistics.

INTERNATIONAL INSTITUTIONS

The exemption of the international institutions from the IET reflects the fact that these institutions (Inter-American Development Bank and International Bank for Reconstruction and Development) are engaged primarily in loans to parts of the world that are exempt from the Interest Equalization Tax, *i.e.*, the lesser developed countries. Further, the institutions are cooperating very substantially with the U.S. payments program; and finally, the Articles of Agreement of these institutions, to which the U.S. is signatory, do provide for exemption from taxes on this type of transaction.

It is the firm policy of the IBRD management to seek the broadest possible market for its securities outside the United States. Such a policy is not only in the general interest of the Bank and the developing countries it serves, but also is in keeping with the principles on which a sound international monetary system must operate.

In the early days of the Bank, the overwhelming proportion of its securities was, of course, held in the United States. In 1956, ten years after it commenced operations, only 45% of its securities were held outside the United States, but by the late 1950's and early 60's, the majority of its securities came to be held in foreign hands. In recent years, further progress has been made in increasing the proportion held by non-U.S. residents. The Bank estimates that at the end of FY '68, 58.3% of its funded debt of $3.8 billion was held abroad; 41.7% was held in the U.S.

During the past few years new IBRD security issues placed abroad have risen steadily in relation to those placed in the U.S. In FY 1969 gross flotations by the Bank exceeded $1.2 billion—more than in any previous year in its history. Of this amount, over $1.0 billion—or approximately 78%—was sold abroad—mostly through securities denominated in currencies other than the dollar.

In addition to this direct borrowing, the IBRD also sells participations in its loans. However, of those participations, which if undertaken directly by U.S. residents, would have been subject to the IET, the IBRD does not sell such participations to U.S. residents.

The Inter-American Bank, in cooperation with the U.S. payments program, also has substantially shifted its borrowing to non-U.S. sources, although the loans it finances from such borrowing are principally to IET-exempt countries. In 1968, such cumulative IDB borrowing in the U.S. was $400 million, compared with total borrowings of $700 million. During 1969 to date, all IDB borrowing (about $117 million) has been outside the U.S.

IBRD BONDS AND NOTES ISSUED IN THE UNITED STATES AND ABROAD, FISCAL YEAR 1964 TO FISCAL YEAR 1969[1]

[In millions of dollars]

	1964	1965	1966	1967	1968	1969
Borrowed in:						
United States	....	200	175	250	300	250
Abroad	100	398	289	305	435	1,011

[1] Based on IBRD data.

Note: The above figures are gross of rollovers of maturing debt.

IBRD BOND ISSUES IN FISCAL YEAR 1969

	Amount (in millions)	Date of issue	Interest rate (percent)	Maturity
In United States	$250.0	Oct. 1, 1968	6⅜	1994
Outside United States:				
German mark	100.0	July 1, 1968	6½	1977–82
Do	100.0	Aug. 1, 1968	6½	1972
Do	32.0	do	6	1973
Do	32.5	do	6	1980
Kuwaiti dinars	42.0	Sept. 15, 1968	6½	1988
U.S. dollars	15.0	Oct. 1, 1968	6⅜	1994
Do	144.5	do	5⅝	1970
German mark	32.0	do	5⅞	1973
Swiss francs	18.6	Nov. 25, 1968	5¼	1984
German mark	37.5	Dec. 16, 1968	6½	1984
Do	31.3	Jan. 24, 1969	6½	1984
Do	32.0	Feb. 1, 1969	6½	1973
Do	32.5	do	6½	1974
U.S. dollars	192.7	Mar. 15, 1969	6¾	1971
German mark	31.3	Apr. 1, 1969	6	1977–84
Do	62.5	June 1, 1969	6½	1975–84
Do	12.5	June 23, 1969	6½	1971
Do	12.5	do	6⅝	1972
Do	12.5	do	6¾	1973
Subtotal	973.6			
Total	1,223.6			

IDB BORROWING—CUMULATIVE ANALYSIS

[$ millions and equivalents]

	1962	1963	1964	1965	1966	1967	1968
A. Gross basis							
(1) Cumulative in United States	75.0	75.0	225.0	225.0	225.0	335.0	405.0
(2) Cumulative outside United States	24.0	24.0	46.2	58.7	169.1	205.1	302.3
(3) Cumulative total	99.0	99.0	271.2	283.7	394.1	540.1	707.3
(2) As percent of (3)	24.0	24.0	17.0	20.7	42.9	38.0	42.7
Net basis (exclusive repayments and sinking funds):							
(1) Cumulative in United States	70.0	70.0	220.0	220.0	220.0	330.0	400.0
(2) Cumulative outside United States	24 0	24.0	46.2	58.7	169.1	180.1	232.3
(3) Cumulative total	94.0	94.0	266.2	278.7	389.1	510.1	632.3
(2) As percent of (3)	25.5	25.5	17.4	21.1	43.5	35.3	36.7

BANK LOANS TO FOREIGNERS

The IET was applied to long-term commercial bank loans to foreigners in early 1965. Subsequently, the substantial outflow of U.S. capital in this form, amounting to over $900 million in 1964, subsided and then reversed as the repayment of previous bank loans began exceeding new loans. Net repayments were $357 million in 1968, and for the first five months of 1969, $115 million. As the attached table indicates these repayments to the U.S. of recent years have come substantially from the developed countries.

The IET does not apply to short-term bank claims on foreigners. An attached table indicates that the total outflow on short-term bank claims in 1968 was $89 million.

Also attached is a table, based on an IET reporting system, which shows long-term U.S. commercial bank loan commitments to foreign countries. The table clearly indicates that, following the application of the IET to commercial bank loans, the amount of such IET-subject loans rapidly diminished. The data in this third table represent commitments, which of course are not necessarily exercised.

The behavior of these bank claims and commitments also reflects the effects of the Federal Reserve voluntary restraint program on bank loans to foreigners, as well as the recent sharp tightening in U.S. domestic monetary conditions.

CHANGES IN LONG-TERM CLAIMS ON FOREIGNERS REPORTED BY BANKS IN THE UNITED STATES

[In millions of dollars; positive figures represent increase]

Area and country	July–December 1963	1964 [1]	1965	1966	1967	1968	January–May [2] 1969	July 1963–May 1969
All countries—total	440	942	232	−337	−255	−357	−115	550
Developed—total	408	670	−10	−448	−525	−293	−44	−24[illegible]
Western Europe developed—total	304	516	−148	−414	−428	−195	9	−356
Austria	37	34	−58	−50	−15	−10	−1	−63
Belgium-Luxembourg [3]	20	26	9	8	−30	−38	----------	−5
Denmark	13	2	−13	−15	−18	−9	(4)	−4[illegible]
France	2	23	−8	−15	3	−9	6	[illegible]
Germany	43	23	34	−64	−68	−9	17	−[illegible]
Italy	91	213	−41	−142	−141	−44	−3	−57
Netherlands	4	10	−8	−2	−4	(4)	−1	−[illegible]
Norway	12	28	−53	−34	−62	−54	−9	−17[illegible]
Portugal	39	7	8	−20	−23	−16	−2	−[illegible]
Spain	27	21	−1	−8	−22	22	11	50
Sweden	10	64	−16	−33	−28	−13	6	−10
Switzerland	3	26	(4)	−21	−5	−6	(4)	−3
United Kingdom	3	39	−1	−16	−14	12	−13	10
Eastern Europe	11	−2	−8	7	6	(4)	−4	10
Canada	33	−17	31	−32	101	1	−31	86
Bahamas and Bermuda	−4	−6	2	−18	−1	−6	−1	−34
Hong Kong	−1	(4)	1	1	−1	−2	(4)	−[illegible]
Japan	91	136	15	−119	−146	−58	−10	−9[illegible]
South Africa	−12	6	15	23	−26	−2	1	5
Australia	−14	37	82	103	−31	−32	−6	139
Less developed—total	34	272	242	111	270	−64	−69	796
Western Europe less developed	28	72	28	27	−15	−34	−9	97
Latin America—less developed	−15	154	18	68	211	−175	−21	240
Other	21	46	196	16	74	146	−40	45[illegible]

CHANGES IN SHORT-TERM CLAIMS ON FOREIGNERS REPORTED BY BANKS IN THE UNITED STATES

Area and country	July–December 1963	1964 [1]	1965	1966	1967	1968	January–May [2] 1969	July 1963–May 1969
All countries—total	456	1,524	−325	84	730	89	268	2,826
Developed—total	269	854	−523	−147	448	−93	210	1,018
Western Europe developed—total	−43	246	−73	156	−103	−21	72	234
Austria	−1	3	−2	8	(4)	−10	6	4
Belgium-Luxembourg [3]	−4	16	4	15	−1	−43	15	2
Denmark	3	14	11	24	−25	−1	−5	21
France	3	9	−9	1	14	−22	23	19
Germany	−136	38	39	24	−51	−8	7	−87
Italy	39	12	−4	−2	−52	46	4	43
Netherlands	−1	6	2	2	−5	5	−2	7
Norway	10	2	9	24	−14	−19	----------	12
Portugal	4	5	3	16	−16	−15	−1	−4
Spain	−18	14	10	17	−13	−8	−6	−4
Sweden	5	17	3	22	(4)	−18	−3	26
Switzerland	5	27	−38	10	10	−2	15	[illegible]
United Kingdom	48	82	−100	−6	51	74	20	169
Eastern Europe	5	5	12	−14	3	3	6	20
Canada	−16	87	−410	−49	−15	−74	218	−259
Bahamas and Bermuda	15	16	−12	8	2	18	−13	34
Hong Kong	−1	15	1	2	−3	2	6	22
Japan	300	481	−59	−266	576	−41	−79	912
South Africa	1	4	14	17	−14	9	----------	31
Australia	8	(4)	4	(4)	2	12	----------	26
Less developed—total	188	671	199	231	281	184	59	1,813
Western Europe less developed	−7	27	32	17	−40	−12	1	18
Latin America—less developed	123	484	66	188	252	159	−69	1,203
Other	72	159	101	26	69	38	125	590

[1] Changes adjusted for changes in reporting coverage and therefore do not agree with changes computed from outstanding figures.
[2] Through 1967, Luxembourg included in "Other Western Europe" (Western Europe, less developed).
[3] Preliminary.
[4] Less than $500,000.

Note: Detail may not add to totals because of rounding.

LONG-TERM U.S. COMMERCIAL BANK LOAN—COMMITMENTS TO FOREIGN COUNTRIES, BY AREA, 1964–68

[In millions of dollars]

	1964	1965 Jan. 1–Feb. 10	1965 Feb. 11–Dec. 31	1966	1967	1968	1969, 1st half
Total, all countries	2,231	773	1,137	896	1,314	1,255	284
Total, IET countries [1]	1,246	574	449	204	212	175	34
Western Europe	718	235	163	98	151	107	24
Other	528	339	286	106	61	67	10
Of IET countries, total:							
Subject to IET [2]	(4)	(4)	204	138	24	[3] 23	6
Exempt from IET	(4)	(4)	[3] 245	[3] 66	187	152	32
Reason:							
U.S. export financing	(4)	(4)	198	64	173	142	16
Other	(4)	(4)	47	2	14	10	16
Total, other countries	985	199	688	691	1,102	1,081	250

[1] IET made applicable to long-term U.S. commercial bank loans as of Feb. 11, 1965.
[2] To extent of amounts actually disbursed.
[3] Includes standby credit; $27,000,000 in 1965, $2,000,000 in 1966, and $15,000,000 in 1968.
[4] Less than 500,000 or not available.

Note: Detail may not add to totals because of rounding.

FOREIGN SECURITIES

U.S. transactions in new and outstanding foreign securities, on a balance-of-payments basis, are shown in the two attached tables.

On the new issues of foreign securities in the U.S. the outflow on IET-subject transactions has remained at negligible levels.

On U.S. transactions in outstanding foreign securities, there is no way of deriving from the available data the gross amounts of outstanding IET-subject foreign securities sold by foreigners to U.S. residents. The only meaningful way of looking at these transactions, in balance-of-payments terms, is to take the U.S. purchases of foreign securities, *net* of any sales. The reason is that there is a significant volume of U.S. brokerage business in these foreign securities, in which the U.S. brokers purchase the securities from foreigners, and resell them to foreigners. There is no practical way of separating out these purely brokerage transactions; and therefore it is necessary to estimate the sale of foreign securities to Americans as a net figure, as shown in the attached table. The outflows on such net transactions substantially have been to the IET exempt countries. If there had not been substantial purchases of gold-mining shares in 1967 and 1968, a good part of which would be recorded for Canada, and for the United Kingdom where such South African shares are traded, the IET-subject countries possibly would have shown net U.S. inflows in those years, as in earlier years.

