ECONOMIC IMPLICATIONS OF MASSIVE INTERNATIONAL CAPITAL FLOWS

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND RESOURCES

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

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WITNESSES

ECONOMIC IMPLICATIONS OF MASSIVE INTERNATIONAL CAPITAL FLOWS

WEDNESDAY, AUGUST 14, 1974

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND RESOURCES OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Senator Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd, Jr., of Virginia and Bennett.

Senator BYRD. The subcommittee will come to order.

The Subcommittee on International Finance and Resources this morning begins a 1-day hearing on the implications for the United States and world economies of the massive shift of capital which now poses serious problems for the international financial system. I refer, of course, to the unprecedented flow of wealth during the past 9 months from the oil-consuming nations to the oil-producing nations of the Middle East, particularly the Persian Gulf. According to the one estimate, more than $105 billion will move into Arab coffers this year because of the precipitous price increases in crude oil which began last November.

The $105 billion in oil revenues which will accrue to the exporting countries this year is up an astounding $80 billion from what they took in last year. More than one-half of this amount will go to one country—Saudi Arabia.

From this revenue, the oil-producing countries will have $60 billion more each year in liquid reserves than they can absorb internally. By 1980, the World Bank estimates that this liquid surplus capital will swell to $400 billion. This means that the oil-producing countries will hold at least 70 percent of the world's total monetary reserves only 6 years from now.

As Joseph Alsop recently wrote:

> The oil producing countries will have to find ways to place an amount of money, in just one year, equivalent to about two-thirds of the total value of all the overseas investments of the United States in the last three-quarters of a century.

Because the oil-producing countries cannot absorb these vast sums of capital within their own economies, the question then becomes to what use will the funds be put? The answer to that question is crucial to oil-consuming countries; it is, indeed, the object of these hearings.

Already we have witnessed the disruptive effects which capital flows of this magnitude can have on the world economy, as nations stagger under the weight of payments and trade deficits. We are beginning to see the disruptions of international trade as countries vie against one another for balance-of-payments surpluses.

Of particular concern is the relationship between these capital flows and inflation within the world and national economies. Rampaging inflation is the single most pressing concern of government leaders throughout the world, but anti-inflation rhetoric has not been matched with anti-inflation action.

It is essential that the United States and other countries immediately take steps to deal effectively with inflation and restore confidence in the world financial structure.

I was gratified to hear our new President state in his first address to the Congress on Monday evening that controlling inflation will be his first priority. I welcome his efforts to put the Government's financial affairs in order and to bring together Members of Congress and economists from labor and industry to convene a domestic summit for American prosperity.

We are fortunate to have with us today two men who are uniquely qualified to discuss these topics because of their responsibilities for domestic and international monetary policies. We are pleased to have Secretary Simon in one of his first appearances on Capitol Hill since our new President took office; I look forward to hearing his recommendations for carrying out the President's fight against inflation.

Secretary Simon will also report on his recent 2-week tour of the Middle East and his talks with the Arab leaders. Governor Wallich is a member of the Federal Reserve Board. This institution which lately has been bearing much—some say too much—of the burden of controlling inflation.

We welcome you. Secretary Simon, please proceed.

[The press release announcing these hearings follows:]

PRESS RELEASE

FOR IMMEDIATE RELEASE
July 29, 1974

COMMITTEE ON FINANCE
Subcommittee on International Finance and Resources
UNITED STATES SENATE
2227 Dirksen Senate Office Bldg.

SECRETARY SIMON, GOVERNOR WALLICH TO TESTIFY BEFORE FINANCE SUBCOMMITTEE

Senator Harry F. Byrd, Jr., Chairman of the Finance Committee's Subcommittee on International Finance and Resources, today announced that Treasury Secretary William E. Simon will testify before the panel at 9:30 a.m. on Tuesday, August 6, 1974. Secretary Simon will report on his recent tour of the Middle East. Henry Wallich, new member of the Federal Reserve Board, will testify at 11:00 a.m. on the same day.

Chairman Byrd stated that it is the Subcommittee's intention to explore the longer term implications for the U. S. and world economies of massive capital flows to the O. P. E. C. nations, particularly the concentration in Persian Gulf countries.

"Ravaging inflation, driven by the rising prices of strategic raw materials, now threatens the stability of international financial and monetary systems," said Chairman Byrd. "It is increasingly apparent that governments throughout the western world are unable to formulate and implement effective policies for dealing with their inflation and balance of payments problems in isolation."

The Subcommittee will explore the question. "Are our economies now so interdependent that nothing short of a unified coordinated attack against inflation by all major developed countries can succeed?"

"We do not fully appreciate all the longer term implications of the flow of capital -- now called 'petrodollars' -- to the oil producing countries. It is the Subcommittee's intention to explore this area beginning with the testimony of Secretary Simon, who has recently returned from talks with Arab leaders, "Senator Byrd said.

"In addition, the Subcommittee will discuss with the Secretary and Mr. Wallich of the Federal Reserve the relationship between the international financial crisis and our own domestic economic troubles. Several banks have engaged in currency speculation and have incurred serious losses. Banks which are borrowing short and lending long are caught in a liquidity squeeze and are calling in loans from even their prime customers.

"Anti-inflation rhetoric is not matched with anti-inflation action. Confidence in our economy and in the world financial structure is at its lowest ebb in years," he said.

The Chairman also said that the Subcommittee will explore whether international competition for petrodollars is resulting in soaring interest rates worldwide.

"The Federal budget remains heavily in the red despite the growing consensus among economists of all philosophical persuasions ranging from that of John Kenneth Galbraith to Alan Greenspan that this country needs a surplus in the Federal budget for the next several years.

"I hope the Secretary's report and Mr. Wallich's testimony will focus on these interrelated and crucially important issues which face this nation today."

The Chairman stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record.

Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies by August 20, 1974 to Michael Stern, Staff Director, Senate Committee on Finance, 2227 Dirksen Senate Office Building, Washington, D. C. 20510.

STATEMENT OF THE HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY; ACCOMPANIED BY ASSISTANT SECRETARIES GERALD L. PARSKY AND FREDERICK L. WEBBER

Secretary Simon. Thank you, Mr. Chairman.

I have a rather long and I think comprehensive statement relative to my recent trip to the Middle East and to the major countries of Europe. I would like to summarize it in the limited time available so I can answer any questions you might have.

Senator Byrd. That will be fine, and your statement will be printed in full in the committee report.

Secretary Simon. Thank you, sir.

The purpose of my trip was to continue our recent diplomatic efforts to achieve a durable and lasting peace in the Mideast. I believe that peace and economic progress are interrelated issues. Without peace, we cannot have economic progress. With economic progress, however, we can minimize the possibility of renewed hostilities.

BACKGROUND

Before outlining the highlights of each of my visits, I think it would be useful to explain the background of how the trip developed. Prince Fahd of Saudi Arabia visited the United States in early June, and at that time we established a Joint Saudi-U.S. Economic Commission. This was a major step in establishing closer economic relations between the United States and Saudi Arabia and we agreed to have working groups meet in Saudi Arabia in July. Subsequently, when the President visited Egypt and Israel and suggested that I visit those countries, we thought it would be useful to go to all three Mideast countries and in Saudi Arabia, to open the working group sessions. Kuwait which was the final stop on the Middle East portion of our trip, offered us the opportunity to bring the first high-level U.S. delegation to a country which has increasingly occupied a critical role not just in energy affairs, but world economic affairs as well. The balance of our trip was devoted to continuing our economic consultations with finance ministers and other leaders in Germany, Italy, France, and England.

As I will describe in detail, all of our meetings, whether they were with heads of state, finance ministers, petroleum ministers, central bankers, or members of the private sector, were based on mutual concerns: striving for political stability and economic stability, and our shared pursuit for peace and economic prosperity.

EGYPT

In discussing the problems in Egypt, which has an economy in an advanced stage of deterioration due to 20 years of controls under Nasser we explored ways to liberalize the economy and attract investment—because 90 percent of Egyptian industry and corporations are state owned. We also had to learn as much as we possibly could about the dimensions of their economy, and most important about the shape of President Sadat's program to progressively return Egypt's economy to an open and more liberal system.

We agreed to set up the mechanisms to establish a senior working group to focus on investment and economic development.

We exchanged documents activating the Investment Guarantee Agreement in order that the U.S. Overseas Private Investment Corp. may insure new U.S. private investments in Egypt.

We discussed plans for hard aid, if you will, making the differentiation between hard aid and soft aid. We already asked Congress for $250 million in appropriations for Egypt; the Public Law 480 program, which would depend, of course, on what our harvest ultimately turns out to be; and increased use of the Export-Import Bank's facilities.

We discussed ways in which we could work together in qualifying Egypt for the maximum financial support from the World Bank.

We also discussed the transfer of valuable technical assistance from the United States in many areas including: Financial administration, debt management, tax administration, developing a statistical base for their economy, agriculture, population control, developing building and electrical codes and many other areas.

In addition to the activities of the guarantee program and the other specifics just mentioned, we can assist them in publicizing the provisions of their new investment law. Their new investment law is critical to their efforts to liberalize their economy and attract foreign investment, not just from the United States but the rest of the world. In the past there were great disincentives because of the way Egypt repatriated profits, in the way that foreign currency could not be exchanged.

We discussed a tax treaty to provide a secure base for investor activity such as the traditional typical tax treaty that we have with many countries in the world.

As you know, Egypt's Foreign Minister Fatah is leading a delegation that is meeting here in Washington this week. In my view this is further evidence of our common commitment to insure that the spirit of our meetings in Cairo last week is carried out.