NEW ISSUES OF FOREIGN SECURITIES PURCHASED BY U.S. RESIDENTS, BY AREA, 1962-68

[Balance-of-payments basis, in millions of dollars]

	1962	1963[5] 1st half	1963[5] 2d half	1964	1965	1966	1967	1968	1969 1st quarter[1]
Total, new issues	1,076	1,000	250	1,063	1,206	1,210	1,619	1,659	507
IET countries, total	356	343	110	35	147	19	14	3	
West. Europe, including United Kingdom	195	219	53	35	95	15			
Japan	101	107	57		52	4	14	3	
Other[2]	60	17							
Of which are exempt from IET[3]			[4] 110	20	52	10	14	3	
Other countries, total	722	656	141	1,027	1,058	1,191	1,605	1,656	507
Canada	458	608	85	700	709	[6] 922	1,007	946	329
Latin America[5]	119	13	23	208	36	68	140	144	16
Other countries	61	35	33	115	134	121	212	176	47
International institutions	84			4	179	80	246	390	115

[1] Not seasonally adjusted because country detail is not available seasonally adjusted.
[2] Australia, New Zealand, South Africa.
[3] Mostly related to the Japanese exemption and U S exports.
[4] Represents commitments made prior to July 18, 1963, the date of inception of the IET.
[5] Includes Latin American Development Bank issue of $145,000,000 in 1964.
[6] Before deducting $162,000,000 of Canadian Government purchases from U.S. residents of outstanding Canadian and other foreign securities in accordance with Canada's agreement not to let its foreign exchange reserves rise as a result of borrowing in the United States.

Source: Survey of Current Business.

NET TRANSACTIONS IN OUTSTANDING FOREIGN SECURITIES BY U.S. RESIDENTS, BY AREA, 1962-68

[Balance-of-payments basis, millions of dollars, net U.S. purchases (—)]

	1962	1963 1st half[1]	1963 2d half[1]	1964	1965	1966	1967	1968	1969 (1st quarter)
Total outstanding issues	—96	—151	102	194	225	300	—135	—53	15
ILT countries, total	15	—85	85	181	234	222	—111	7	8
United Kingdom	31	17	23	49	9	—7	—71	—95	—32
West Europe	—47	—69	31	103	110	156	—25	21	75
Japan	—23	—25	—4		6	10	—5	6	—2
Canada[2]	79	7	30	17	147	68	—8	84	—33
Other[3]	—25	—15	5	12	—38	—5	—2	—9	
Other countries, total	—13	—6	10	2	—8	26	—36	—87	—13
Latin America[4]	—25	—3	1	—13	—13	2	—13	—85	—30
Other countries	12	—3	9	15	5	24	—23	—2	17
International institution	—98	—60	6	11	—3	51	13	26	20

[1] Seasonally unadjusted.
[2] Excludes Canadian repurchases, undertaken in 1966, 1967, and 1968 for reserve management purposes.
[3] Australia, New Zealand, South Africa.
[4] Includes Latin American Development Bank issue of $145,000,000 in 1964.

Note: These data are at best only a rough indicator of the volume of IET liability incurred on transactions in outstanding issues. First, these data reflect residence of seller rather than the original country of issue of the security (the basis on which tax is liable); second, to obtain the net figure, U.S. purchases of foreign securities are subtracted from U.S. sales of foreign securities. U.S. transactions in which a broker buys a foreign security, and resells it to another foreign resident are netted out. Buy necessarily, other transactions also are netted out.

Source: Department of Commerce, Survey of Current Business, June 1968 and June 1969.

Foreign Purchases and Sales of U.S. Domestic Stocks and U.S. Direct Investment Abroad

Attached per your request are also tables showing, by major countries, foreign purchases and sales of U.S. domestic equities, and a set of tables showing direct investment capital outflows and income including fees and royalties.

I have also attached a table showing the effect of the liquidation of the U.K. Government portfolio of U.S. securities on net foreign purchases.

FOREIGN PURCHASES AND SALES OF U.S. DOMESTIC STOCKS AS REPORTED BY BANKS AND BROKERS IN THE UNITED STATES

[In millions of dollars, net U.S. outflows (—)]

	1962	1963	1964	1965	1966	1967	1968	Jan.-May 1969 [1]
United Kingdom:								
Purchases	405.6	741.5	632.7	546.8	389.1	681.6	893.1	411.7
Sales	446.2	544.6	809.5	945.0	913.4	796.5	921.1	493.3
Net purchases (+)	−40.6	+196.9	−176.8	−398.2	−524.3	−114.9	−28.0	−81.6
Other Europe:								
Purchases	1,183.7	1,224.5	1,472.3	1,975.8	2,353.1	4,160.5	7,583.2	3,163.4
Sales	1,029.9	1,255.4	1,717.4	2,049.5	2,466.0	3,704.0	5,963.4	2,397.2
Net purchases (+)	+153.8	−30.9	−245.1	−73.7	−112.9	−456.5	+1,619.8	+766.2
Canada:								
Purchases	335.8	371.5	527.4	671.9	1,146.9	1,966.2	2,511.4	966.7
Sales	302.9	366.3	492.3	625.2	916.4	1,701.5	2,125.6	838.6
Net purchases (+)	+32.9	+5.2	+35.1	+46.7	+230.5	+264.7	+385.8	+128.1
All other:								
Purchases	335.1	386.5	443.8	525.4	851.4	1,224.5	2,130.1	1,063.3
Sales	370.1	360.2	406.1	513.5	778.0	1,074.1	1,837.8	914.2
Net purchases (+)	−35.0	26.3	+37.7	+11.9	+73.4	+150.4	+292.3	+149.1
Grand total;								
Purchases	2,260.2	2,724.0	3,076.2	3,719.9	4,740.5	8,032.8	13,117.8	5,605.1
Sales	2,149.1	2,526.5	3,425.3	4,133.2	5,073.8	7,276.1	10,847.9	4,643.3
Net purchases (+)	+111.1	+197.5	−349.1	−413.3	−333.3	+756.7	+2,269.9	+961.8

[1] Preliminary, seasonally adjusted.

Note: Detail may not add to totals because of rounding.

TABLE I—DIRECT INVESTMENT CAPITAL OUTFLOWS

[Millions of dollars]

	1962	1963	1964	Average 1962-1964	1965	1966	1967	1968	1st quarter 1969
OBE total (net of Delaware subsidiary borrowing)	−1,654	−1,976	−2,328	−1,986	−3,416	−3,194	−2,876	−2,240	−633
OBE total (including Delaware subsidiary borrowing)	−1,654	−1,976	−2,328	−1,986	−3,468	−3,639	−3,154	−3,025	−806
Less developed countries	−218	−483	−349	−350	−822	−546	−725	−1,034	−261
Developed countries	−1,435	−1,492	−1,979	−1,635	−2,647	−3,094	−2,431	−1,992	−546
Canada	−314	−365	−298	−326	−962	−1,152	−403	−594	−134
United Kingdom	−170	−124	−215	−170	−317	−381	−353	−375	−122
Western Europe	−699	−800	−1,174	−890	−1,162	−1,432	−1,127	−620	−216

Source: Department of Commerce, "Survey of Current Business"; June 1969.

TABLE II.—DIRECT INVESTMENT INCOME

[In millions of dollars]

	1962	1963	1964	Average 1962–64	1965	1966	1967	1968	1st quarter, 1969
OBE total	3,044	3,129	3,674	3,282	3,963	4,045	4,517	4,985	1,325
Less developed countries	1,889	2,029	2,218	2,045	2,236	2,352	2,639	2,962	764
Developed countries	1,154	1,100	1,455	1,236	1,727	1,694	1,879	2,023	561
Canada	476	455	634	522	703	756	789	849	181
United Kingdom	211	199	281	230	270	251	274	281	101
Western Europe	309	308	378	332	498	479	576	635	169

Source: Department of Commerce, Survey of Current Business; June 1969.

TABLE III.—DIRECT INVESTMENT FEES AND ROYALTIES

[In millions of dollars]

	1962	1963	1964	Average 1962–64	1965	1966	1967	1968	1st quarter, 1969
OBE total	580	660	756	665	924	1,030	1,136	1,279	296
Less developed countries	180	195	218	198	270	270	306	341	78
Developed countries	402	467	538	459	656	761	830	938	218
Canada	127	134	162	141	185	215	243	268	62
United Kingdom	79	98	109	95	140	151	164	176	43
Western Europe	144	175	197	172	242	292	309	359	81

Source: Department of Commerce, Survey of Current Business; June 1969.

NET FOREIGN PURCHASES OF U.S. CORPORATE SECURITIES

[Millions of U.S. dollars, net foreign sales, B/P basis]

	Net foreign purchases [1]	Net transactions by United Kingdom residents	U.S. Delaware subsidiary issues	Net foreign purchases, excluding columns 2 and 3
	(1)	(2)	(3)	(4)
1950–54 average	73			73
1955–59 average	238			238
1960	282	−48		330
1961	324	−17		341
1962	134	−34		168
1963	282	207		75
1964	−84	−3		−81
1965	−357	−520	191	−28
1966	909	−101	594	416
1967	1,016	−453	446	1,023
1968	4,360	(2)	2,129	2,231
1969, 1st quarter	1,372		401	971

[1] Differs from Treasury Bulletin gata in that transactions representing foreign direct investment in the United States are deducted from Treasury data.

[2] Adjustment not applicable after end 1967 completion of United Kingdom Government portfolio liquidation.

Source: Department of Commerce, Survey of Current Business.

The CHAIRMAN. The next witness will be Mr. Peter K. Nevitt, on behalf of the GATX-Armco-Boothe of San Francisco.

STATEMENT OF PETER K. NEVITT, SENIOR VICE PRESIDENT, GATX-ARMCO-BOOTHE, SAN FRANCISCO, CALIF.; ACCOMPANIED BY LEONARD L. SILVERSTEIN, SPECIAL TAX COUNSEL

Mr. NEVITT. My name is Peter K. Nevitt. I am senior vice president of GATX-Armco-Boothe. I am accompanied by Leonard Silverstein, special tax counsel.

I will submit a statement outlining our views on the clarification of H.R. 12829 to promote export sales and thus help the U.S. balance-of-payments position. I will summarize the contents of the statement.

Briefly stated, we propose that H.R. 12829 be amended to clarify that certain finance leases are not subject to the interest equalization tax where foreign subsidiaries of U.S. companies lease equipment manufactured in the United States for foreign use where such equipment is purchased by the lessor with funds borrowed from foreign sources. It is contemplated that most of the equipment leased by us will be manufactured in the United States.

American manufacturers, especially aircraft manufacturers, need to develop alternate means of financing export sales to foreign users in order to compete with foreign manufacturers.

In view of the serious balance-of-payments problem about which members of the committee have expressed much concern this morning, it is essential that every effort be made to increase rather than deter exports of capital goods and equipment manufactured in the United States.

The aircraft industry, for example, projects export sales of over $1 billion per year over each of the next 5 years, as shown in the exhibit attached to my written statement. These export sales of aircraft are expected to total, and will total, over $20 billion over the next 12 years.

My exhibit, incidentally, is based on market surveys by Boeing, and is comparable to similar surveys made by Lockheed and McDonnell-Douglas.

Additional means of financing such export sales must be developed if the U.S. aircraft manufacturers are to attain these export sales goals in competition against foreign aircraft manufacturers which often have financing subsidized by the Government.

In view of the scope and importance of leasing transactions, we recommend that Congress provide the Secretary of the Treasury with authority to promulgate regulations specifically clarifying the entire question of a lease and its possible characterization as a debt obligation for purposes of the interest equalization tax. In this regard, we believe the determination of whether a lease is a debt obligation for interest equalization tax purposes should be guided by different criteria than those presently utilized in the consideration of a lease for income tax purposes. Administrative clarification of this issue would eliminate the uncertainty which presently faces many taxpayers presented with this situation.

We therefore urge that in view of the necessity for increasing exports in order to expand our share of the foreign markets and thereby improve our balance-of-payments position, the committee amend the provisions of H.R. 12829 relating to finance companies to provide

that the interest equalization tax will be inapplicable in a factual situation involving a lease by a U.S.-owned foreign subsidiary lessor to a foreign person of property manufactured, produced, grown, or extracted in the United States where the property is acquired by such lessor from funds derived solely from foreign sources. To maintain the present uncertainty or to permit imposition of the interest equalization tax in such a situation would clearly be inconsistent with and contrary to the purpose of the tax and detrimental to our economical position as reflected by our balance of payments.

The CHAIRMAN. Senator Gore?

Senator GORE. No questions.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. No questions.

The CHAIRMAN. Senator Anderson?

Senator Jordan?

Senator Miller?

Thank you very much.

Mr. NEVITT. Thank you very much, sir.

(Mr. Nevitt's prepared statement follows:)

STATEMENT OF PETER K. NEVITT, SENIOR VICE PRESIDENT, GATX-ARMCO-BOOTHE

My name is Peter K. Nevitt. I appear before you today in my capacity as Senior Vice President of GATX-Armco-Boothe, to testify with respect to a proposed amendment to H.R. 12829, the Interest Equalization Tax Extension Act of 1969 to exonerate from such Tax a form of transaction which presently may fall within the ambit thereof and would thereby have a substantial adverse impact on the U.S. balance of payments position. I am accompanied by Leonard L. Silverstein, Special Tax Counsel.

GATX-Armco-Boothe is a partnership located in San Francisco, California which is engaged in the purchase and lease of aircraft and other major items of capital equipment to airlines and other users. GATX-Armco-Boothe also provides management services for the conduct abroad by certain affiliates of General American Transportation Corporation ("GATX") engaged in activities of leasing and selling aircraft and other major items of capital equipment to foreign users. GATX is a corporation located in Chicago, Illinois, which is engaged in the business of manufacturing, leasing and selling specialized equipment, including railroad rolling stock.

Under the present method of operation, GATX organized a financing corporation incorporated in the United States which borrows funds solely from foreign sources. A portion of the proceeds of such foreign borrowings is then used by the domestic financing subsidiary for the acquisition of a 50 percent interest in a foreign financing corporation. The foreign financing subsidiary in turn borrows funds from foreign banks and foreign institutional lenders under loan agreements. GATX guarantees repayment of a portion of such loans. (Debentures convertible into stock of GATX have not been issued by such domestic or foreign finance subsidiaries.) The foreign financing subsidiary, either directly or through its foreign subsidiaries, sells or leases to foreign users items of capital equipment. It is contemplated that a substantial portion of the equipment leased by such foreign subsidiaries will be manufactured in the United States.

Under present law, there is substantial uncertainty as to the application of the Interest Equalization Tax by reason of the lease of property to foreign persons in the above-described situation. The imposition of the Interest Equalization Tax on the acquisition by GATX of the stock of the domestic financing subsidiary and on the acquisition by the domestic financing subsidiary of the stock of the foreign financing subsidiary appears to be largely dependent upon whether the least instruments executed by the foreign financing subsidiary and/or its foreign subsidiaries with foreign lessees constitute "debt obligations" for purposes of the Interest Equalization Tax. The Tax would not apply unless the foreign financing

subsidiary is deemed to have been "formed or availed of by the United States person for the principal purpose of acquiring, through such corporation. . ., an interest in stock of *debt obligations* (of one or more other foreign issuers or obligors) the direct acquisition of which by the United States person would be subject to the tax imposed by section 4911." [1] (Emphasis added). If the execution of a lease is deemed to constitute the acquisition of a "debt obligation" of a foreign obligor (i.e., the foreign lessee), the Interest Equalization Tax may be imposed both on the acquisition by the domestic financing subsidiary of the stock of the foreign financing subsidiary and, by virtue of section 4912(b)(3), in acquisition by GATX of the stock of the domeste financing subsidiary.

The status of current law as to the treatment of a lease as a "debt obligation" for purposes of the Interest Equalization Tax is unclear. Neither the statute nor the regulations provide rules as to whether a lease constitutes a "debt obligation" in the context considered. Several taxpayers have submitted formal requests for ruling by the Internal Revenue Service on this question. The Internal Revenue Service, however, has held up issuance of such ruling requests (which have been pending for more than one year) until the outcome of a study of this question undertaken by the Treasury Department. To this day, the Treasury Department has not resolved the question and it appears unlikely that an administrative resolution of this problem will be forthcoming in the near future.

It is submitted that the Interest Equalization Tax should not apply in a factual situation involving a lease to foreign persons of capital equipment where the lessor generates the funds to finance the purchase of such equipment solely from foreign sources. The Tax was designed to "bring the cost of capital raised in the U.S. market by foreign persons more closely into alignment with the costs prevailing in markets in other industrial countries . . ." and to "aid our balance of payments position by restraining the heavy and accelerated demand on our capital market from other industrialized countries." [2] Since the lease of property to foreign persons under the circumstances described above does not result in the acquisition by foreign obligors of capital in the U.S. market or in any other way result in the outflow of capital from the United States, no occasion is presented for application of the Tax.

Moreover, it is particularly important that the Interest Equalization Tax not be imposed where the leased property purchased by the lessor with funds generated from foreign sources is constructed in the United States. In view of the serious balance of payments problem which has faced this country in recent years, it is essential that every effort be made to increase rather than deter exports of capital goods and equipment. The Department of Commerce has, since 1968, implemented a foreign direct investment program to improve our balance of payments position by restricting certain transfers of capital abroad. However, such program is in no way intended or operated to limit the export of capital goods for use by unaffiliated foreign nationals; indeed, any such limitation would be contrary to the purpose of Department of Commerce program.

The necessity for encouraging exports can be demonstrated in the aircraft industry, which is the nation's largest manufacturing exporter. The projected share of the world sales market for aircraft manufactured in the United States over the next 10 years is illustrated in Table I attached hereto. The figure shown therein indicate the magnitude of projected exports by domestic aircraft manufacturers and reflect the industry's expectation of a 20 percent increase in export sales of U.S. manufactured aircraft over such 10 year period. In order to effectively compete with foreign aircraft manufacturers for a share of the world-wide aircraft market, domestic aircraft manufacturers must be encouraged rather than impeded in their efforts to increase their exports. Imposition of the Interest Equalization Tax by reason of the lease of U.S. manufactured aircraft in the above-described situation may significantly curtail the number of aircraft to be exported and will thus be detrimental to both the aircraft manufacturing industry and to our overall U.S. balance of payments position.

The importance of leasing as a method of facilitating the export of aircraft and other items of capital equipment is quite apparent. The leasing mechanism provides a method of financing which permits the utilization of such capital equipment in situations where the user would otherwise be unable to obtain sufficient financing to purchase the property. Foreign aircraft manufacturers

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[1] Section 4915(c)(1), Internal Revenue Code of 1954.

[2] H. Rept. No. 1046, 88th Cong., 1st Sess., p. 1; S. Rept. No. 1267, 88th Cong., 2d Sess., p. 1.

offer government subsidized financing in amounts and on terms and at rates which are often not available from foreign banks and lending institutions for financing of aircraft manufactured in the United States. Lease financing of aircraft manufactured in the United States and sold to foreign airlines constitutes an important alternate means of financing to help meet the competition of government subsidized financing of foreign aircraft. It is axiomatic that sales of aircraft manufactured in the United States will be lost if alternate means of financing sales to foreign airlines are not developed. Other export items of the United States will likewise be affected.

That imposition of the Tax on leases involving property manufactured, etc. in the United States was not intended by Congress is illustrated by the enactment in 1965 of section 4914(c)(6)[3] pursuant to which the Tax is not applied to the acquisition from a foreign obligor by a U.S. person of a debt obligation of such obligor arising out of a lease of personnel property to such obligor by the U.S. person if, *inter alia*, 50 percent of the value of the property subject to the lease is attributable to the use of tangible personal property manufactured, produced, grown, or extracted in the United States. The legislative history of such provision indicates clearly that Congress sought to exclude from the Tax the lease to persons abroad of property manufactured in the United States in the same manner as the exclusion previously enacted[4] for certain export sales. Section 4914(c)(6) is, however, limited to the acquisition of a debt obligation by a United States person and does not cover the acquisition of such debt obligation by the foreign lessor in the situation described above. However, the rationale underlying the exclusion from the Tax of property manufactured in the United States which is leased abroad is identical in both situations and parallel treatment should be provided.

It is therefore submitted that in view of the magnitude and importance of the balance of payments problem, it is essential that the tax laws (in this situation, the Interest Equalization Tax) not be applied in such manner as to impede the export of equipment from the United States where the funds therefor are derived abroad and thus no demand is made on our capital market. It is thus necessary that the Internal Revenue Code be amended so as to make clear that a lease will not constitute a "debt obligation," or at least will be exonerated from the Interest Equalization Tax under an appropriate export provision, where the property in question has been manufactured, produced, grown, or extracted in the United States and the funds therefor are derived abroad.

We are mindful of the possible negative inference which may be created as to leases of other property by the enactment of a provision which limits exclusion from the definition of debt obligations to leases of property manufactured in the United States. As previously indicated, we believe that a lease should not constitute a debt obligation for purposes of the Interest Equalization Tax where the property is generated by funds derived solely from abroad, regardless of the place of manufacture of such property. In the absence of enactment of an exclusion covering leases of all property in such situation, we believe that the U.S. balance of payments position compels an exclusion for leases of property manufactured in the United States. The special considerations pertaining to export property, however, should not result in the exclusion for leases of export property being interpreted as requiring leases of all other property to be classified as debt obligations.

It is therefore important that any amendment to H.R. 12829 which would exclude from the imposition of the Tax a transaction involving a lease to foreign persons of property manufactured, etc. in the United States must specifically negate a negative inference with respect to the question of whether a lease constitutes a debt obligation in other factual situations for purposes of the Interest Equalization Tax. The importance of exports to U.S. manufacturers of equipment and to the overall economy of the nation justifies a statutory provision expressly excluding the imposition of the Tax in a situation involving the lease of export property. The considerations underlying such amendment are unique to the situation and are motivated by a desire to improve our balance of payments position. Such amendment should neither expressly or impliedly permit a negative inference as to whether a lease is a debt obligation in other situations.

In view of the scope and importance of leasing transactions, we recommend

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[3] P.L. 89-243, section 4(a)(1).
[4] Section 4914(c)(5).

that Congress provide the Secretary of Treasury with authority to promulgate regulations specifically clarifying the entire question of a lease and its possible characterization as a debt obligation for purposes of the Interest Equalization Tax. In this regard, we believe that the determination of whether a lease is a debt obligation for Interest Equalization Tax purposes should be guided by different criteria than those presently utilized in the consideration of a lease for income tax purposes. Administrative clarification of this issue would eliminate the uncertainty which presently faces many taxpayers presented with this situation.

We therefore urge that, in view of the necessity for increasing exports in order to expand our share of the foreign market and thereby improve our balance of payments position, the Committee amend the provisions of H.R. 12829 relating to finance companies to expressly provide that the Interest Equalization Tax will be inapplicable in a factual situation involving a lease by a foreign lessor to a foreign person of property manufactured, produced, grown or extracted in the United States, where the property is acquired by such lessor from funds derived solely from foreign sources. To maintain the present uncertainty or to permit imposition of the Interest Equalization Tax in such situation would clearly be inconsistent with and contrary to the purpose of the Tax and detrimental to our economic position as reflected by our balance of payments.

I appreciate this opportunity to express my views to the Committee.

TABLE I.—WORLD JET AIRCRAFT DELIVERIES—U.S. AND FOREIGN MANUFACTURERS, DOLLARS PER YEAR (MILLIONS), WITHOUT SPARES [1]

	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	Total 1969–80
Sales to U.S. airlines:													
U.S. manufacturers	2,144	2,012	1,902	2,314	1,734	2,445	3,076	3,438	3,677	4,463	5,600	6,031	38,836
Foreign manufacturers	31	19	11		2			157	350	292	152	26	1,040
Total	2,175	2,031	1,923	2,314	1,736	2,445	3,076	3,585	4,027	4,755	5,752	6,057	39,876
Sales to foreign airlines:													
U.S. manufacturers	828	1,067	1,588	1,341	1,311	1,521	1,776	2,253	1,591	1,749	3,648	3,960	22,633
Foreign manufacturers	253	137	198	50	75	228	315	651	1,103	1,055	1,039	1,089	6,193
Total	1,081	1,204	1,786	1,391	1,386	1,749	2,091	2,904	2,694	2,804	4,687	5,049	28,826
U.S. share of foreign sales (percent)	76.6	88.6	88.9	96.4	94.6	87.0	84.9	77.6	59.1	62.4	77.8	78.4	78.5
U.S. manufacturers subtotal	2,972	3,079	3,490	3,655	3,045	3,966	4,852	5,691	5,268	6,212	9,248	9,991	61,469
Foreign manufacturers subtotal	284	156	209	50	77	228	315	808	1,453	1,347	1,191	1,115	7,233
Total world aircraft sales	3,256	3,235	3,699	3,705	3,122	4,194	5,167	6,499	6,721	7,559	10,439	11,106	68,702
U.S. share of world sales (percent)	91.2	95.2	94.3	98.7	97.6	94.6	93.4	87.6	78.4	82.1	88.6	90.0	89.5

[1] Spares add approximately 20 percent to total.