ISRAEL

After our talks in Egypt, we visited Israel for 1½ days to explore ways to attract investment to Israel and expand trade with the United States. We established a Joint United States-Israel Committee on Trade and Investment. We also agreed to establish four subcommittees dealing with investment, trade, raw materials, research and development, and we agreed to explore ways to establish a joint United States-Israel Economic Council consisting of private U.S. businessmen and Israeli private businessmen and Government officials.

SAUDI ARABIA

My visit to Saudi Arabia, which followed the talks in Israel, was part of our continuing effort to establish a closer economic relationship with the Saudis. It is important, at the outset, to point out that Saudi Arabia's growing accumulation of monetary revenues, which today exceed their ability to absorb them domestically, has confronted them with a two part challenge: First, how can they spend their resources at home in such a way as to diversify their country and industrialize their economy, second, how can they increase their funds abroad in a manner that will maximize profit without creating unwieldy and unwarranted pressures on the world monetary system.

We held broad ranging discussions in the 3 days we were there. We outlined proposals for investment in the U.S. Treasury Securities, special issues, and held discussions on the advantages both countries would share in negotiating a tax treaty. We further discussed the impact of oil prices on the developed as well as less developed countries of the world. The Saudis have clearly been working toward achieving more reasonable prices.

We also opened the initial meetings of the joint working group on industrialization.

The specific action areas that we put into place includes comprehensive U.S. Government-Saudi technical cooperation agreement for reimbursement of technical services to our Government.

KUWAIT

Following our stop in Saudi Arabia we made a brief visit to Kuwait. Our meetings there were especially significant from a number of viewpoints.

First, they marked the first visit of a high-level delegation to this critical oil-producing country.

Second, I had extensive and quite frank discussions with Kuwait's Minister of Oil and Finance Abdul Rahman and Atiqi regarding the price of oil. There are still considerable differences of opinion on this subject but it was a most constructive dialog and opened the way for future discussions.

Third, we had an opportunity to discuss the Kuwaitis' investment objectives, as well as their willingness to assist not only developing Arab countries, but countries throughout the world through such vehicles as the Kuwait Fund. They were also most interested in receiving as much information as possible regarding the possibility of Treasury Special Securities.

Before discussing the European part of my trip I think it would be appropriate to summarize certain oil policy issues that would certainly underline my visits in the Middle East. I am sure that members of this subcommittee are well aware of my views about the present surplus and the possible future declining price of oil. I would like to add to the overview I have already given publicly. I have stressed that the cutbacks in production by producers would turn out to be economically harmful for three reasons. In the first place, the price of such cutbacks would inevitably lead to further intensification of research and investment relating to alternative sources of energy and alternatives to energy use. The effect would reduce the total value the exporters would receive for their oil over the life of their producing field. Cutbacks might bring a higher price for the shorter run, but they would bring a more than offsetting reduction in revenue for a long time thereafter.

In the second place, maintenance of present costs of export oil, even with no increase would threaten severe economic and in some cases political damage to a large number of consuming countries to the extent that it could result damaging backlash toward the producers as well.

In the third place, our Treasury studies of supply and demand elasticity indicate that reductions in demand need not be very great to reduce the total size of the oil market significantly. Reductions in demand due to present prices coupled with increases in competing supplies will result in a steady reduction of OPEC's market. Thus, Treasury studies show that for a wide range of plausible demand and supply elasticities, recent price increases, if maintained, will cost OPEC a sizable fraction of its sales.

I sensed real concern in Saudi Arabia and Kuwait about these questions. Both governments have requested that we continue our discussions of energy issues and, in particular, they are interested in our estimates on the projected U.S. needs for oil from the oil-producing countries.

In conjunction with some of the discussions in the Middle East on the responsibility of oil producers to aid lesser developed nations, I itemized in my statement the many actions that are being taken by all of the countries contributing to the special facility in the International Fund on a multilateral as well as bilateral basis to assist not only their lesser developed brethren but also some of the lesser developed countries of the world who are suffering economically as a result of these very high prices.

EUROPE

After the discussions in the Mideast, I was pleased to have the opportunity to meet with a number of European leaders. In my view, the Secretary of the Treasury has always met with the European Community's Finance Ministers on a regular basis to exchange ideas and mutual concerns. I have met for over 3 hours with Chancellor Helmut Schmidt and Finance Minister Appel and went on to Rome and Paris and the United Kingdom to meet with the Finance Ministers in those countries.

Inflation is obviously the No. 1 economic problem facing the world today. Our general discussions in the European Community encompassed the No. 1 problem of inflation, oil prices, the recycling of funds, the investment of funds, and international financial stability.

We exchanged many ideas on what each country is doing domestically. I must admit they took a somewhat different view of the economy in the United States and its very fundamental strength than many people in this country do today. While our inflation rate is most certainly unacceptable by any standards, it is one of the lowest in the industrialized world today. Only Germany has a lower rate of inflation. I think they have a very low tolerance for inflation and strong support for policies of restraint which have been in place for sometime, and I attribute this restraint program with the diminution of their inflation rate.

I then went into the detail on the recycling problem, how much oil revenue, as you said, Mr. Chairman, ranging in the area of $100 billion this year, reasonably expecting that 40 percent of that money would be maximum that could be invested and spent internally, leaving $60 billion to be used in other ways.

Discussions of ability of the private markets to handle the reinvestment and what indeed the Government's role really should be is discussed in my statement in greater detail.

I will be delighted to respond to any questions you have at this time.

Senator BYRD. Thank you, Secretary Simon.

I have a number of questions. I will confine the first round to 10 minutes and then I will yield to the distinguished Senator from Utah, Mr. Bennett.

Mr. Secretary, what are the oil-producing countries doing with their petro dollars?

Secretary SIMON. It varies, Mr. Chairman, from country to country. Saudi Arabia is looking beyond its days of oil primacy and wishes to industrialize and diversify its economy. The Saudis also recognize they cannot do it overnight. They have 25 percent of the world's proven oil reserves. As a result they are going to have by far the largest revenues.

In the interim, while they are moving ahead with industrialization and diversification, they are doing several things. One, they are granting aid through the special facility in the International Monetary Fund and through bilateral means to other countries in the world like their aid to Egypt.

Senator BYRD. That would be very little relatively, would it not?

Secretary SIMON. Their revenue in Saudi Arabia this year will be approximately $25 billion. Their budget for this year is just short of $13 billion, which has resulted literally in an explosion in internal spending in their country.

Senator BYRD. Their revenues will be double the anticipated expenditures?

Secretary SIMON. That is correct. They will have approximately $13 billion to use for investment, for aid, and meeting their additional priorities. There is some question in everyone's mind whether or not they have the ability to spend $12.8 billion internally. But the fact of the matter is they are going to commit this money and contract various projects like a new airport for $400 million, et cetera.

In talking to the Finance Minister in Saudi Arabia I told him that I thought that he had even a harder job than I did in my efforts to approach control spending in this country. He said, "You are certainly right." They say, well, we have it, why shouldn't we spend it, and indeed they have a great many priorities.

So I don't think we have really gaged the internal demands in these countries properly when looking in the years ahead.

In Kuwait, a country about the size of New Jersey with approximately 825.000 people. Their annual income, assuming oil prices remain at this level, will be in the area of $8 billion. They intend to concentrate their efforts on downstream activities in the petroleum and natural gas, petrochemicals, fertilizers, tankers, et cetera. They are highly sophisticated people and have been investing for sometime and diversifying in many areas of investment in common stock, in fixed income securities and real estate investments.

Senator BYRD. In the United States you mean?

Secretary SIMON. Yes, sir; that is correct.

They also have given a great deal in aid. They have just increased the size of the Kuwaiti Fund from $6.2 to $8 billion and it is going to be used for the lesser developed countries in the world. Both countries have given substantial amounts and indicated they are going to continue giving substantial amounts of aid to not only the lesser developed countries but the other countries as well.

Senator BYRD. Would you be able to predict the volume of Middle East oil money that would be coming to the United States?

Secretary SIMON. That is judgmental. In our judgment 40 percent of the moneys can be spent internally while x percent will be spent in direct aid, such as Iran's $1.2 billion to the United Kingdom and $5 billion long-term arrangement with France. Oil producers are looking to aid Italy as well. I have read reports in the newspapers that we expect $10 to $12 billion in investment. In my judgment, that is an exaggerated number that it would be significantly smaller than that at the outset, although one could expect we would get the larger portion over the period of time because we have the most highly developed markets in the world and the most liquid markets.

Senator BYRD. What area of investment are the Arabs concentrating on in the United States?

Secretary SIMON. That again varies country to country. I think you will see them buying U.S. Government securities and corporate securities and equities. It will be very broad and diversified. They are very conservative investors, Mr. Chairman.

Senator BYRD. Yes.

Do you foresee any danger from potential Middle East control of strategic domestic industries or companies, shipping, steel, oil?

Secretary SIMON. We have safeguards here in this country in the Security and Exchange Commission regulations, the Defense Department and in our antitrust laws. I am not suggesting that they provide adequate safeguards. We ought to continually watch the national security implications of investment in certain industries in this country.

But I find absolutely no indication, Mr. Chairman, that they wish to come over and take a controlling interest in any company. This is the antithesis of their philosophy in the investment area and, second, they have grand dreams for their own countries and are looking at their needs in the future.

Senator BYRD. Yes; but their excess dollars are what we are speaking of and this year you estimate it will be—all the countries together it will be about $60 billion.

Secretary SIMON. That is our judgment; that is correct. But that money is going to be spent in many countries in the world in many ways in the form of loans as well as investment, and part of these loans will be put into Government securities in governments around the world, not only the United States. It will also be put into real estate and other investments.

Senator BYRD. Would you speculate on how long the price of Middle East oil would be held artificially high?