The CHAIRMAN. A number of organizations have communicated with the committee expressing an interest in this matter and we will print these in the record.

(The material referred to follows:)

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N.Y., July 25, 1969.

Re H.R. 12829, 91st Congress, First session, Interest Equalization Tax Extension Act of 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR MR. LONG: The National Foreign Trade Council, comprised of a broad cross-section of United States companies engaged in all major fields of international trade and investment, including manufacturers, exporters and importers appreciates the opportunity to comment on H.R. 12829, 91st Cong., 1st Sess., the proposed Interest Equalization Tax Extension Act of 1969.

The Council's comments set forth in Part 1 of this memorandum are directed solely to section 4(e) of the proposed bill dealing with certain financing subsidiaries. Part 2 of this memorandum is directed to certain other technical changes which should be adopted if the interest equalization tax is to be further extended.

PART 1—FINANCING SUBSIDIARIES

NATURE OF DEBT OBLIGATIONS

Paragraph (2) of proposed Section 4920(d) provides that: (A) at least 90 percent of the debt obligations owned by the domestic sales finance company at all times consists of debt obligations described in paragraph (1) (A), and (B) all debt obligations owned by such company at all times be those described in paragraphs (1)(A) or (1)(B), or both.

Under the language of proposed Section 4920(d)(2)(B), the sales financing company would not be permitted to own debt obligations consisting of accounts receivable arising from normal day to day business operations. Since these receivables are not described in paragraphs (1)(A) or (1)(B), this would preclude the acquisition of accounts receivable arising from: (1) normal relations with employes, for example: salary advances, travel advances and loans, etc.: (2) settlement of insurance and other claims pending actual receipts of cash; (3) overpayments of local taxes; (4) mistakes resulting in overpayments to dealers or other persons; or (5) security deposits to landlords which are not considered prepaid rent.

A finance company which is exclusively engaged in the financing business described in proposed Section 4920(d)(1) is expressly permitted, pursuant to subparagraph (C), to engage in incidental activities in connection with such finance business. Consistent therewith, paragraph (2)(B) of proposed Section 4920(d) should be amended to permit the acquisition of accounts receivable arising in the normal day to day activities of the sales finance business.

RECOMMENDATION

Accordingly, proposed Section 4920(d)(2)(B) should be amended to provide as follows:

"(B) all debt obligations owned by such corporation at all times during the taxable year are debt obligations described in paragraph (1), *or debt obligations owned in connection with the activities described in paragraph (1)*" (New language underscored.)

SOURCE OF FUNDS TO FINANCE DEBT OBLIGATIONS

A sale finance company described in proposed Section 4920(d) may acquire debt obligations solely out of the proceeds of sale of debt obligations and out of other items prescribed in paragraph (3), thereof.

1. Other Items—Contributed Capital

Proposed Section 4920(d)(3)(B) permits a sales financing company to acquire debt obligations out of the proceeds of payment for stock or contributions to capital of such financing corporation. However, such proceeds or contribution must be derived from the sale of debt obligations to non-U.S. persons by one or more includable corporations in an affiliated group, as defined in Section 48(c)(3)(C), and provided further that such debt obligations would be subject to interest equalization tax if acquired by a United States person.

New Finance Companies.—The requirement that the debt obligations of the related corporation, which are sold to non-U.S. persons in order to provide capital for the sales finance company must be subject to interest equalization tax in the hands of a U.S. person, was not contained in the Treasury draft of this Bill This requirement would necessitate obtaining such funds through an existing foreign sales finance affiliate, a foreign incorporated offshore capital funding corporation, or a domestic 4912(b)(3) corporation. There are serious problems in raising funds through any of these routes, as discussed below.

One possible source of funds might involve the parent finance company borrowing from an existing foreign sales finance affiliate. However, this approach might prove entirely impractical. In this respect, the governments and regulatory agencies of many foreign countries impose restrictions on the amount of borrowings by a sales finance subsidiary. Such restrictions are imposed in the United Kingdom, Australia, Peru, Germany, and other countries. Inasmuch as sales finance subsidiaries often operate with borrowings at or near the permitted maximums, it would be a serious problem for such subsidiary to borrow funds to loan the parent to capitalize an affiliated sales finance company.

Moreover, requiring the parent of the electing sales finance company to borrow from either an offshore capital funding corporation or a Section 4912(b)(3) company could create U.S. income tax problems. A loan by the offshore capital funding company to a U.S. corporation could constitute an investment in U.S. property under Section 956 of the Code which could be immediately taxable to the U.S. parent of the offshore company.

The Section 4912(b)(3) company which loans funds to the parent of the electing sales finance corporation will presumably be a so-called "80/20 corporation" affiliated with the manufacturing corporation to which the finance company also is related. The typical 80/20 corporation represents to its foreign lenders that interest payments by it to such lenders will be free of U.S. withholding tax. Exemption from U.S. withholding can only occur if less than 20% of the Section 4912(b)(3) corporation's gross income is from U.S. sources. Where the parent financing company must pay interest to the domestic Section 4912(b)(3) corporation from which it borrows, such payments will generate U.S source income in the latter's hands. The receipt of such U.S. source income may result in the failure of the Section 4912(b)(3) corporation to meet its 80/20 test. This would require U.S. withholding at source at 30 percent or lower treaty rate on interest paid to such non-U.S. lenders. Since the Section 4912(b)(3) corporation has guaranteed to such lenders that interest will be free of U.S. withholding the imposition thereof could be extremely costly and defeat the purpose of the Section 4912(b)(3) corporation.

Requiring that the parent finance corporation borrow funds from a foreign sales finance affiliate, a foreign incorporated offshore capital funding corporation, or a domestic Section 4912(b)(3) corporation to capitalize the electing sales finance subsidiary could develop a tax cost. The regulations under Section 482 would require the parent of the electing sales finance company to pay interest to the related lending company in an amount which would produce a profit for such company. This could result in the imposition of additional U.S. and/or foreign taxes on the increment.

The question also arises as to the effectiveness of the requirement of proposed Section 4920(d)(3)(B) that debt obligations, the proceeds from the sale of which are used as a contribution to capital of, or to purchase stock in, the sales finance subsidiary, must be subject to interest equalization tax if acquired by a U.S. person. For example, it would appear that the U.S. parent or another U.S. affiliate of the sales finance company might be able to acquire the notes of the lending company free of interest equalization tax.

Existing Finance Companies.—The requirements of proposed Section 4920(d)(3)(B) would appear to preclude most exciting domestic or foreign financing corporations from making the election provided for in proposed Section 4920(d)

or proposed Section 4915(c)(3), respectively. This is because debt obligations acquired out of long existing capital would most probably not have been derived from the sale of debt obligations described in proposed Section 4920(d)(3)(B).

RECOMMENDATION

To resolve the problem for new sales finance subsidiaries, the Council recommends that the following language at the end of proposed Section 4920(d)(3)(B) be *eliminated:*

". . . and such debt obligations, if acquired by United States persons, would be subject to the tax imposed by Section 4911 . . ."

2. Other items—funds generated in business

Paragraph (3)(D) of proposed Section 4920(d) permits the acquisition of debt obligations by the sales financing company out of trade accounts and accrued liabilities which are payable by such corporation within one year from the date incurred or accrued and which arise in the ordinary course of the financing business otherwise than from borrowing.

Many accrued liabilities of a sales finance company to non-U.S. persons and arising in the ordinary course of the finance business described in proposed Section 4920(d)(1) are not payable within one year. For example, foreign income taxes accrued in one year (under U.S. concepts) are often not payable to the foreign government or other local taxing authority until a later year. This is the case, for example, in Australia, the U.K., New Zealand and Switzerland. In Australia, taxes accruing in year one, are reported on a return in year two, and are paid in year three.

An example of trade accounts which are not normally paid within one year would be accounts payable to dealers representing the amount retained by the finance company for its protection in event of the dealer's inability or failure to discharge his obligation to the finance company. These are liabilities to the foreign dealer from the finance company which are withheld by the finance company and paid to the dealer over a period of time as certain conditions are met.

Under proposed Section 4920(d)(3)(D) the normal cash flow arising from these types of liabilities could not be used in the ordinary course of the financing businesses. Moreover, such funds could not even be placed in local bank accounts since this would constitute an acquisition of debt obligations not permitted by proposed Section 4920(d)(3).

RECOMMENDATION

Accordingly, the Council recommends that proposed Section 4920(d)(3)(D) be amended to encompass trade accounts and might discourage exports from U.S. arising in the ordinary course of the financing business which are payable by such corporation within three years from the date they were incurred or accrued.

ELECTION PROBLEMS

The election provided for in proposed Section 4920(d) is required to be made on or before the 60th day after organization of a corporation making such election or the 60th day after the date of enactment of the Interest Equalization Tax Extension Act of 1969, whichever is later. However, no provision is made for an election by an existing domestic sales finance company, the stock of which is acquired more than 60 days after enactment of the Act. A similar problem exists with respect to an election made by a foreign sales finance company under proposed Section 4915(c)(3), the stock of which is acquired more than 60 days after enactment of the Act.

RECOMMENDATION

Accordingly, the Council recommends that proposed Section 4920(d) be amended as follows:

"The election under paragraph (6) shall be made, under regulations prescribed by the Secretary or his delegate, on or before the 60th day after the organization of the corporation, *on or before the 60th day after the corporation becomes a member of an affiliated group as defined in Section 48(c)(3)(C) . . .*"
(New language italic.)

Part 2

OTHER TECHNICAL AMENDMENTS

Section 4915(a)

1. *Indirect Loans.*—Section 4915(a) provides an exclusion from interest equalization tax for certain direct investments. Thus, a U.S. person may loan money free of tax to a foreign corporation 10 percent or more of whose stock it owns directly or indirectly, or to a foreign partnership where it owns an interest of 10 percent or more in the profits of such partnership.

Because of competition with foreign companies which are not controlled by U.S. interests, restrictions of foreign law, and the diverse interest of the foreign participants from that of the U.S. participants, it is often necessary to make a loan to a foreign corporation or partnership in which a U.S. person has a 10 percent or more interest through an indirect route. Although section 4915(a) makes it clear that a loan to such a foreign corporation or partnership would qualify for the exemption under section 4915(a) if made directly to such foreign entity, it is not clear that such result would be obtained if the loan were made indirectly.

For example, assume that a U.S. person in order to obtain an interest in certain foreign mineral concessions agrees to form a foreign partnership (or a jointly-owned foreign corporation) with another foreign corporation and, in addition, is required to lend such partnership (or jointly-owned foreign corporation) an amount of money in excess of its equity share in such foreign partnership (or jointly-owned foreign corporation) for investment or other operational purposes. Also assume that the foreign corporation with whom the joint arrangements are developed insists on the money being first loaned to it who will in turn lend the money to the jointly owned foreign partnership (or jointly-owned foreign corporation). The foreign corporation insists on this loan route so that it can take advantage of certain provisions of the foreign tax law so as to minimize the foreign tax on the foreign partnership operations. Under present law it appears that such arrangement may be subject to the interest equalization tax. If such is the case, then it is quite inequitable since a direct loan to the partnership would not be taxed. Therefore, applying the tax to the indirect loan would merely lessen the flexibility of U.S. companies competing with foreign companies abroad with the result that such approach would hamper, not help, the U.S. balance of payments situation.

Similarly, as a condition for the purchase of a 10 percent or more interest in a foreign corporation by a U.S. person from an unrelated foreign stockholder, such stockholder may insist that any future capital required by the foreign corporation, *e.g.*, to expand plant facilities for the processing or servicing of ores or minerals, must be supplied by the U.S. person. If the U.S. person loans the funds directly to the jointly-owned foreign corporation, it is clear that such is exempt from the interest equalization tax under section 4915(a); however, if because of prior contractual commitments or local foreign law, shareholder loans must be pro rata, it is not clear that the loan would be exempt if it is made to the unrelated foreign shareholder who, in turn, is required to loan the money to the jointly-owned foreign corporation. On the other hand, it would certainly be an anomaly if the statute intended to tax an indirect loan when such would not be taxed if done directly. It is clear from a consideration of both the legislative history and statutory provisions of the interest equalization tax that it was the intent of Congress to levy the tax on the substance of a transaction, rather than its form. Compare section 4912(b)(2) and 4915(c) wherein the form of the transaction is disregarded for the substance.

RECOMMENDATION

Accordingly, the Council recommends that it be made clear in the statutory provision that in the case of a U.S. person who owns directly or indirectly a 10 percent or more interest in the profits of a joint venture (partnership) or the stock in a foreign corporation, loans made indirectly by such U.S. persons to such joint venture or foreign corporation qualify for the exclusion provided for in section 4915(a) where such indirect loan would have qualified for the exemption had it been made directly. This suggested modification will be consistent with the principle recognized in section 4914(c)(5)(B) which provides for an exemption from interest equalization tax in the case of a loan in certain situations where the proceeds thereof are used either by the borrower or by a person controlled by the borrower. Exhibit A attached hereto contains suggested amendments to section 4915(a) which we believe would accomplish the proposed clarification.

2. *Direct Investment.*—Section 4915 provides an exclusion from interest equalization tax for direct, as opposed to portfolio, investments because decisions with regard to making such investments are based upon market position, long-range profitability, and business necessity rather than upon concern with interest rate differentials.

Because of the magnitude of certain ventures which are essential to the conduct of certain related businesses, there is a growing tendency to form joint ventures to undertake the construction of certain required facilities. For example, in Europe, a number of crude oil pipelines are joint ventures in which the companies with local refining and marketing interests participate. In general, the equity interest in the pipeline is in proportion to the actual or expected use by each participating company. The reason for the equity/use rule is to insure that decisions as to what are for the best overall interests will be influenced more by overall users than by those using only a smaller proportion of the line. Since percentage of ownership in these industry pipelines are based on through-put, if a particular company has less than 5 percent through-put, less than 5 percent of the stock ownership will be held by such company.

Thus, while there can be no doubt that such investment in the pipeline situation is business oriented and can in no way be considered a portfolio-type investment, such investment even though substantial in amount does not qualify for the exclusion provided for in existing section 4915 (a) or (b) where the requisite percentage ownership test cannot be met.

Inasmuch as it is clear that these types of investments are solely business oriented for the purpose of transporting the crude oil of the owners of the facility and constitute part of an active business operation (as distinguished from portfolio investments), it is inequitable to tax such investments (or related loans in connection there with) merely because the specified ownership of the equity interest is not possible.

RECOMMENDATION

Accordingly, the Council recommends that section 4915(a) be amended so as to exempt business oriented investments (as distinguished from portfolio investments) or loans from the interest equalization tax even though the requisite percentage interest now required under existing law is not owned where such investments constitute an integral part of the conduct of an active business.

The Council will be happy to discuss these proposals further with you or members of your staff.

Very truly yours,

ROBERT T. SCOTT, *Vice President.*

EXHIBIT A

SUGGESTED DRAFT LANGUAGE RE AMENDMENT OF SECTION 4915(A)

This proposed amendment could be accomplished by first inserting after the following phrase appearing in section 4915(a)(1):

(a) "10% or more of the total combined voting power of all classes of stock of such foreign corporation"

the following phrase:

"(or a person who will use the proceeds of the indebtedness)"

In addition, the last sentence of section 4915(a)(1) would be amended to read as follows:

"For purposes of the preceding sentence, (i) stock owned (directly or indirectly) by or for a foreign corporation shall be considered as being owned proportionately by its shareholders, and stock owned (directly or indirectly) by or for a foreign partnership shall be considered as being owned proportionately by its partners, and (ii) if the U.S. person so elects under regulations prescribed by the Secretary, a debt obligation of a foreign corporation shall be considered to be a debt obligation of a foreign partnership if the proceeds arising from such debt obligation are invested (directly or indirectly) by such foreign corporation in a foreign partnership which uses such proceeds and in respect of such foreign partnership such foreign corporation owns (directly or indirectly) 25% or more of the profits interest in such foreign partnership."

STATEMENT ON BEHALF OF CHAMBER OF COMMERCE OF THE UNITED STATES, BY ROBERT R. STATHAM, TAXATION AND FINANCE MANAGER

The Chamber of Commerce of the United States appreciates the opportunity to express its views on H.R. 12829 to extend the interest equalization tax to March 31, 1971.

The National Chamber opposes an interest equalization tax and, more specifically, the proposed Interest Equalization Tax Extension Act of 1969.

SUMMARY OF THE POSITION OF THE CHAMBER OF COMMERCE

The Chamber is deeply concerned with H.R. 12829 which extends the interest equalization tax for twenty months. Originally adopted in 1964 as a temporary measure, and made retroactive to July 1963, this "temporary tax" is proposed to be extended for the third time since its enactment.

The National Chamber has consistently opposed the interest equalization tax. The tax contravenes established national policies and does not advance our long-term balance-of-payments goals. The tax restricts trade and investment and imposes artificial controls on the free international movement of capital.

It is recognized that the United States' balance-of-payments position needs strengthening, but the extension of this temporary measure—which has proved difficult to administer and enforce—is no solution to the problem.

NOT A SOLUTION TO THE BALANCE-OF-PAYMENTS PROBLEM

The interest equalization tax was enacted as a corrective measure to assist in reducing this country's balance-of-payments problem. This excise tax on the purchase by U.S. persons from foreign nationals of portfolio securities of foreign issuers was a departure from our traditional position of maintaining free capital markets and allowing the unrestricted movement of capital.

At the time of enactment, it was apparent that any such attempt to solve the Nation's balance-of-payments problem had to be temporary in nature. While initially foreign investments are of a deficit nature, the repaying of such investments—carrying with them interest and dividends—creates a surplus. Therefore, reduction in portfolio investments in foreign securities might be desirable on a short term basis, but in the long run it acts against a surplus by reducing the income to be received by persons in this country from foreign investments.

It would be preferable to attack our balance-of-payments deficit by reducing domestic inflation through restraints on domestic, public and private spending and by a reduction in Government overseas outlays. Reduced pressures to import, more competitive prices for exports, and more encouragement to overseas business investment, particularly in underdeveloped countries, constitute long range approaches to solving our payments problem.

In an effort to improve the Nation's balance of payments, the Chamber has encouraged a study of the value-added tax. More recently, the Department of Commerce has made a similar proposal in their publication *U.S. Foreign Trade, a Five Year Outlook*. The National Chamber believes the Federal Government should undertake immediately a comprehensive study of a value-added tax, or similar tax, and its adoption as a means of correspondingly reducing the income tax and improving the Nation's international balance of payments.

RESTRICTS TRADE AND INVESTMENTS

The interest equalization tax restricts trade and investment. However, restriction on the free movement of private goods and capital is not the solution to our balance-of-payments problem. Remedial measures should be oriented to expansion rather than restriction of world trade and investment. Business should not be asked or required to conduct its operations for a protracted period in ways that do not maintain it fully competitive with international business.

This type of tax barrier encourages other nations to impose tax and investment restraints. The interest equalization tax is interpreted by overseas powers as a form of exchange control, and retaliation may be anticipated.

ARTIFICIAL CONTROLS UNDESIRABLE

Artificial controls in peacetime on the free international movement of capital are undesirable. Such controls disrupt normal business decisions. The flexible restraint provisions in the law introduce an element of uncertainty, further disrupting normal business decisions.

Artificial controls tend to bring about artificial results. For the investor, there is in effect a devaluation of his dollar, since the tax increases the cost of his investment. The tax also tends to reduce the quality of foreign investments

marketed in this country, since foreign borrowers resort to marketing their securities in the United States if they cannot readily be sold elsewhere.

IN CONCLUSION

It is time that short-run effects are given less emphasis, and primary consideration is given to long-run objectives. President Nixon has recognized this approach and so indicated in his Balance-of-Payments Statement on April 4, 1969:

". . the problem of regaining equilibrium in the U.S. balance of payments cannot be solved with expedients that postpone the problem to another year. We shall stop treating symptoms and start treating causes, and we shall find our solutions in the framework of freer trade and payments."

CHRYSLER CORP.,
August 28, 1969.

Re: H.R. 12829 (91st Congress, 1st Session) Interest Equalization Tax Extension Act of 1969

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: Chrysler requests that the following comments set forth below be considered by the Senate Finance Committee in its hearings scheduled for September 3, 1969, on subject bill.

(1) Proposed Section 4920(d)(2)(B) be amended to permit the acquisition of debt obligations arising from incidental activities in connection with such finance business;

(2) Proposed Section 4920(d)(3)(B) be amended to delete the requirement that "such debt obligations, if acquired by United States persons, would be subject to the tax imposed by Section 4911", and simply provide that the proceeds of payment for stock or a contribution to capital be derived from the sale of debt obligations to persons who are neither citizens nor residents of the United States. (This latter approach was incorporated in the Treasury Department's draft of the proposed bill to assure that there would be no adverse effect on the U.S. balance of payments position as a result of such financing activities.)

(3) Proposed Section 4920(d)(3)(D) be amended by expanding from one year to three years the permissible maturity of trade accounts and accrued liabilities to non-U.S. persons arising in the ordinary course of the financing business;

(4) Proposed Section 4920(d) be amended to provide for elections on or before the 60th day after the corporation becomes a member of an affiliated group;

(5) Proposed Section 4915(c)(3) be amended to provide for an election on a similar basis as Section 4920(d)(6); and

(6) Proposed Section 4915(c) be modified to permit domestic finance companies qualifying under Section 4912(b)(3) to loan funds borrowed outside the United States to foreign finance subsidiaries qualifying under Section 4915(c)(3).

Chrysler has, since enactment of the Interest Equalization Tax Act in 1965, attempted to obtain relief to enable it to borrow funds abroad for investment and use in connection with foreign financing activities. PL 90-59, effective August 1, 1967, included legislation designed to provide taxpayer relief in this area. However, the stringent restrictions and limitations included in its provisions made it unworkable and nullified the remedial effect sought. It is respectfully requested that the above amendments be made so that the numerous restrictions and limitations contained in this 1969 legislation will not also nullify the relief intended.

Yours very truly,

E. A. SIGLER,
Manager, Income Tax Department.

THE BOEING CO.,
Seattle, Wash., September 2, 1969.

Mr. THOMAS VAIL,
Chief Counsel, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. VAIL: In connection with the hearings on H.R. 12829, dealing with the extension and modification of the Interest Equalization Tax, The Boeing

Company would like to submit the following comments for the consideration of the Committee on Finance.

As a manufacturer of commercial jet aircraft we believe it is important that the export market developed by the American aircraft industry be maintained. Since the introduction of jet aircraft in 1958, export sales of the industry have averaged over 300 million dollars annually. For the past four years the average has been more than 500 million dollars annually. We are forecasting a foreign market for commercial jet transports in the 1970's well in excess of one billion dollars annually.

The importance of the foreign segment of our business cannot be overemphasized. Not only for the obvious domestic employment effects in the U.S., but more importantly at this time, the very vital contribution these foreign commercial jet transport sales have made and will make in the future toward a favorable balance of payments for the United States.

Despite foreign government monopolies, subsidies and other competitive advantages, the United States manufacturers have made a remarkable penetration of the world market capturing about 70% of total sales of jet aircraft to foreign airlines.

The major constraint which could significantly reduce this degree of market penetration is the ability of foreign airlines to finance their desired purchases through existing financing sources. It is vital that all possible means of financing aircraft sold to foreign airlines be developed.

Clarification of the law to permit long-term lease financing of aircraft sales and leases to foreign airlines by United States based finance companies without concern as to probable implications related to the Interest Equalization Tax would be an additional valuable sales tool assisting United States aircraft manufacturers in maintaining their dominant position in the expanding foreign commercial jet market.

Very truly yours,

H. W. HAYNES,
Vice President-Finance.

LEE, TOOMEY & KENT,
Washington, D.C., September 3, 1969.

Hon. RUSSELL B. LONG,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: I wish to suggest an amendment to the bill to extend the Interest Equalization Tax H.R. 12829, which is necessary with respect what appears to be an oversight in drafting one of its provisions.

Section 4a of the bill amends section 4920(a)(3B) of the Code redesignating it as section 4920(d), with references to certain domestic financing companies. Paragraph (3) of section 4(e) extends the benefits of this provision to certain foreign finance companies by amendment of section 4915(c)(3).

The provision is elective. Section 4920(d)(6), as amended, permits an election to be made within 60 days after organization of the corporation or within 60 days after the date of enactment of the Interest Equalization Tax Act of 1969, whichever is later. This election may be made within such time, either by a domestic or foreign finance company.