Secretary SIMON. That is not just an economic question but, more important, a political question, so it is just speculation. If the market were allowed to function right now with the surplus in the world today with approximately 2½ million barrels a day with storage tanks brimfull, I think we would see a lower price of oil right now. Saudi Arabia announced an auction for sometime in August while I was there. It may result in a lower price than the 93 or 94.8 percent of the posted price that is now being negotiated on a credit basis. Whether this auction will be held or not is presently unclear to me, but it is clear to me there are pressures on the world oil prices due to the surplus.

Senator BYRD. What is the current size of the Eurodollar market?

Secretary SIMON. At the end of last year it was approximately $150 billion and the financial judgment is that it is upward of $200 billion.

Senator BYRD. How much is controlled by branches of American banks?

Secretary SIMON. I don't have that number and I am not sure that number is readily available, but if it is, Mr. Chairman, I will supply it for the record.

[The following was subsequently supplied for the record:]

The foreign branches of U.S. banks had $101 billion in dollar deposits at the end of May. This compares to total dollar deposits at foreign banks in major financial centers, of an estimated $270 billion in mid-May, 1974.

Senator BYRD. Thank you.

Do you know how much U.S. corporations have on deposit in Eurodollars?

Secretary SIMON. No sir, but I will supply that also, Mr. Chairman.

[The following was subsequently supplied for the record:]

The data collected by the Treasury Department from major non-banking concerns on their liquid assets abroad show that as of the end of July, 1974, these firms held $3.2 billion in dollar deposits abroad.

Senator BYRD. Thank you.

In the past year the international money markets have been hit hard by some unexpected devaluations, and of course the oil price change. Has the international monetary system worked satisfactorily, do you feel?

Secretary SIMON. I feel it has, Mr. Chairman, yes. I think advocates of the floating rate have been heartened by the developments of the past year, and I think that the markets have acted with great stability when one takes into consideration the extraordinary events that have occurred. I often think about what would have happened under the old fixed rate system that governments were bound to protect and that gave a target, if you will, for the speculators. I think that the market has responsed admirably.

Senator BYRD. The oil crisis seems to be partially at fault for the financial situation which Italy already finds itself. There is much speculation the country might go bankrupt. What would that mean to the world financial situation and to the United States?

Secretary SIMON. I consider the possibility of it going bankrupt—impossible to accept, Mr. Chairman. I would say that you are extremely accurate when you say it is partially due to the higher oil prices. The rest of it is due to their internal economic policy which has taken a dramatic turn around as far as the new demand restraint programs. They are putting their internal house in order and this is going to, over a period of time, assist them. But they have to first put their own house in order and set the proper economic policies domestically, and they can be helped to bridge this period of time until these economic policies work through the special facility in the International Monetary Fund, through swap lines with other central banks, which have been in existence since the sixties and they do have a substantial amount of gold that they can use for collateral to make other loans.

There are also indications, as I mentioned previously, they are getting these direct loans from producer nations as well.

Senator BYRD. Fundamentally it really has to do what the United States has to do, put its financial house in order?

Secretary SIMON. That is correct.

Senator BYRD. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

I have indicated it was Saudi Arabia that was going to dedicate about $6.2 billion to other countries.

Secretary SIMON. No, Senator, Kuwait established the Kuwait Fund that has been increased from $600 million to $8.2 billion.

Senator BENNETT. Are other oil-producing programs planning similar programs?

Secretary SIMON. Yes; I have listed them in my statement, including the countries that have taken steps to aid the industralized countries as well as the LDC's. The International Monetary Fund has established a facility to concentrate immediately on the most seriously effected nations.

Senator BENNETT. Where in your statement is that list?

Secretary SIMON. Page 19, it says six OPEC nations have pledged over $3 billion to a special facility in the IMF to provide supplementary financing for oil-importing countries. Four more OPEC countries are considering contributions. It is contemplated that this facility would be somewhat below market rates, but not in the concessional area, and would help both developing countries and developed countries with balance of payments problems arising from increased oil costs.

Kuwait is expanding its economic development fund from approximately $600 million to over $8 billion. Assistance from the Kuwait Fund will no longer be confined to Arab nations, and the new funds are to be lent on a concessional basis. Expansion of operations from current levels may be relatively slow because of the fund's shortage of qualified technical personnel, but the World Bank has offered technical assistance to overcome this staffing problem.

Iran is extending over $1 billion in bilateral project assistance on favorable terms to Middle East and South Asian countries in addition to providing special price and financing arrangements for certain of its oil exports. Saudi Arabia and Iraq are extending similar project and/or oil financing facilities in the region.

Senator BENNETT. The total goals—would indicate the total amount against this $60 billion that you are worried about?

Secretary SIMON. I would say it approaches approximately 25 percent.

Senator BENNETT. About $15 billion?

Secretary SIMON. Yes, sir.

Senator BENNETT. How much of the $60 billion of oil money available will be recycled through the international monetary fund?

Secretary SIMON. It is impossible to tell, really. The one overriding consideration when we talk about the recycling of funds is recognizing first that everyone acts in their economic self interest. It is in the economic self interest of the oil producer countries who are going to receive this tremendous amount of funds in such a short period of time to make sure that it does not create disorder in the world finance system. They need the liquidity. They want to have stable international finance markets, and I think they have demonstrated that they don't intend to, as some people have suggested, shift massive amounts of funds from one market to the other to take advantage of strengths or weaknesses in various currencies, or to take advantage of various inter-fluctuations. First of all, it would be impossible for them to shift this amount of funds in the marketplace.

Senator BENNETT. We think in terms of $60 billion, actually that total is divided and different parts are under the control of different individuals and different objectives and countries with different programs, so that it is not a solid total.

Have you got any idea of what the international monetary reserve position of these countries will be at the end of the year?

Secretary SIMON. There again, it can only be judgmental. This is a new experience for us as well. We know that their revenues are going to be in the area of $100 billion. Their ability to absorb these revenues internally are about 40 percent of that, so that would be our initial judgment. But that is subject to question.

Senator BENNETT. Is there any picture developing as to how these reserves will be held, whether in dollars or gold or SDR's?

Secretary SIMON. I doubt sincerely that gold is a prospect for investment. I think that people have learned that the gold market like other commodity markets declines as well as increases in price. It also doesn't pay any interest.

Senator BENNETT. The theory has always been that these Arab rulers like gold and that this was kind of the final resting place of the gold in the world; is that true?

Secretary SIMON. I don't believe that. While I think that they may own some gold, I received absolutely no indication from them whatsoever in our very frank conversations that gold would be an area of potential investment for them. On the contrary, especially in Kuwait they spoke in a very sophisticated fashion as far as the opportunities in many of the finance markets all over the world in their desire to diversify and invest in many areas. In Saudi Arabia as well, they are talking to many of the leading finance entities in the world, commercial banks as well as investment bankers to give them investment advice in many areas of opportunities for their moneys, and they are going to do it very, very cautiously because that is their nature. They are very conservative and responsible and, in many areas, very sophisticated investors. People sometimes think that there is no sophistication. When one studies the history of this world they recognize that trade and commerce started over there and they are indeed a highly sophisticated people.

Senator BENNETT. I don't think an American tourist is equal when he attempts to haggle with a Middle Eastern salesman over things that a tourist might buy.

Secretary SIMON. Not even your humble Finance Minister.

Senator BENNETT. Somewhere along the line this morning you talked about the oil tanks brimming with oil. There are a lot of people who are writing letters to the editor saying that why are the refineries cutting back, why aren't we refining to our ultimate capacity, and are we getting to a position where we are filling up all the empty tanks we can and unable to, with a commodity that isn't moving as fast as it might otherwise. If that is the case should we expect the American oil refineries to reduce their price on the theory that there is a surplus?

Secretary SIMON. Well, let me start at the beginning when we talk first about the domestic demand for petroleum. Today we are importing, which is a good indication of demand, about 6.4 million barrels a day. This is exactly what we were importing when the embargo was put in place last October.

It was anticipated our forecast demand for the summer of 1974 was approximately 7.7 million barrels a day of imports. So this shows you that we have reduced demand significantly in this country over what was forecast, because gasoline demand had been rising in the area of 5 to 6 percent a year.

First, refineries will only refine what they can sell, especially when their storage tanks are beginning to fill up, recognizing the reduction in demand.

Second, this is the time of year when refiners shut down and shift from the production of gasoline to the production of No. 2 heating oil for winter.

Someone told me they were up in Philadelphia and there are gasoline wars going on. This does occur because inventories are held, and while gasoline may have cost the wholesaler 50 cents a gallon it is costing him a good deal to carry this and he must sell it. This is going to continue to occur, assuming production remains at current levels worldwide. That is a political question, Senator Bennett, not an economic one.

Senator BENNETT. I want to raise the question because I agree with you. I think it is simplistic, to assume that because, as you say, that refiners are turning from manufacturing gasoline to manufacture of heating oil that that indicates that the price of gasoline should come down, there are also some assumptions made by people who write for the papers that because they are turning to heating oil we have got more gasoline than we need—or I will say it another way—that in order to hold the price up they are cutting back on their production of gasoline and turning to heating oil, and if they really produced the normal amount the price would come down.

Secretary SIMON. Senator Bennett, I have read both. This accusation and the other one that they are creating a greater surplus for heating oil so they will get a greater price for that next winter. These fellows can't win no matter what they do. They will be in the doghouse until their profits start to slide, which will be early next year.

Senator BENNETT. Mr. Chairman, I have no further question, Mr. Chairman.

I have to go on to another meeting and I will ask you to take care of the Secretary.

Senator BYRD. Thank you, Senator Bennett.