However, the qualification requirements of section 4920(d), (2)(A) and (B), which require that only debt obligations of a prescribed type be owned by the electing corporation, must be met "at all times during the taxable year." Thus, an existing corporation making the election during the calendar year 1969 (if this is its taxable year) would be unable to qualify if, during the portion of the year prior to its election, it held debt obligations other than those described in paragraphs (A) and (B) of section 4920(d)(2). It would not seem that this result was intended if, at all times *after* the election, it held qualifying debt obligations in the prescribed amounts.

The particular situation we have in mind involves a Swiss finance company owned by a U.S. corporation. The Swiss corporation is engaged solely in financing the sale of goods manufactured by foreign affiliates of the U.S. parent. Because of the restrictive provisions of prior section 4920(a)(3B), the finance company has operated, thus far, by simply loaning funds to the affiliates on a short-term basis. It would prefer, however, to finance receivables directly, in the manner of credit companies operating in the U.S., and thus would make an election under section 4920(d)(6). However, since the affiliate debt obligations now

held are not described in section 4920(d)(1), it could not qualify under the present language.

It is suggested that section 4920(d)(2)(A) be amended by inserting in line 2, page 11 of the bill, after the words "during the taxable year", the following: "(or during the part thereof which occurs after the date of an election made under paragraph (6))" and by amending paragraph (B) of the same section by inserting in line 5, page 11, after the words "during the taxable year" the words "or such part thereof".

A possible alternative solution would be to permit the election made under section 4920(d)(6) to become effective commencing with the *next* taxable year of the electing corporation.

Respectfully,

THOMAS E. JENKS.

BENEFICIAL FINANCE CO.,
Wilmington, Del., *September 2, 1969.*

THOMAS VAIL, ESQ.,
Chief Counsel, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SIR: Beneficial Finance Co., a Delaware corporation, is a holding company which owns for all practical purposes all the stock of an Australian subsidiary, BFC Finance Limited, which "is primarily engaged in the lending or finance business through offices located outside the United States and holds itself out in the course of such business outside the United States as lending money to the public generally" (See Section 4920(a)(3)(C) of the 1954 Internal Revenue Code). Another subsidiary, Beneficial Finance Co. of England, a Delaware corporation and qualified to do business in Great Britain, also "is primarily engaged in the lending or finance business through offices located outside the United States and holds itself out in the course of such business outside the United States as lending money to the public generally." Beneficial Finance International Corporation, a Delaware corporation and a wholly-owned subsidiary of Beneficial Finance Co., is a corporation primarily engaged in lending money to one or more other corporations, each of which is affiliated with it and each of which satisfies the requirements of clauses (i) and (ii) of Paragraph (3)(C) of Section 4920(a) of the 1954 IRC. Thus, as a result of the definition of "foreign issuer", "foreign obligor" and "foreign issuer or obligor" contained in Section 4920(a)(3)(C) of the Code, loans made by Beneficial Finance Co. of England to the general public of Great Britain and by Beneficial Finance International Corporation to either Beneficial Finance Co. of England or BFC Finance Limited are exempt from the Interest Equalization Tax if proper elections are made.

Beneficial Finance International Corporation, because of the definition of "United States person" contained in Section 4920(a)(4)(C) is not considered a "United States person" and thus any contribution to the capital of Beneficial Finance International Corporation would subject Beneficial Finance Co. to Interest Equalization Tax thereon pursuant to Section 4915 of the Code.

The Beneficial Finance system, which comprises Beneficial Finance Co. itself and its various operating subsidiaries, is subject to the Federal Reserve Guidelines as a non-bank financial institution. A copy of these Guidelines is attached for your information. The Federal Reserve Bank in Philadelphia was contacted when a so-called "80–20" Delaware international finance subsidiary was to be formed to determine whether or not there would be a violation of the Federal Reserve Guidelines if the funds utilized to capitalize the corporation were only invested in the United States and never used to purchase stock or make loans outside the United States. You will see from the attached "Exhibits A, B, C and D" that so long as certain procedures were followed, there would be no violation.

It appears to me to be inequitable that a manufacturing corporation can form an "80–20" Delaware corporation to finance its foreign subsidiaries who are engaged in manufacturing abroad whereas a finance company may not finance its lending operations abroad, whether by way of a domestic corporation or a foreign corporation, through an "80–20" Delaware corporation. The only way I know to correct this inequity would be to exclude from the definition of a "United State person" a corporation described in Section 4920(a)(3)(C) for all purposes other than the purchase of stock or a contribution to the paid-in surplus by a United States corporation in such a corporation so long as the capital funds are used by said corporation to invest only in the United States.

Anything that could be done to alleviate the inequity described above would be greatly appreciated.

Very truly yours,

EDGAR D. BAUMGARTNER.

EXHIBIT A

MARCH 19, 1969.

Mr. DAVID C. MELNICOFF,
Senior Vice President,
Federal Reserve Bank of Philadelphia,
Philadelphia, Pa.

DEAR MR. MELNICOFF: When our meeting ended last Friday, it was agreed that I would write you a letter spelling out the facts which I set forth orally and then ask for a written confirmation of your oral opinion based upon such facts.

The facts are:

1. Beneficial International Finance Corporation (International), a Delaware corporation, is a wholly-owned subsidiary of Beneficial Finance Co. (Beneficial), also a Delaware corporation.
2. Beneficial proposes to make capital contributions (by way of stock purchases or contributions to paid-in surplus) in U.S. dollars to International.
3. The U.S. dollars so contributed will not leave the United States but will be loaned to either Beneficial or its operating subsidiaries.
4. International then proposes to borrow Eurodollars or foreign currencies in developed countries and then loan these borrowings to subsidiaries of Beneficial operating in other developed countries. Thus, at all times the funds borrowed abroad by International will equal the funds loaned abroad by International.

We would appreciate your written opinion, based upon the above set of facts, that the capital contributions by Beneficial to International will not be considered "covered foreign assets" or "foreign financial assets not covered" for purposes of the Guidelines For Non-Bank Financial Institutions.

Thanking you in advance for your kindness in this matter, I am

Very truly yours,

EDGAR D. BAUMGARTNER,
Tax Counsel.

EXHIBIT B

FEDERAL RESERVE BANK OF PHILADELPHIA,
Philadelphia, Pa., March 27, 1969.

Mr. EDGAR D. BAUMGARTNER,
Tax Counsel, Beneficial Finance Co.,
Wilmington, Del.

DEAR MR. BAUMGARTNER: It is our understanding from information furnished in your letter, dated March 19, 1969, and previous conversations, that Beneficial Finance Co., (Beneficial), Wilmington, Delaware, has formed a wholly-owned subsidiary, Beneficial International Finance Company, (International), a Delaware corporation. Beneficial proposes to make its capital contributions to International in U.S. dollars. This capital contribution will not be loaned, invested, or used in any way to create a foreign claim.

Based on the above conditions only, International would be a domestic corporation, and the capital contributions by Beneficial to International will not be considered "covered foreign assets" or "foreign financial assets not covered" for purposes of the Guidelines for Nonbank Financial Institutions under the Voluntary Credit Restraint Program.

International proposes to borrow Euro-dollars or foreign currencies in developed countries and then loan these borrowings to subsidiaries of Beneficial operating in other developed countries. Under the guidelines, the investment of these funds is to be limited to the same country in which the funds are acquired, or to countries that are subject to the same or more liberal guidelines under the Program.

All claims on foreigners created or incurred by International or any other subsidiary of Beneficial must be included in the report submitted by the parent,

Beneficial, under the Federal Reserve guidelines. Claims should be reported on the proper lines of Form FR 392R 12/68 and any borrowed funds in developed countries abroad (except Canada and Japan) to carry "covered" assets should be reported on line 19 on the report. The amount on line 19 will be considered by the Federal Reserve Bank as an offset to total holdings reported on line 4 when the report is reviewed for compliance with the Program.

In summary, as long as the U.S. dollar capital investment by Beneficial, in its wholly-owned subsidiary, International, is held in U. S. accounts or invested in the U. S., such investment is not subject to the Program. Foreign claims created by Beneficial, International or any subsidiaries of Beneficial are reportable to the Federal Reserve Bank as detailed above.

You mention in paragraph 4 of your letter that the foreign currencies borrowed by International will be loaned to subsidiaries of Beneficial operating in other developed countries. We assume these latter subsidiaries are presently in existence and Beneficial's loans and investments in these subsidiaries are included in the reports Beneficial has been submitting to the Federal Reserve Bank.

Sincerely,

DAVID C. MELNICOFF,
Senior Vice President.

EXHIBIT C

JUNE 27, 1969.

MR. DAVID C. MELNICOFF,
Senior Vice President,
Federal Reserve Bank of Philadelphia, Philadelphia, Pa.

DEAR MR. MELNICOFF: Beneficial Finance International Corporation, a Delaware corporation organized on June 23, 1969 and a wholly-owned subsidiary of Beneficial Finance Co., is planning to borrow 30 million Swiss francs from Credit Suisse of Zurich, Switzerland on July 1, 1969. There will be three loan contracts, each in the amount of 10 million Swiss francs and each bearing the interest rate of 6¾% per annum payable semi-annually on January 1 and July 1 of each year. The first loan contract will mature on July 1, 1972 and be issued at a discount of 98.67%. The second loan contract will mature on July 1, 1973 and be issued at a discount of 98.29%. The third loan contract will mature on July 1, 1974 and be issued at a discount of 97.93%. The loans will be made in Zurich, Switzerland and will be guaranteed by Beneficial Finance Co. The loans will be used to finance the foreign operations of subsidiaries of Beneficial Finance Co. outside the United States.

Until Reserve Bank approval is obtained in Australia for BFC Finance Limited, a wholly-owned Australian subsidiary of Beneficial Finance Co. except for directors' qualifying shares, to borrow the Swiss francs, or their equivalents, from Beneficial Finance International Corporation, it is proposed that the Swiss francs, or their equivalents, be invested in one of the developed countries of Western Europe.

The aforementioned transactions are almost identical to those outlined in my letter to you of March 19, 1969 and your reply to me of March 27, 1969. However, in light of the requirements contained in Circular Letter 2419, dated April 7, 1969 to the effect that "Any institution desiring to offset foreign borrowing against foreign investment * * * should discuss its plans with the Federal Reserve Bank before entering into such an arrangement." Will you please confirm that the comments made in your letter as applying to Beneficial International Finance Corporation also apply to the financing discussed above.

Thanking you in advance for your kindness in this matter, I am

Very truly yours,

EDGAR D. BAUMGARTNER,
Tax Counsel.

EXHIBIT D

FEDERAL RESERVE BANK OF PHILADELPHIA,
Philadelphia, Pa., June 30, 1969.

MR. EDGAR D. BAUMGARTNER,
Tax Counsel,
Beneficial Finance Co.,
Wilmington, Del.

DEAR MR. BAUMGARTNER: It is our understanding from your letter, dated June 27, 1969, that Beneficial Finance Company, Wilmington, Delaware, has formed a

wholly-owned subsidiary, Beneficial Finance International Corporation, a Delaware corporation. This subsidiary corporation, we understand, was formed in the same fashion as the subsidiary that you proposed forming as outlined in your letter, dated March 19, 1969. The parent corporation will contribute its capital contributions in U.S. dollars, but these U.S. dollars will not be loaned, invested, or used in any way to create a foreign claim.

The borrowing of 30 million Swiss francs, planned by the subsidiary, is permitted within the guidelines of the Federal Reserve Voluntary Foreign Credit Restraint Program, provided the funds are invested only in the same country in which they are acquired, or in countries that are subject to the same or more liberal guidelines under the Program.

It should be noted that all claims on foreigners created or incurred by the subsidiary or any other financial subsidiary of Beneficial Finance Company must be included in the report submitted by the parent, under the Federal Reserve guidelines. Claims should be reported on the proper lines of Form FR392R12/68 and any borrowed funds in developed countries abroad (except Canada and Japan) to carry "covered" assets should be reported on line 19 on the report. The amount on line 19 will be considered by the Federal Reserve Bank as an offset to total holdings reported on line 4 when the report is reviewed for compliance with the program.

In summary, as long as the U.S. dollar capital investment by Beneficial Finance Company in its wholly-owned subsidiary, Beneficial Finance International Corporation, is held in U.S. accounts or invested in the U.S., such investment is not subject to the Program. Foreign claims created by the subsidiary are reportable to the Federal Reserve Bank, as detailed above.

Sincerely yours,

DAVID C. MELNICOFF,
Vice President.

FEDERAL RESERVE BANK OF PHILADELPHIA,
Philadelphia, Pa., April 7, 1969.

To: Bank and Nonbank Financial Institutions and Nonprofit Organizations in the Third Federal Reserve District.

THE PRESIDENT'S BALANCE-OF-PAYMENTS PROGRAM—REVISED 1969 GUIDELINES FOR FINANCIAL INSTITUTIONS

The Board of Governors of the Federal Reserve System issued revised 1969 guidelines, effective immediately, covering foreign credits and investments by U.S. banks and other financial institutions. The revisions represent a modification of earlier announced guidelines, and are designed to permit additional flexibility to finance U.S. exports and to resolve some serious equity problems.

The Voluntary Foreign Credit Restraint Program (VFCR) is one of several elements in the government's over-all program to strengthen the U.S. balance of payments position.

Under the revised guidelines, a bank will either retain its present ceiling on foreign lending or adopt a new ceiling equal to 1½ per cent of its total assets as of December 31, 1968. This formula will permit a modest increase of $400 million in the foreign lending ceilings for banks which stood at $9.7 billion at the end of last year.

For nonbank financial institutions—such as insurance companies, mutual funds, finance companies and bank trust departments—the ceiling in foreign assets will be restored to 100 per cent of the end-of-1967 base. The ceiling had earlier been continued at 95 per cent of that base for the current year. This modification—designed primarily to simplify administration of the program—will increase the ceiling for nonbank financial institutions by an estimated $40 million during 1969. At the end of last year investments by nonbank financial institutions covered by the guidelines amounted to $1.4 billion.

Governor Andrew F. Brimmer, who administers the program in behalf of the Board of Governors, said the banks had an unused leeway of $475 million at the end of 1968. Thus the revision would potentially allow banks to increase their existing level of credits to foreigners by about $875 million. It is expected that the full potential will not be used, and a substantial leeway will continue to be maintained. Furthermore, the potential increase will be lessened slightly as bank

ceilings continue to be progressively reduced by the amount of repayments of term loans to residents of developed countries of continental Western Europe.

The program has been in force since February 1965 and was last revised in December of last year when guidelines for 1969 were issued. In considering the program at that time, the Board concluded that the balance of payments prospects for 1969 did not permit any basic change in VFCR. Yet, in view of the need to improve the trade balance, the Board said it planned to re-examine the program early in 1969 to determine whether additional flexibility for financing U.S. exports might be provided in the guidelines.

As part of that review, Governor Brimmer has held a series of seven regional meetings throughout the country at the Federal Reserve Banks of Boston, New York, Philadelphia, Atlanta, Chicago, Dallas, and San Francisco. Representatives of other Federal Reserve Banks and of the reporting commercial banks and other financial institutions participated in these meetings.

Governor Brimmer said it became apparent as the regional meetings progressed that some additional flexibility in the guidelines was needed to finance U.S. exports and to reduce inequities among banks of different size inherent in the VFCR program. The financing of U.S. exports under the VFCR refers to credits extended by the banks to foreigners to finance purchases from the United States. The program does not affect credits to American producers and exporters to finance U.S. exports.

Under the guidelines issued last December 23, the 1969 ceiling on foreign credit extensions by banks remained at the level specified in the guidelines, as adjusted, of one year earlier. For about one-half of the approximately 160 reporting banks (accounting for more than 90 per cent of the aggregate ceiling), this was essentially 103 per cent of the 1964 base. For the remainder of the reporting banks, the ceiling was the 1967 ceiling plus one-third of the difference between that amount and 2 per cent of total assets as of December 31, 1966.

A copy of the newly revised guidelines is attached. They will be made available to financial institutions through the Federal Reserve Banks.

Revised Guidelines—Banks and Nonbank Financial Institutions

I. General Purpose

In order to help to strengthen the U.S. balance of payments, U.S. financial institutions are asked to continue to restrain their foreign loans and investments.

II. Banks

A. Ceiling restraints

1. *Basic Restraint.*—A bank should not hold claims on foreigners (defined in G–2 below) at any time in excess of its ceiling, as determined in 2 below, except for temporary overages as the result of the extension of export credit.

2. *Ceiling.*—The foreign lending guideline amount (hereafter, "ceiling") for a bank that has been reporting under previous Federal Reserve foreign credit restraint guidelines is the larger of—

(*a*) the ceiling it was expected to observe on December 31, 1968 under the guidelines in existence on that date; or

(*b*) 1½ per cent of its total assets as of December 31, 1968.

3. *Special Ceiling.*—(*a*) A bank that, on December 31, 1968, had outstanding claims on foreigners of less than $500,000 and that has no special ceiling under previous guidelines may discuss with the Federal Reserve Bank in its District the possibility of adopting a special ceiling adequate to permit the bank to meet reasonable credit demands of existing customers or other reasonable credit demands originating in its normal trade area.

(*b*) In discussing the ceiling of such a bank, the Federal Reserve Bank will take into account the bank's previous experience with foreign transactions, including acceptance of foreign deposits or handling foreign collections, and other circumstances concerning prospects for the bank's engaging in foreign transactions.

4. *Priority Credits.*—(*a*) Within its ceiling, and as among all types of credit to foreigners, a bank should give first priority to credits to finance exports of U.S. goods (hereafter "export credits") and second priority to credits to developing countries.

(*b*) Export credits that result in sales taking place on credit rather than, in the absence of such credits, on the basis of cash are not to be considered as priority credits.

5. *Western Europe.*—(*a*) *Term loans.*—Banks should not make new term loans (loans with maturities of over one year) to residents of developed countries of continental Western Europe, except to finance U.S. exports. A bank's ceiling should be reduced each month by the dollar amount of any repayments it receives on term loans to such residents outstanding on December 31, 1967.

(*b*) *Short-term credits.*—Banks should hold the amount of short-term credits (credits with original maturities of one year or less) to residents of these countries to not more than 60 per cent of the amounts of such credits outstanding on December 31, 1967.

6. *Equity Investments.*—Equity investments, including those in developed countries of continental Western Europe, may be made within a bank's ceiling, subject to requirements of the Board of Governors.

7. *Sale of Foreign Assets.*—Any bank that sells a claim on a foreigner that is subject to these restraints, without recourse, (a) to a U.S. resident other than a financial institution participating in the Federal Reserve credit restraint program or other than a direct investor subject to the controls administered by the Department of Commerce or (b) to the Export-Import Bank should reduce its ceiling by an equivalent amount.

8. *Total Assets.*—For the purpose of calculating a ceiling under A-2-b above, total assets are those shown in the Official Report of Condition, submitted to the relevant supervisory agency, as of December 31, 1968.

B. Exclusions

1. *Canada.*—These guidelines are not to restrain the extension of credit to residents of Canada. For the purpose of determining the aggregate amount of a bank's outstanding claims on foreigners, any net increases in claims on residents of Canada after February 29, 1968 should be deducted from total claims on foreigners, and any net reductions in claims on residents of Canada after February 29, 1968 should be added to total claims on foreigners.

2. *Certain Guaranteed and Insured Loans.*—Loans to finance U.S. exports that either are guaranteed, or participated in, by the Export-Import Bank, or guaranteed by the Department of Defense, or are insured by the Foreign Credit Insurance Association are exempt from these credit restraints.

C. Temporary overages

1. A bank would not be considered as acting inconsistently with the purpose of the giudelines if it temporarily exceeded its ceiling as the result of the extension of an export credit.

2. Such a bank should, however, refrain from making new extensions of nonpriority credits so as to reduce its claims on foreigners to an amount within the ceiling as quickly as possible. It should also take every opportunity to withdraw or reduce commitments, including credit lines, that are not of a firm nature and to assure that drawings under credit lines are kept to normal levels and usage. At time of renewal, each credit line should be reviewed for consistency with the program.

3. A bank whose foreign credits are in excess of the ceilings will be invited periodically to discuss with the approriate Federal Reserve Bank the steps it has taken and proposes to take to reduce its credits to a level within the ceiling.

D. Applicability to financial institutions

1. *General.*—The guidelines are applicable to all U.S. banks (exclusive of the trust departments of commercial banks, which should follow the guidelines for nonbank financial institutions) and to "Edge Act" and "Agreement" Corporations.

2. *Edge Act and Agreement Corporations.*—(*a*) Edge Act or Agreement Corporations that, under previous guidelines, adopted a ceiling separate from those of their parent banks may continue to be guided by a separate ceiling or may combine their foreign loans and investments with those of their parent banks.

(*b*) No special ceilings are provided for Edge Act or Agreement Corporations established after March 3, 1965. An Edge Act or Agreement Corporation which has been established after March 3, 1965, as a subsidiary of one bank should share the ceiling of the respective parent bank. An Edge Act or Agreement Corporation which has been formed after March 3, 1965, and is a subsidiary of two

or more banks (not associated in a bank holding company) may be assigned a share or shares of the ceilings of its parent banks. Any contemplated reallocations of ceilings to the Edge Act or Agreement Corporation should be discussed with the Federal Reserve Bank of the District in which the bank desiring to make the transfer is located.

3. *Bank Holding Companies.*—(*a*) A registered bank holding company will be treated as a bank for the purpose of these guidelines.

(*b*) Banks and Edge Act or Agreement Corporations which are owned by a registered bank holding company may consolidate the ceilings of one or more banks in the group.

4. *Foreign Branches of U.S. Banks.*—(*a*) The guidelines are not designed to restrict the extension of foreign credits by foreign branches of U.S. banks if the funds utilized are derived from foreign sources and do not add to the outflow of capital from the United States.

(*b*) Total claims of a bank's domestic offices on its foreign branches (including permanent capital invested in, as well as balances due from, such branches) represent bank credit to foreigners for the purposes of the program.

E. Conformity with objectives of guidelines

1. *Department of Commerce Program and Nonbank Financial Institutions Guidelines.*—Banks should avoid making loans that would directly or indirectly enable borrowers to use funds abroad in a manner inconsistent with the Department of Commerce program or with the guidelines for nonbank financial institutions.

2. *Substitute Loans.*—Banks should not extend to U.S. subsidiaries and to branches of foreign companies loans that otherwise might have been made by the banks to the foreign parent or other affiliate of the company or that normally would have been obtained abroad.

3. *Management of Liquid Assets.*—A bank should not place its own funds abroad (other than in Canada) for short-term investment purposes, whether such investments are payable in foreign currencies or in U.S. dollars. Banks need not, however, reduce necessary working balances held with foreign correspondents.

4. *Transactions for Customers.*—While recognizing that it must follow a customer's instruction, a bank should discourage customers from placing liquid funds outside the United States, except in Canada. A bank should not place with a customer foreign obligations that, in the absence of the guidelines, it would have acquired or held for its own account.

5. *U.S. Branches and Agencies of Foreign Banks.*—Branches and agencies of foreign banks located in the United States are requested to act in accordance with the spirit of these guidelines.

F. Reporting

Each bank that is eligible for a ceiling under these guidelines should file a Monthly Report on Foreign Claims (Form FR 391/69.1) with the Federal Reserve Bank in the District in which the bank is located. (Forms are available at the Federal Reserve Banks.)

G. Definitions

1. "Foreigners" include: individuals, partnerships, and corporations domiciled outside the United States, irrespective of citizenship, except their agencies or branches located within the United States; branches, subsidiaries, and affiliates of U.S. banks and other U.S. corporations that are located in foreign countries; and any government of a foreign country or official agency thereof and any official international or regional institution created by treaty, irrespective of location.

2. "Claims on foreigners" are claims on foreigners held for a bank's own account. They include: foreign long-term securities; foreign customers' liability for acceptances executed, whether or not the acceptances are held by the reporting banks; deferred payment letters of credit described in the Treasury Department's Supplemental Reporting Instruction No. 1, Treasury Foreign Exchange Reports, Banking Forms, dated May 10, 1968; participations purchased in loans to foreigners (except loans guaranteed or participated in by the Export-Import Bank or guaranteed by the Department of Defense, or insured by the Foreign Credit Insurance Association); loans to financial subsidiaries incorporated in

the United States, 50 per cent or more of which is owned by foreigners; and foreign assets sold, with recourse, to U.S. residents other than financial institutions participating in the Federal Reserve credit restraint program or direct investors subject to the controls administered by the Commerce Department.

"Claims on foreigners" exclude: contingent claims; unutilized credits; claims held for account of customers; acceptances executed by other U.S. banks; loans to finance U.S. exports guaranteed or participated in by the Export-Import Bank or guaranteed by the Department of Defense or insured by the Foreign Credit Insurance Association; and, in the manner determined in B–1 above, claims on residents of Canada.