The Senator from Ohio, Mr. Metzenbaum, who is not a member of the subcommittee, but the subcommittee is happy and pleased to have Senator Metzenbaum here this morning. He has taken a tremendous interest in this subject and just recently made a splendid speech in the Senate.

The committee is happy to have Senator Metzenbaum, and Senator, you may proceed with your questioning as you wish.

Senator METZENBAUM. Thank you, Senator Byrd.

I want to express to you my appreciation for your kind invitation to me to be here in order to direct inquiries to the Secretary. I do have some questions.

Mr. Simon, you and I had something of a colloquy, but I said earlier that, before you went to the Middle East, you were quoted as saying you had a shopping list of opportunities for potential investors there, including investments in the stock market, as a way of encouraging the Arab oil-producing nations to invest some of their billions in the United States. The quote is from an Associated Press dispatch of July 5, 1974.

Did you have such a shopping list? And if you did, in what U.S. corporate securities did you encourage the Saudi Arabians to invest?

Secretary SIMON. I have often been misquoted in the press. Although I go at great pains when I am speaking on the record to carefully choose my words, I talk about a shopping list of items to talk to the Saudi Arabians about—not about specific investments as far as the stock market or the equity area is concerned. It is not the function and it would be highly improper for the Secretary of the Treasury to be peddling U.S. securities other than U.S. Government securities, which is my direct responsibility overseas to anyone.

Senator METZENBAUM. I thought that would be the case. That is the reason I made the inquiry.

Secretary SIMON. I did speak to them about U.S. Government securities, which of course the world knows. Many countries own U.S. Government securities. These securities have some things that many people don't understand, and that is that special issues of Treasury securities give them great advantage and we pointed out those advantages.

Senator METZENBAUM. Did you encourage them to invest in the equity market in the United States?

Secretary SIMON. No, sir.

Senator METZENBAUM. The news report to which I referred also quoted one member of your delegation as having stated: "There is no certainty they will invest, or want to hear our suggestions, but we will be prepared to make a presentation if they wish." But if you didn't make the statement, you didn't. I agree with you that it would be inappropriate to have done so.

Secretary SIMON. I wonder if he wasn't talking about whether there was some question we were going to discuss Treasury issues and what they were going to do. We did not discuss going over there to secure all of the moneys from the Middle East producers. That was not the purpose of my visit. So there was some question of whether or not we should bring up investment in U.S. Government securities, that they would feel that this was really the reason we were coming over and it was not.

Senator METZENBAUM. Since you agree we shouldn't do it, and since you say the statement was not correct, I don't think we need to belabor the point.

If the oil-producing nations invest in U.S. corporations, they may begin to acquire a controlling interest in companies and key industries. In view of the fact that never before in world history has such a concentration of resources existed, do you believe our country must establish a policy on foreign ownership of corporations? Would you not agree that at a minimum, the American people should know the extent of foreign ownership, particularly of industries related to national security?

Before you answer that question, let me say I am not quite as sanguine as you are about their interest in moving into America industry. I have here a newspaper story, datelined Jidda, Saudi Arabia, and entitled: "Will Arabs Buy U.S. Firms?" It reads as follows: "Whether Americans like it or not, oil producing nations expect to invest their vast wealth where they want." If nations like Saudi Arabia want to buy stock in General Motors Corp., they could do so freely. They could control major U.S. corporations by purchasing a majority of shares.

I think that the oil states clearly intend to move into the equity market.

Secretary SIMON. I admit there is an intent to move into the equity market and I think we ought to have a very careful dialog about disclosure. Do we wish to encourage world investment in the United States? I think that is a very fundamental question. Our companies, multinational in many industries, have invested $100 billion outside the United States, which has benefited, we believe, the U.S. economy on the repatriation consistent with our philosophy of free trade and investment in this world. I also understand that there are national security implications, both miltary and economic in investments in this country, and as I said, we have SEC regulations and Defense Department regulations and antitrust regulations to deal with this, but we ought to look very close at other safeguards.

Senator METZENBAUM. The SEC regulations provide no disclosure at all, as a very fine study by the Subcommittee on Intergovernmental Regulations of the Senate Committee on Government Operations, headed by Senator Metcalf and published on March 4, 1974, clearly indicates.

Time and again, the Metcalf study states that there is no way of knowing who owns American corporations because of the use of nominees. For example, the study quotes a General Accounting Office study as follows: "We X'd a limited number of reports and applications requiring ownership. It appeared that for large regulated companies, the names of nominees are often shown in lieu of stockowners. Who told us that companies were not in a position to know who the stockowners were? Officials stated companies could only report names of the stockholders of record, which includes nominees."

There isn't any question that the SEC does accept nominees and does not require disclosure of actual ownership.

What concerns me is that at some time in the future, the American people will find that certain of our major American corporations are owned and controlled by foreign nations, something which may or may not be in the best interest of our country. Certainly it would be easy for the Saudi Arabians to invest their money in a Lebanese bank, which might then make a transfer in the name of a nominee, perhaps the Chase Manhattan or the First National City Bank. In such circumstances, there would be no possible way to know that 10 or 15 or 20 percent of General Motors or A.T. & T. or Boeing or any of a host of other companies was owned or controlled by foreign interests.

I would point out that since American investment has been made overseas, Japan, Iran, Mexico, Canada, and a host of other nations have not only adopted disclosure requirements but have gone far beyond that in order to control investment.

In our national interest, isn't it imperative that, at a minimum, we know who is buying up interest in American companies?

Secretary SIMON. I think these safeguards are extremely important. We ought to discuss and identify all of this information and identify and define the national security precautions that we wish to have. Disclosure, one can argue, and full disclosure one can argue from the other side will discourage investment. Do we wish to discourage it on a broad scale or say these are industries we do not look favorably upon, if they do indeed exist?

Ray Garrett testified he favors full disclosure on the part of institutions as far as stockownership is concerned. I happen to think this is a very good idea in my preliminary judgment.

If Kuwait or Saudi Arabia or any other oil-producing countries wish to buy 10 or 15 or 20 percent of the major corporations in this country they would publicly have to have a tender offer and it would be publicized. There is no doubt about that. There is also no doubt in my mind, because they explained this to me, that their investments will be concentrated in areas that they will be doing business in their own country while they are diversifying and industrializing such as cement and wood, et cetera. These are going to be their areas of interest. If they are going to be buying all of these materials they feel it is profitable for the company they are buying from so they should have a stake in it.

Senator METZENBAUM. I take issue with some of your points; for example, that they need to make a tender offer. I have more questions. I hope I might have further time.

Secretary SIMON. I am sorry if I took too long answering your question, Senator.

Senator BYRD. Senator Metzenbaum in his statement said we have offered OPEC nations an opportunity to place a portion of their funds in special U.S. Government securities. Now, what kind of Government securities are you speaking of especially, U.S. securities?

Senator METZENBAUM. I will explain, Mr. Chairman, at the outset that using the term "special" does not mean that OPEC nations will get special interest rates. They will receive the same interest rate that institutions, American citizens, and other foreign governments receive when they purchase U.S. Government bonds. There will be no devaluation guarantee and no inflation proofing in any way, shape, or form. They will be regular Government securities. We use the term "special" and we have approximately $25 billion in special issues out today.

Since foreign governments have large holdings of American dollars, they would be penalized were they to buy Government securities in the marketplace. That is as they buy with this large amount of money, prices would be forced up and consequently, the interest rate would go down. Conversely, as they sell the market would become depressed, recognizing that they own all these funds. A method for avoiding such disruptions in the marketplace and for protecting these investors is to give them the opportunity to deal on a government-to-government basis.

Senator BYRD. How extensively have they gone into the Government bond market?

Secretary SIMON. There have been purchases in the open market, small purchases in the open market by the Federal Reserve in New York, but thus far essentially none in the area of special issues. They are just considering this.

Senator BYRD. Do you expect them to utilize that to some substantial degree?

Secretary SIMON. My judgment is that they will. My further judgment is that it will not be substantial to the investment of $10 billion to $12 billion as some newspapers have reported recently. Initially, although the U.S. Government securities market is still the primary market qualitywise and liquiditywise in the world in this market.

Senator BYRD. Earlier this year you said we have removed our capital controls and opened our markets to foreign borrowers again.

What restraints, if any, Secretary Simmon, do you think we should retain?

Secretary SIMON. Well, there again away from precautions that Senator Metzenbaum and the safeguards that we talked about for our national security we should have a free and open marketplace, one that encourages investment both ways and that is what we have done, and through this reflow where we don't penalize foreign borrowers enables funds to intermediate throughout the world.

Senator BYRD. So you feel we should have a minimum of restraints?

Secretary SIMON. Yes, sir.

Senator BYRD. To what extent do you think the Middle East oil money causes instability in the short-term money markets?

Secretary SIMON. I think the instability in the short-term money market has been more the informations of people than the informations of the flow of money being quickly moved from one area to the next, and thus far it hasn't created any great instability but that has created some strains.

Senator BYRD. Some strains?

Secretary SIMON. Yes, some strains in the marketplace by the initial investor from receiving large amounts of funds on a short term. A short-term market is not intent and the interbank rate, to use that as an example as the going rate in the European Community, they would receive the interbank rate from the bankers. Well, the bankers will do that for a period of time as long as they can reinvest these funds profitably, and make sure to the best of their ability that their assets and liabilities are matched, because the old borrowing short and lending long syndrome is recognized as not prudent finance practice. Well, that occurred at first.

The second phase was where the bankers were no longer willing to pay the interbank rate because they could not reinvest it profitably and they penalized the lender 2, 3, 4 percentage points. The lender then says I don't wish to be penalized and they moved their funds into the intermediate and longer term area.

Senator BYRD. To what extent will the additions of oil dollars to the U.S. money supply tend to lower interest rates, increase inflation or spur the economy?

Secretary SIMON. Investment in the United States by these foreign governments will reduce the demands of the U.S. Treasury Department on the capital markets, will obviously have a positive effect on the strength of the amount of money that is increased here directly in the U.S. Treasury securities or indirectly throughout the marketplace. By positive effect let us not suggest that interest rates will come down to any acceptable level because of this. The only way we will bring interest rates down in this country is when we show a firm resolve to do something about inflation.

Senator BYRD. Can the United States achieve a 6- to 7-percent inflation rate without controlling the flow of funds to and from money markets with a higher inflation rate?

Secretary SIMON. Yes, I believe we can, although there is a problem in the interdependence of the world today of exporting inflation to a degree away from the special factors, if you will, of 1973, for the food, the petroleum, the simultaneous boom of the industrialized nations, and the devaluation of the dollar which contributed to part of our problem today. Our fundamental problem has been the way we managed our fiscal and monetary scene here for the past decade, and we are just paying the price for this mismanagement.

Senator BYRD. Your economic agreement as I understand it was worked out with Saudi Arabia last month. Does this create a new bilateralism in U.S. policy?

Secretary SIMON. When we talk about bilateralism there has been some confusion and Secretary Kissinger and I in February attempted to define bilateralism. Trade by its very nature has always been bilateral. To go and make unconstrained bilateral deals involving oil at exorbitant prices, was what we were strongly opposed to. It was counterproductive for everyone, most particularly the countries that were contracting for oil at what I consider ridiculous prices. The market since has borne me out on these ridiculous prices because they have declined substantially from the $16, $20, $25 price in February. When we talk about bilateralism, we are talking about trade and industrialization and diversification and finance and economical and technical expertise the U.S. Government can bring to all of these governments, Egypt and Saudi Arabia in particular. We are also speaking about what our industrial complex in this country will be encouraged to do regarding the desire of these countries to diversify their economies. Our businesses will see an opportunity for investment and profit and expansion of their scope of operations, and this is a very healthy development and it is one thing that is going to assure the lasting peace that we all need in this world.

Senator BYRD. Let me shift a moment to an area where you have unusual expertise. What is the present state of the domestic banking business, in your judgment?

Secretary SIMON. Well, the domestic banking business, if we are speaking of the commercial banking business, is on the whole extremely healthy. It is suffering just as the investment banking and capital markets in our country from the exorbitant rates of inflation, and there again—this is just a culmination of extraordinary events that have occurred in the last 10 years in the financial markets that have eroded the confidence and ingrained the high rate of expectation and caused a deterioration in the confidence of the American people. One talks about banking and markets and they tend to isolate their thinking to a very narrow one-way street called Wall Street. Our markets are not Wall Street. They are the people of the United States, the 30 million investors in our equity market and the thousands, literally millions of private decisions that are made in our free enterprise economy that affects the marketplace. The markets are nothing more than a barometer of what's happening. You can go back to the credit crunch of 1966 and the insane policy of guns and butter during the Vietnam war which was a major contributor to our crisis of the inflationary period thereafter. All of us have paid for this and we have continued to spend, and now we are suffering a hangover from it, Mr. Chairman.

Senator BYRD. Basically what you are saying so far as the banking business is concerned, is that there is no cause for alarm.

Secretary SIMON. There most certainly is not any cause for alarm. The recent experience of the Franklin National Bank, some people said, signalled basic malice. This is just not accurate. It was a particular case as was the HerStatt Bank in Germany of gross mismanagement in going over their heads in foreign exchange dealings in an attempt to make great profits. They over leveraged their assets.

Senator BYRD. Thank you, sir.

Senator Metzenbaum?

Senator METZENBAUM. Thank you, Senator.

In your answer to my previous inquiry, it was not clear whether you do or do not agree that the American people are entitled to know the extent of foreign ownership of American corporations when such ownership goes over a particular percentage, say 5 percent, of a given corporation. Would you favor that policy?

Secretary SIMON. Senator, I answered that, I believe, that I think that we ought to. Rather than me giving a snap judgment on a complete and full disclosure, we ought to have a dialog on the issue of investment and what our policies are in the United States. Should it be full disclosure of anything over 5 or 10 percent, limited to specific industries? I would like the opportunity to examine both sides of this issue very carefully, but I did say and I feel this very strongly that if you do come down on the side of full disclosure being one of the safeguards, whether that is one or not, I think we need definite safeguards to prevent some of the things you suggest.

Senator METZENBAUM. I think we are now living through the very period in which oil-producing nations have the excess billions to invest. It seems to me that governments always act after the fact. I wonder, since you are talking about safeguards, what safeguards you have in mind and when you think they should be enacted?

Secretary SIMON. I think this dialog should be commenced immediately between Congress and the executive branch to explore all the ramifications of this area of investment. It is a very broad subject. That is why I don't beg the question, Senator.

Senator METZENBAUM. I am attempting to start the dialog and I think you are saying that you are not quite prepared at this moment to respond. Is that correct, sir?

Secretary SIMON. Yes sir.

Senator METZENBAUM. Let me say that I am contemplating legislation in this area. I would be very much interested in your Department's thinking on the subject, but I would like to have it before me as promptly as possible.

Secretary SIMON. All right. We will go to work on that immediately, Senator.

Senator METZENBAUM. Let me go into another area, which has to do with the political impact of economic power.

Creditor nations are in a position to have substantial political impact on debtor nations, a fact which was recently mentioned in a New York Times story which quoted one Abraham M. Oweiss, a native of Egypt and a professor at Georgetown University. That article raised the possibility that the West might seek accommodation with the Arab oil producers on their own political terms. The United States, said the professor, should take another look at its foreign policy in view of the new economic situation and should think about its real economic interests. The United States and the Arabs, he claims, can build up cooperation and mutual respect, which will lead Arab investments to flow into the United States. The New York Times writer described that approach as a more subtle and dangerous form of blackmail than the oil embargo.

How do you assess the power of petrodollars vis-a-vis our own dollar as well as the currencies of other nations? I think, as a businessman and as one who has been in the investment banking business, that we both know that the creditor, in one way or another, does have some impact upon the political status of the debtor nation. I wonder whether our country has a policy in this area. Or whether, perhaps, we have a policy of having no policy?

Secretary SIMON. Senator Metzenbaum, this of course is a possibility and every one recognizes the fact that vast finance power, the power that they would have if these revenues continued for very long, could change the balance in many areas as far as the political situation in the world is concerned.

Prior to going on this trip, the entire game plan for it was worked out between Secretary Kissinger and myself. Since my return we have met almost daily. Recognition of just what you were saying, foreign policy, political and economic aspects of oil prices, petrodollars and the basic subject of energy is just so interrelated that it is going to take a lot of work on our part to devise the various scenarios and policies for the good of the United States and the rest of the world.

Senator METZENBAUM. Are you in position to share your policy conclusions at this point?

Secretary SIMON. Not at this point. We have been for the last 2½ weeks in the process of developing them.

I did discuss most of what our thinking has been in the executive session in one of the committees I testified to before this week, but many of the conclusions I would say are tentative at this point and would not serve a useful purpose for disclosure.

Senator METZENBAUM. It seems to me that one of the major problems facing this Nation as well as the world is this shift of economic power, rather than any change in the distribution of guns and bombs and military power.

Secretary SIMON. The potential shift of power, that is correct, Senator Metzenbaum, and I think that the overriding concern and the desire of everyone's part to cooperate on the part of the producers and the consumers is evident. As time goes on I believe this information will be relayed. We must be aware of all the ramifications that you and I just discussed.

Senator METZENBAUM. Mr. Secretary, I apologize for running in and out but I am trying to cover two meetings.

I will be back, Senator. Excuse me.

Senator BYRD. Thank you, Senator Metzenbaum.

Mr. Secretary, presumably large amounts of cash will be banked in this country by the Middle East countries. One Virginia bank holding company, I understand, has sent a representative to the Arab countries soliciting funds. What protection will be required against withdrawals that could effect the stability of finance institutions?

Secretary SIMON. As I explained before, as far as protection is concerned in the U.S. banking system, we have the most comprehensive regulatory mechanism of any country in the world as far as commercial banks are concerned. We have the Comptroller of the Currency, the FDIC, the Federal Reserve, et cetera, and of course, to some degree the U.S. Treasury Department. Recent events have made the regulatories much more aware of the potential problems and their surveillance has increased.

Senator BYRD. But there is nothing to prevent sudden withdrawals.

Secretary SIMON. That is correct, but with your statement you are assuming that all of these moneys that will be deposited here will be called deposits and that they will be invested for relatively short periods of time?

Senator BYRD. That has been the case up to this point, hasn't it?

Secretary SIMON. No, the bankers have demonstrated to me and I have spoken to quite a few of them. Unless they could get the money on their own terms they were turning the money down, and by their own terms it meant they wanted to have a close asset-liability mix and not be subject to the danger of borrowing short, lending.

Senator BYRD. This next question is being asked out of complete ignorance. Who regulates and what steps are being taken to regulate international banking in the following categories: U.S. branch banks abroad, foreign banks of U.S. branches and consumer arrangements abroad?

Secretary SIMON. The Federal Reserve Bank has made public statements and Henry Wallich, I guess, who is appearing right after me can give you the definitive policy relative to all these areas.

Senator BYRD. If that is the case we will withhold this case until Governor Wallich comes forth.

Secretary SIMON. Yes, sir.

Senator BYRD. This may or may not be for Governor Wallich. Does the administration intend to adopt a stance as to foreign banks establishing branches in various finance centers of the United States?

Secretary SIMON. Yes; there are studies going on downtown right now on the proper treatment and regulations of foreign bank branches operating in the United States. We are asking: Should they operate in this country under the same ground rules as our commercial banks do or should they operate under the ground rules of their own banks? If we make them operate under our ground rules, will they do the same to our commercial banks that have branches overseas.