3. "Credits to finance exports of U.S. goods" and "export credits" are transactions that are identifiable through documents available to the bank.

4. Developing countries are all countries other than: Abu Dhabi, Australia, Austria, the Bahamas, Bahrain, Belgium, Bermuda, Canada, Denmark, France, Germany (Federal Republic), Hong Kong, Iran, Iraq, Ireland, Italy, Japan, Kuwait, Kuwait-Saudi Arabia Neutral Zone, Libya, Liechtenstein, Luxembourg, Monaco, Netherlands, New Zealand, Norway, Portugal, Qatar, Republic of South Africa, San Marino, Saudi Arabia, Spain, Sweden, Switzerland, and the United Kingdom; and other than: Albania, Bulgaria, the People's Republic of China, Cuba, Czechoslovakia, Estonia, Hungary, Communist-controlled Korea, Latvia, Lithuania, Outer Mongolia, Poland (including any area under its provisional administration), Rumania, Soviet Zone of Germany and the Soviet sector of Berlin, Tibet, Union of Soviet Socialist Republics and the Kurile Islands, Southern Sakhalin, and areas in East Prussia that are under the provisional administration of the Union of Soviet Socialist Republics, and Communist-controlled Vietnam.

(These Guidelines for Banks supersede those published in our circular letter 2390 dated December 23, 1968. Communications and questions on foreign lending activity should be directed to Mr. David C. Melnicoff, Senior Vice President.)

III. NONBANK FINANCIAL INSTITUTIONS

A. *Types of institutions covered*

The group of institutions covered by the nonbank guidelines includes: trust companies; trust departments of commercial banks; mutual savings banks; insurance companies; investment companies; finance companies; employee retirement and pension funds; college endowment funds; charitable foundations; and the U.S. branches of foreign insurance companies and of other foreign nonbank financial corporations. Investment underwriting firms, securities brokers and dealers, and investment counseling firms also are covered with respect to foreign financial assets held for their own account and are requested to inform their customers of the program in those cases where it appears applicable. Businesses whose principal activity is the leasing of property and equipment, and which are not owned or controlled by a financial institution, are not defined as financial institutions.

B. *Ceiling and priorities*

Each institution is requested to limit its aggregate holdings of foreign assets covered by the program to no more than 100 per cent of the adjusted amount of such assets held on December 31, 1967.

Institutions generally are expected to hold no foreign deposits or money market instruments (other than Canadian). However, an institution may maintain such minimum working balances abroad as are needed for the efficient conduct of its foreign business activities.

Among other foreign assets that are subject to the guideline ceiling, institutions are asked to give first priority to credits that represent the bona fide financing of U.S. exports, and second priority to credits to developing countries. In addition, institutions are requested not to increase the total of their investments in the developed countries of continental Western Europe beyond the amount held on December 31, 1968, except for new credits that are judged to be essential to the financing of U.S. exports. This means that reductions through amortizations, maturities or sales may be offset by new acquisitions in these countries. However, institutions are expected to refrain from offsetting proceeds of sales to other Americans by new acquisitions from foreigners.

Institutions may invest in noncovered foreign assets generally as desired. However, they are requested to refrain from making any loans and investments, noncovered as well as covered, which appear to be inconsistent with other aspects of the President's balance of payments program. Among these are the following:

1. Noncovered credits under this program that substitute directly for loans that commercial banks would have made in the absence of that part of the program applicable to them.
2. Noncovered credits to developing country subsidiaries of U.S. corporations that would not have been permitted under the Department of Commerce program if made by the U.S. parent directly.
3. Credits to U.S. corporate borrowers that would enable them to make new foreign loans and investments inconsistent with the Department of Commerce program.
4. Credits to U.S. subsidiaries and branches of foreign companies that otherwise would have been made to the foreign parent, or that would substitute for funds normally obtained from foreign sources.

C. Covered assets

Covered foreign financial assets, subject to the guideline ceiling, include the following types of investments, except for "free delivery" items received after December 31, 1967:

1. Liquid funds in all foreign countries other than Canada. This category comprises foreign bank deposits, including deposits in foreign branches of U.S. banks, and liquid money market claims on foreign obligors, generally defined to include marketable negotiable instruments maturing in 1 year or less.
2. All other claims on non-Canadian foreign obligors written, at date of acquisition, to mature in 10 years or less. This category includes bonds, notes, mortgages, loans, and other credits. Excluded are bonds and notes of international institutions of which the United States is a member, and loans guaranteed or participated in by the Export-Import Bank or the Department of Defense or insured by the Foreign Credit Insurance Association, regardless of maturity.
3. Net financial investment in foreign branches, subsidiaries and affiliates, located in developed countries other than Canada and Japan.[1] Such financial investment includes payments into equity and other capital accounts of, and net loans and advances to, any foreign businesses in which the U.S. institution has an ownership interest of 10 percent or more. Excluded are earnings of a foreign affiliate if they are directly retained in the capital accounts of the foreign business.
4. Long-term credits of foreign obligors domiciled in developed countries other than Canada and Japan.[1] Included in this category are bonds, notes, mortgages, loans, and other credits maturing more than 10 years after date of acquisition. Excluded are bonds of international institutions of which the United States is a member.
5. Equity securities of foreign corporations domiciled in developed countries other than Canada and Japan, except those acquired after September 30, 1965, in U.S. markets from American investors.[1] The test of whether an equity security is covered will depend on the institution's obligation to pay the Interest Equalization Tax on acquisition. Exclusion from covered assets under this program normally will be indicated when, in acquiring an equity security that otherwise would be covered, the purchasing institution receives a certificate of prior American ownership, or brokerage confirmation thereof.

D. Base-date holdings

Base-date holdings for any reporting date in 1969 are defined as:

1. Total holdings of covered foreign assets as of December 31, 1967;
2. Minus, equity securities of companies domiciled in developed countries (except Canada and Japan), that are included in (1) but had been sold to American investors prior to the current quarter;
3. Plus, or minus, the difference between sales proceeds and "carrying" value of covered equities sold prior to the current quarter to other than American investors or in other than U.S. markets. On each reporting date in

[1] See Note on p. 21.

1969, "carrying" value should be the value reflected in the institution's report (on Form FR 392R–68) for December 31, 1967, in the case of equities held on that date, and it should be cost in the case of equities purchased after that date.

"Adjusted" base-date holdings, to which the 100 per cent ceiling applies, are equal to "base-date" holdings as defined above adjusted for sale *during the current quarter* of included covered equities in accordance with the procedures specified in (2) and (3) of the preceding paragraph.

E. Noncovered assets

Foreign financial assets not covered by the guidelines are still reportable on the quarterly statistical reports to the Federal Reserve Banks. Such noncovered foreign investments include the following:

1. All financial assets in, or claims on residents of, the Dominion of Canada.
2. Bonds and notes of international institutions of which the United States is a member, regardless of maturity.
3. Long-term investments in all developing countries and in Japan, including credit instruments with final maturities of more than 10 years at date of acquisition, direct investment in subsidiaries and affiliates, and all equity securities issued by firms domiciled in these countries.
4. Equity securities of firms in developed countries other than Canada and Japan that have been acquired in U.S. markets from American investors (see Point 5 above).

Foreign assets of types covered by the program and acquired as "free delivery" items—that is, as new gifts or, in the case of trust companies or trust departments of commerical banks, in new accounts deposited with the institution—are not defined as covered assets, if they were acquired after December 31, 1967. Such assets should be reported as a memorandum item, as should all loans held that are guaranteed or participated in by the Export-Import Bank or the Department of Defense, or insured by the Foreign Credit Insurance Association.

F. Credits to certain U.S. corporations

Any loan or investment acquired by a nonbank financial institution after June 30, 1968, that involves the advance of funds to a domestic corporation which is simply a financing conduit (commonly known as a "Delaware sub"), and which in turn will transmit the funds to a foreign business, should be reported as a foreign asset if one or more foreigners own a majority of the "Delaware" corporation. The amounts of such foreign loans or investments should be classified according to the country where the funds are actually to be used, not according to the residence of the owners of the "Delaware" corporation. In the event that U.S. residents hold a majority ownership interest in the "Delaware" corporation, no part of a loan or investment in such a corporation is to be regarded as a foreign asset of the institution.

G. Leasing of physical goods

The foreign leasing activities of firms which engage primarily in the leasing of physical assets (e.g., computers, real property, ships, aircraft), and which are not owned or controlled by a U.S. financial institution, are not reportable under the nonbank program. However, such activities are reportable when they are undertaken by nonbank financial institutions. These institutions should report the book value of any physical assets leased to foreigners on the appropriate line of the quarterly form they file with their Federal Reserve Bank.

H. Investment in certain foreign insurance ventures

Net investment in foreign insurance ventures should be reported as such wherever possible. In the case of any such ventures in which there is no segregated net investment, the U.S. insurance company may exclude from its foreign assets investments within the foreign country involved, in amounts up to 110 per cent of reserves accumulated on insurance sold to residents of that country, or (if it is larger) the minimum deposit of cash or securities required as a condition of doing insurance business within that country.

I. Long-term credits to developing-country businesses

Institutions are requested to discuss with their Federal Reserve Bank in advance any future long-term loans or direct security placements that would involve extensions of credit of $500,000 or more to private business borrowers located in the developing countries.

J. Reporting requirement

Each nonbank financial institution holding, on any quarterly reporting date, covered assets of $500,000 or more, or total foreign financial assets of $5 million or more, is requested to file a statistical report covering its total holdings on that date with the Federal Reserve Bank of the Federal Reserve district in which its principal office is located. The reports are due within 20 days following the close of each calendar quarter, and forms may be obtained by contacting the Federal Reserve Bank.

Institutions with holdings below these levels, although not requested to file formal reports, are also expected to abide by the provisions of the program.

K. Covered assets in excess of ceiling

Some institutions increased, rather than reduced, their holdings of covered assets in 1968. In most such instances, there may have been special circumstances—such as inability to reduce existing investments by enough to offset new investments made to honor long-standing firm commitments or to accommodate requests for bona fide and essential financing of U.S. exports. Nevertheless, every institution whose December 31, 1968, holdings of covered assets exceeded its adjusted base-date holdings should review its situation with its Federal Reserve Bank with a view to working out an individually tailored program for eliminating the excess during 1969.

In view of the balance of payments objectives of the program, it is noted that covered investments of nonbank financial institutions may be permitted to exceed the guideline ceiling to the extent that the funds for such investment are borrowed abroad for investment in the same country or in countries that are subject to the same or more liberal guideline limitations. Thus, funds borrowed in the developed countries of continental Western Europe may be used to finance investments in these countries and elsewhere, and funds borrowed in other developed countries (except Canada and Japan) may be used to finance investment in covered foreign assets anywhere but in the developed countries of continental Western Europe. Any institution desiring to offset foreign borrowing against foreign investment, however, should discuss its plans with the Federal Reserve Bank before entering into such an arrangement.

These Guidelines for Nonbank Financial Institutions supersede those published in our circular letter 2390 dated December 23, 1968. Communications and questions on foreign lending activity should be directed to Mr. David C. Melnicoff, Senior Vice President.

Note.—Developed countries other than Canada and Japan: continental Western Europe—Austria, Belgium, Demark, France, Germany (Federal Republic), Italy, Liechtenstein, Luxembourg, Monaco, Netherlands, Norway, Portugal, San Marino, Spain, Sweden, and Switzerland; other developed countries are: Abu Dhabi, Australia, the Bahamas, Bahrain, Bermuda, Hong Kong, Iran, Iraq, Ireland, Kuwait, Kuwait-Saudi Arabia Neutral Zone, Libya, New Zealand, Qatar, Republic of South Africa, Saudi Arabia, and the United Kingdom. Also to be considered "developed" are the following countries: Albania, Bulgaria, the People's Republic of China, Cuba, Czechoslovakia, Estonia, Hungary, Communist-controlled Korea, Latvia, Lithuania, Outer Mongolia, Poland (including any area under its provisional administration), Rumania, Soviet Zone of Germany and the Soviet sector of Berlin, Tibet, Union of Soviet Socialist Republics and the Kurile Islands, Southern Sakhalin, and areas in East Prussia which are under the provisional administration of the Union of Soviet Socialist Republics, and Communist-controlled Vietnam.

The CHAIRMAN. We stand adjourned until 10 o'clock tomorrow, when we will hold hearings on the tax reform bill.

(Whereupon, at 12 noon, the committee adjourned.)

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