Senator BYRD. But if we don't, then we would in effect, would we not, be establishing interstate banking policy?

Secretary SIMON. Yes, that is another part of the discussion. If that adds to legislation in this area, it is going to be a hotly debated topic.

Senator BYRD. The Treasury Department is not involved in that?

Secretary SIMON. We are involved in the discussion but have not arrived at a policy in this area.

Senator BYRD. You are still trying to determine whether the foreign banks should operate under the same ground rules as U.S. banks or whether they would be permitted to operate under the ground rules existing in the particular country?

Secretary SIMON. Yes; that is correct. We are asking: What is the effect on our commercial banks that have some 90-odd branches overseas, if we intend, indeed impose, all of the regulations?

Senator BYRD. Yet, if you don't it would permit them to do what our own banks could not do in respect to interstate banking.

Secretary SIMON. Yes.

Senator BYRD. Negotiations between Saudi Arabia and the Arabian-American oil company are scheduled to take place in August. If the Saudis take over Aramco, thereby it will be wiping out the international oil companies' share of production, will the price of oil be driven even higher than it is now?

Secretary SIMON. You are right. At present on the 60–40 relationship oil-producing countries have with the companies, the take-up price of 40 percent share is $7.12. The country's share of it is $10.85. If they are nationalized, the producing countries have indicated that they wish to remove the so-called windfall profits from the oil corporations and this would result in approximately $18 billion added oil bills for the consuming world.

Senator BYRD. $18 billion?

Secretary SIMON. That is approximately right.

Senator BYRD. What proportion of that bill would be United States?

Secretary SIMON. Well, we import today 6,400,000 barrels a day. So the increase of $3 a barrel——

Senator BYRD. Proportionately about 20 percent of that $18 billion?

Secretary SIMON. Yes.

Senator BYRD. We are consuming about 18——

Secretary SIMON. Of course, there is no certainty that that is going to happen yet, although that has been widely discussed.

Senator BYRD. Refresh my memory, would you? We are consuming about 18 million barrels of petroleum a day and importing about——

Secretary SIMON. 6.4—I believe our computation is closer to 17 million barrels a day.

Senator BYRD. Seventeen and we are importing about 6,400,000 barrels a day.

Secretary SIMON. Yes; 6.4.

Senator BYRD. Mr. Secretary, do you believe the devaluations which took place, it was in last year, has been a major cause of our inflation?

Secretary SIMON. They have been a contributor to it. Economies have assigned various degrees of that to the inflation.

Senator BYRD. How do you assess it?

Secretary SIMON. My judgment would be perhaps 15 percent of the inflation problem in this country would be due to the devaluation but that is a rough judgment. The devaluation of our dollar, as you know, Mr. Chairman, was overdue, and when we talk about two devaluations, the first one obviously was not sufficient with the agreement at the end of World War II. With the strongest economy in the world, the U.S. dollar was overvalued. To strengthen the other countries of the world and it was allowed to strengthen too long as other countries grew and trades grew, and so did our balance of payments.

Senator BYRD. Our liquid liabilities continue to grow to foreigners, also.

Secretary SIMON. Our liquid liabilities, after the devaluation, showed a sure plus. We had become competitive in the world markets. This was turned around again when the oil prices were quadrupled.

That is our problem today. The problem of the reflow, in my judgment. is going to be handled—there will be strains, but through the cooperation of the producers and consuming nations we will alleviate these strains in the market. The problem of our oil price is our greatest problem today, and problem No. 2 is inflation. We must bring inflation under control and work toward a lower price of oil.

Senator BYRD. But our liquid liabilities to foreigners is now approaching $100 billion. It was $97 billion at the end of June or May, I don't remember which. I assume that will continue up. That is double since 1970, which was a very dramatic increase. It is not going up as fast as now, but I assume you feel it will still continue to go up.

Secretary SIMON. Away from the oil area, it is not going up at all obviously.

Senator BYRD. Taking it overall?

Secretary SIMON. Overall, we are going to have a balance of payments deficit due to significantly higher prices of oil.

Senator BYRD. You and I both, Mr. Secretary, are deeply concerned about the U.S. financing of the debt as well as the debt itself. In June Under Secretary Volcker testified that interest on the national debt would be $31.5 billion for fiscal 1975 at interest rates of about 8 percent. But now the interest rates, I see the Treasury is paying somewhat more than 8 percent now for money. If the interest rates go up as much as 1 percent the increased cost would be 3.9, in addition 3.9 in interest charges. Are you sticking with the 31.5?

Secretary SIMON. Yes, we are, and when you suggest our last financing, our 33-month note was at 8.59 percent interest cost, which was actually down from .872 from financing before. I must admit, I cannot comprehend suggestions that we would have an overall 1 percent increase in our total outstanding debt.

Senator BYRD. That doesn't seem realistic to you.

Secretary SIMON. No, sir; it doesn't. But I agree with you, the interest costs are just frightening and we have to work on the fundamental problem. Why have interest rates risen too dramatically? As you and I know, Mr. Chairman, it is because of inflation.

Senator BYRD. The more the Government goes into the money market the greater impact that has on interest rates.

Secretary SIMON. It most certainly does. At the end of last year we were preempting 62 percent of the debt markets in this country which to me is unconscionable. We couldn't in our pursuit, and I recognize social priorities; we must help housing and help this and help that and we create every agency that just competes and squeezes out the disadvantages in our market. I am testifying tomorrow on what the budget deficit really is and part of this table which I will send to you is quite illuminating because I know of your keen interest in what our actual budget has been when one includes all the exact budgetary agencies we have created in the last few years.

Senator BYRD. I am very glad both you and Dr. Allen Greenspan, whose nomination is on the Senate calendar now, are not disciples of the full employment budget, which in my judgment is a fraud on the American people. I asked him his views of the full employment budget concept, and he said if you want runaway inflation that is the best way to get it. That is one reason we have got this problem in this country, because of this very foolish and wrong, and in my judgment, fraudulent budget concept that was fostered on the American people several years ago.

Mr. Secretary, you had a great deal of success with the recent offering of 9 percent Treasury notes in $1,000 denominations. Do you foresee the Treasury making more offerings aimed at the small investor?

Secretary SIMON. Well judging this on a case-by-case and issue-by-issue basis, we maintain denominations of $10,000 as far as Treasury bills, because they in our opinion will not cause danger and large intermediations from our thrift institutions. After our last damage which we caused—we were immediately having $5,000 and $10,000 pieces. Why shouldn't the consumer saver be encouraged from buying this highest credit opportunity in the country, indeed, if in the world? They passed a resolution that effectively spreads the intent that we should give the opportunity when we thought it wouldn't be damaging to the individual investor, the consumer-saver to participate in U.S. Government securities. You know, there are many investments in the United States that our investors can disintermediate into. Treasury securities is only one of them. They have learned over recent periods since 1966; three or four times they have become educated on all of these opportunities, and they are very quick to move out of the 5½ percent that is paid in a thrift institution. Why should a market saver be penalized when inflation rates are 10 or 11 or 12 percent and they are receiving less than half of that amount for their savings? We have suggested legislation to change this, to allow the thrifties to expand and strengthen their asset and liability powers and to give them the ability to compete for funds. We think this is one of the final answers to this problem.

Senator BYRD. Of course, many of the financial institutions feel that has been hurtful to them. The other side of the equation, as you pointed out, is that under the existing system an investor with $100,000 can get any interest rate as high as he is able to find, which is permitted by law, but if someone wants to invest $1,000 or $10,000 or $5,000 they are held down by law as to what the institution can pay them.

Secretary SIMON. The opportunities for investment diminish with the smaller amount of money you have. We reward the wealthy in this country with investment opportunities. You are right, Mr. Chairman, and this is wrong.

Senator BYRD. What the Government needs to do is to find a way where the small investor can benefit by investing his funds to the same degree as the larger investor can.

Secretary SIMON. That is correct.

Senator BYRD. I know, Mr. Secretary, that you have another commitment, so I don't want to prolong this meeting.

Legislation has been suggested along this line that if the Congress itself does not cut appropriations sufficiently to bring the total down to $295 billion, then the President would have the right to withhold the expenditure of funds up to a total of 13 percent for any one program in order to get that figure down to $295 billion. Would you have a view one way or the other on such legislation.

Secretary SIMON. I am not aware of this legislation.
Senator BYRD. That has not been introduced yet. Senator Buckley and I are considering it.
Secretary SIMON. I think that whatever can be done to move the budget back toward balance and to keep it there should be done, even if it is a measure that would give the ability to the President to do it unilaterally. I must admit that my preference would be the new budget reform mechanism that has been set up that provides a forum for the executive and legislative branches to work on the specific areas of cuts.
Senator BYRD. That cannot be operative for the fiscal 1975 budget. We have gone down the road too far on that.
Now, this proposal would deal only with fiscal 1975.
Secretary SIMON. I think that sounds like a very useful suggestion, Mr. Chairman.
Senator BYRD. It is the responsibility of the Congress to appropriate and to make the appropriate appropriations, but if the Congress is not willing or is not able to get the expenditures down to that $295 level then some of us are seeking a mechanism by which the executive branch can reduce to the extent that the Congress fails to reduce, to get down to that $295 billion. I personally do not like the idea of an item veto, a degree of which this would give the President. But if the Congress is not willing to do it and if we feel there is an important and definite need to get down to $295 total expenditure, then I don't know of any other way really to tackle the problem than to give the President a little more discretion.
Secretary SIMON. Mr. Chairman, I have always felt it would be useful to give the President some fiscal flexibility, recognizing the changing economic scene, and that the need for whatever fiscal actions, whether it is stimulus or restraint are needed at a particular time, whether a tax increase or tax reduction, just to give that as an example, that by the time it goes through Congress and it is enacted and indeed has its impact on the economy it is too late.
Senator BYRD. I must say frankly I cannot—as one Senator I cannot vote to give the President the right to increase the people's taxes. I cannot do that. President Kennedy proposed it, for example, and I opposed the Kennedy plan.
Secretary SIMON. Senator, when you say giving the President the ability to withhold 15 percent by impoundment, that is one fiscal mechanism you are giving him that can if he wishes to restrain spending in the economy. Another would be to give him the mechanism of reducing or increasing taxes by 5 or 10 percent. There are lots of ways to do it. I was using that as an illustration.
Senator BYRD. I understand. I approve of one but not the other. That is what I am saying.
When you reduce spending then you tend to hold down the people's taxes or lean toward reducing the people's taxes. But when you give the President, one man, the right to increase taxes that is something I can't go along with. That is something that should be done only by the Congress.
One final question. Looking down the road aways would you make any predictions about the longevity of our present economic troubles. Can we get back to a period of relative economic stability?

Secretary SIMON. I think that if we do everything we are all talking about now and have talked about for several months and get our fiscal and financial house in order, in short order, that we can look forward to a period of improving stability in this country. But as you and I well know, it is going to be a long time before we get the rate of inflation down to any—what we might call acceptable rate. I would accept the judgment that has been voiced publicly of 2 to 5 years. I don't really consider it a 2- to 5-year exercise. I think that basically: Why shouldn't we always run our house, the house of Government in a prudent, financial and economic sense, recognizing there are times when the economy needs stimulus and there are times when the budget needs deficit? Conversely there are times when we just should be the opposite. Politicians have dictated the opposite.

Having been on an unsound basis for so long, we can hardly get back to a sound basis in so short a time.

There is no doubt about that, because not only do we have to bring down the actual rate of inflation through prudent action but also squeeze out of the American people the expectation of inflation and regain the confidence of the American people in our ability to run our Government prudently.

Senator BYRD. Just one final question happened to come to my mind and I will conclude this part of the hearing.

There has been a great deal of concern expressed both in the Congress and among the public that at one time or another efforts were made to use the Internal Revenue Service for political or partisan purposes. I assume, as Secretary of the Treasury, that you have taken steps to be certain that that is not done in the future?

Secretary SIMON. There is nothing that is more important to me as Secretary of the Treasury, Mr. Chairman, than maintaining the integrity of the Internal Revenue Service and protecting it from any outside interference, recognizing that our tax system, which is quite a remarkable system, recognizing it depends 100 percent on the complaints and confidence of the American people. If they are not being treated fairly and that if it is used for any political purpose it will be destroyed. I am dedicated to protecting it.

Senator BYRD. I believe you are right and I appreciate that strong statement.

Thank you for appearing before this committee today. That has been a great help to us.

[The prepared statement of Secretary Simon follows:]

STATEMENT BY THE HONORABLE WILLIAM E. SIMON, SECRETARY OF THE TREASURY

Mr. Chairman and members of the subcommittee: I am delighted to have the opportunity to be here today to discuss my recent trip to the Middle East and Europe. As part of such discussion, I think it is important to focus on the effect on the U.S. and world economies of increased capital flows to the oil exporting countries.

The purpose of my trip was to continue our recent diplomatic efforts to achieve a durable and lasting peace in the Mideast. I believe that peace and economic progress are interrelated issues. Without peace, we cannot have economic progress. With economic progress, however, we can minimize the possibility of renewed hostilities. Fortunately, the diplomatic efforts of the President and Secretary Kissinger in recent months have established a framework for peace and stability in the Middle East that hasn't existed for three decades. After my meetings, I am optimistic that we can help these countries strengthen their economies and achieve needed industrialization and development, which in turn will contribute greatly to the cause of peace.

BACKGROUND

Before outlining the highlights of each of my visits, I think it would be useful to explain the background of how the trip developed. Prince Fahd of Saudi Arabia visited the United States in early June, and at that time we established a Joint Saudi-U.S. Economic Commission. This was a major step in establishing closer economic relations between the United States and Saudi Arabia and we agreed to have working groups meet in Saudi Arabia in July. Subsequently, when the President visited Egypt and Israel and suggested that I visit those countries, we thought it would be useful to go to all three Mideast countries and in Saudi Arabia, to open the working group sessions. Kuwait which was the final stop on the Middle East portion of our trip, offered us the opportunity to bring the first high-level U.S. delegation to a country which has increasingly occupied a critical role not just in energy affairs, but world economic affairs as well. The balance of our trip was devoted to continuing our economic consultations with finance ministers and other leaders in Germany, Italy, France and England.

As I will describe in detail, all of our meetings, whether they were with heads of state, finance ministers, petroleum ministers, central bankers, or members of the private sector, were based on mutual concerns: striving for political stability and economic stability, and our shared pursuit for peace and economic prosperity.

EGYPT

The visit to Egypt was in many respects one of the most intriguing aspects of our trip. While the visit was aimed at seeing how we could assist the Egyptians in strengthening their economy, I was especially aware of Egypt's unique historical role as a seat of political and cultural leadership in the entire Middle East.

We were there not only to offer assistance, but to learn as much as we possibly could about the dimensions of Egypt's economy, about their emerging economic aspirations, and, most important, about the shape of President Sadat's program to ~~progressively return~~ Egypt's economy to an open, and more liberal, system.

I would especially like to stress the point that in our meetings with President Sadat, Deputy Prime Minister Hegazi, and Finance Minister Fatah, the Egyptian leaders repeatedly reaffirmed their gratitude for the President's and Secretary Kissinger's role in securing an initial framework for peace in the Middle East.

Our stay in Egypt was marked with intense, frank and cordial discussions which brought a number of tangible results:

In addition to groups that have already been formed in scientific and technological cooperation, medical cooperation, and cultural exchange, we agreed to establish a senior working group to focus on economic development and investment. A broad cross section of representatives from the Departments of State, Agriculture, Commerce, Treasury, and other agencies will participate and Assistant Secretary of the Treasury Gerald Parsky will serve as co-chairman. The Egyptians agreed to name a co-chairman shortly. This work group will contain five subcommittees to cover:

(1) Investment,
(2) Domestic development and industrialization,
(3) Foreign trade,
(4) Agriculture,
(5) Suez Canal reconstruction and development.

We exchanged documents activating the Investment Guarantee Agreement in order that the U.S. Overseas Private Investment Corporation (OPIC) may insure new U.S. private investments in Egypt. This step was made possible by the decision announced earlier to establish a Joint Commission to seek settlement of U.S. Private claims against the government of Egypt.

We discussed plans for detailed utilization of the transfer of official resources from the U.S. to Egypt through:

(1) the $250 million of economic assistance which has been proposed to the Congress for the current fiscal year and which I urge you to act favorably on;

(2) an expanded program of PL-480 sales of U.S. agricultural products to Egypt on the basis of long-term loans on favorable terms;

(3) increased use of the facilities of the U.S. Export-Import Bank to assist other U.S. exports to Egypt on a long-term credit basis.

We also discussed ways in which we can work together in qualifying Egypt for the maximum in financial support from the World Bank, the International Monetary Fund, and other official agencies both national and international.

Not only did we discuss the transfer of financial assistance, but also of valuable technical assistance from the U.S. in many fields, including the fields of financial administration, including debt management; tax administration; statistics; agriculture; population control; building and electrical codes and standards; and many other areas.

Further, we agreed to explore the possibility of establishing a Project Development Institute which would assist in the development of viable projects by providing a mechanism for feasibility studies, thus serving as an inducement to increased investment in Egypt.

We also explored additional ways in which we can work together to attract private investment to Egypt not just from the U.S. but from all parts of the world, particularly investment made jointly with the benefit of U.S. technological contributions. In addition to activation of the Guaranty Program, mentioned above, we offered to assist:

(1) in publicizing the provisions of the new Egyptian Investment Law,

(2) in making widely known those areas in which Egyptian authorities believe there are promising opportunities for investment in Egypt, and

(3) by negotiating a tax treaty to provide a secure base for investor activity.

After this first visit, I have concluded that there is great potential in Egypt for investment. They want investment and are looking for ways to attract it. For instance, while we were in Egypt, Dr. Hegazi announced the acceptance of permits from four major U.S. banks to establish offices in Egypt. This was a most significant indicator of Egypt's commitment to attracting U.S. investment and of moving to liberalize their economy.

ISRAEL

After my talks in Egypt, I visited Israel. During our one and a half days of intensive consultations with Prime Minister Rabin, and other key members of the Israeli Cabinet, we moved in a deliberate fashion to find ways to attract investment to Israel and to expand trade with the U.S. To assist in these efforts we took the following actions:

Established a Joint U.S.-Israel Committee on Trade and Investment co-chaired by Finance Minister Rabinowitz and me. We also agreed to establish four subcommittees dealing with a) investment, b) trade, c) raw materials, and d) research and development.

Invited Finance Minister Rabinowitz to visit the U.S. for the first meeting of the Joint Committee in early November and he accepted.

Agreed to explore ways to establish a Joint U.S.-Israel Economic Council consisting of private U.S. businessmen and Israeli private business and government representatives.

We indicated that we are prepared to assist Israel by providing a broad range of technical assistance and expertise. We also agreed to explore the possibility of a tax treaty and other incentives that may stimulate private investment in Israel.

I believe my visit to Israel demonstrated that our new economic relationships in the other areas of the Middle East in no way signify a diminution of our sensitivities to Israel's needs and our desire to work cooperatively with them.

SAUDI ARABIA

My visit to Saudi Arabia which followed the talks in Israel was part of our continuing efforts to establish a closer economic relationship with the Saudis, and followed the President's June meeting in that country, as well as Prince Fahd's June visit to Washington, when we established the Joint Saudi-U.S. Economic Commission and the Joint Working Groups to deal with the specific areas of industrialization, manpower and education, science and technology and agriculture.

At the outset, it is important to point out that Saudi Arabia's growing accumulation of monetary reserves, which today exceed their ability to absorb them domestically has confronted them with a two-part challenge:

First, how can they spend their resources at home in such a way as to diversify their economy and industrialize their country so that their reliance on oil will be diminished. Make no mistakes about it, the Saudis are looking beyond the day of oil primacy.

Second, how can they invest their funds abroad in a fashion that maximizes profit without creating unwieldy and unwanted pressures on the world monetary system.

During the visit, we held intense and broad-ranging discussions not only on the economic goals of Saudi Arabia but also on their investment objectives as well. We outlined a proposal for investment in U.S. Treasury Special Issues, and began an initial discussion of the advantages both countries would share in negotiating a tax treaty between the U.S. and their country.

Further, we discussed the impact of world oil prices on the developed and less developed countries. They recognize the effects of high oil prices and have clearly been working toward achieving more reasonable prices. In this regard I believe it's important to note that during our visit, Oil Minister Yamani announced the Saudis' intention to hold an oil auction in August and that they would accept whatever price was bid.

Finally, I opened the initial meeting of the Joint Working Group on Industrialization. This group and the group focusing on Manpower and Education met for a week after I left. These groups had representation from our Departments of State, Commerce, Labor, HEW, and AID, and Assistant Secretary of the Treasury Gerald Parksy remained behind to coordinate both groups. I believe these groups accomplished a great deal during these first meetings. Let me briefly outline what was agreed to:

1. We will enter into a comprehensive U.S. Government-Saudi Technical Cooperation Agreement for reimbursement of technical services to our government;

2. The U.S. Government will assign a number of U.S. Government experts to work full time in Saudi Arabia as part of the Joint Commission effort;

3. During August, the U.S. Government will send experts to Saudi Arabia for a temporary period

(*i*) to improve the Saudi statistical and industrial information base,

(*ii*) to advise on customs,

(*iii*) to improve on port management, and

(*iv*) to advise on environmental and pollution standards.

4. During September, the U.S. Government will send additional experts for a temporary period

(*i*) to improve standards for industrial construction,

(*ii*) to advise on the development of marine fisheries,

(*iii*) to advise on establishment of international standards for protection of patents and copyrights, and

(*iv*) to advise on the improvement of communication facilities.

5. The U.S. Corps of Engineers will be requested to expand its role beyond that now performed for the Saudi Ministry of Defense to assist on important infrastructure projects needed for industrialization in Saudi Arabia.

6. Two Saudi representatives will visit the Tennessee Valley Authority within the next two months to recommend the types of TVA assistance needed in the Saudi program to increase fertilizer production.

7. Finally, the Joint Working Group on Industrialization will meet again in late September in Washington.

In addition, the working group on Manpower and Education agreed that:

1. In August, the U.S. will send three technical experts to Saudi Arabia to evaluate current vocational training, including on-the-job training, and develop a proposal for the establishment of technical assistance for additional training programs;

2. In September, the U.S. will send five experts to evaluate the overall Saudi educational system and recommend full assistance projects to implement improvements in the system;

3. During September, Saudi experts will be sent to the U.S. to study government employee training and the petrochemical industry; and

4. Finally, during August and September 1974, the U.S. group agreed to mobilize U.S. resources in the following priority areas:

(*i*) Access for Saudi students to U.S. educational facilities, particularly in law and medicine, including medical internships,

(*ii*) Institutional and program development for Saudi universities and colleges, particularly in business administration, industrial management, extension services (conducting special seminars), and technical services,

(*iii*) Professional recruitment and exchange, including seconding arrangements for American professors to teach in Saudi Arabia, and visiting professors,

(*iv*) Establishment of junior colleges, preferably utilizing existing university facilities, and

(*v*) Development of technical-level training program in the petrochemical field.

We plan to hold the initial meetings of the third and fourth working groups, on Agriculture and Science and Technology, in Saudi Arabia in September. We are hopeful that they will be as successful.

KUWAIT

Following our stop in Saudi Arabia, we made a brief visit to Kuwait. Our meetings there were especially significant from a number of viewpoints.

First, they marked the first visit of a high-level delegation to this critical oil-producing country which, in the last decade, has come to occupy a position of growing importance in the world community.

Second, I had extensive and quite frank discussions with Kuwait's Minister of Oil and Finance Abdul Rahman Atiqi regarding the price of oil. There are still considerable differences of opinion on this subject but it was a most constructive dialogue and opened the way for future discussions.

Third, we had an opportunity to discuss the Kuwaitis' investment objectives, as well as their willingness to assist not only developing Arab countries, but countries throughout the world through such vehicles as the Kuwait Fund.

The Kuwaitis were most interested in receiving as much information as possible regarding the possibility of Treasury Special Issues. They recognized that the U.S. capital market is the most liquid and stable in the world economic community and were interested in the unique opportunities Special Issues avail to the large-scale investor.

With respect to energy issues, I think it was significant that they asked that we send Treasury energy experts to give them a thorough briefing on the econometric studies which support our view that lower oil prices are not only in the interests of the consuming nations, but the producing nations as well. These meetings took place within days after my departure from Kuwait.

ENERGY POLICY MATTERS

Before discussing the European part of the trip, I think it would be appropriate to summarize certain oil policy issues that certainly were underlying my visits in the Mideast.

I am sure that Members of this Subcommittee are well aware of the viewpoint I have expressed about the present surplus and future declining price of oil. But I would like to add to the overview, I have already given publicly.

At various times during my talks, I stressed the fact that cutbacks in production, even apart from the political and security implications for the producers, would turn out to be economically harmful to the producers for two reasons. In the first place, the price effects of such cutbacks would inevitably lead to such further intensification of research and investment relating to alternative sources of energy and to alternatives to energy use that the effect would be to reduce the total value which the exporters would receive for their oil over the life of their producing fields. Cutbacks might bring a higher price for a short period, but they would bring a more than offsetting reduction in revenues for a long time thereafter—in view of the importers' increased commitment to alternatives.

In the second place, maintenance of present costs of export oil—even with no increase—would threaten severe economic—and, in some cases, political—damage to a large number of consuming countries to an extent which could not help but cause damaging backlash on the producers as well.

In the third place, our Treasury studies of supply and demand elasticity indicate that reductions in demand need not be very great to reduce the total size of the oil market significantly. Reductions in demand size due to present prices coupled with increases in competing supplies will result in a steady reduction in OPEC's market. Thus, Treasury studies show that for a wide range of plausible demand and supply elasticities, recent price increases, if maintained, will cost OPEC a sizeable fraction of its sales.

I sensed real concern in Saudi Arabia and Kuwait about these questions. Both Governments have requested that we continue our discussions of energy issues and, in particular, they are interested in our estimates on the projected U.S. needs for oil from the oil-producing countries.

In conjunction with some of the discussions in the Middle East on the responsibility of oil producers to aid lesser developed nations, I would like to provide the Subcommittee with the following examples of constructive actions taken by the OPEC countries:

1. Six OPEC countries have pledged over $3 billion to a special facility in the IMF to provide supplementary financing for oil importing countries. Four more OPEC countries are considering contributions. It is contemplated that this facility would be somewhat below market rates, but not in the concessional area, and would help both developing countries and developed countries with balance of payments problems arising from increased oil costs.

2. Kuwait is expanding its Economic Development Fund from approximately $600 million to over $3 billion. Assistance from the Fund will no longer be confined to Arab nations, and the new funds are to be lent on a concessional basis. Expansion of operations from current levels may be relatively slow because of the Fund's shortage of qualified technical personnel, but the World Bank has offered technical assistance to overcome this staffing problem.

3. Iran is extending over $1 billion in bilateral project assistance on favorable terms to Middle East and South Asian countries in addition to providing special price and financing arrangements for certain of its oil exports. Saudi Arabia and Iraq are extending similar project and/or oil financing facilities in the region.

4. Venezuela is actively negotiating the establishment of a $500 million trust fund with the Inter-American Bank for concessional lending. Venezuela is also making a further $30 million available to the Caribbean Development Bank.

5. Negotiations were completed in May on a charter for a 24-member Islamic Development Bank, with an initial capital in excess of $1 billion. Formal approval is expected—with an operational target of end-1974.

6. On the basis of less definite information, Middle East OPEC countries appear to be considering special funds for Africa totalling perhaps $500 million, including a $200 million fund which would initially help with financing oil imports and then be recycled into longer term projects.

While we do not have complete and detailed information on all the financial initiatives, I think the preceding list amply indicates that oil producers are channelling a portion of their resources to the poorer countries, that at least a part of these resources is being made available on the favorable terms that the situation requires, and that we can anticipate still more constructive steps in the future.

EUROPE

After these discussions in the Mideast, I was pleased to have the opportunity to meet with a number of European leaders. In my view, a close acquaintance, and frequent and informal conversations with those responsible for economic and financial policy abroad are more than a useful tradition—they are an essential part of our management of an increasingly complex world economy. There is no substitute for a face-to-face discussion of the current problems our nations face domestically as well as internationally. On this occasion, I particularly welcomed the chance to meet Minister Fourcade in France and Minister Colombo in Italy, since both had missed the Committee of Twenty Meeting in Washington in June because of the press of domestic matters.

This Subcommittee has expressed specific interest in the problems of re-cycling oil money, and I will offer some comments on that situation in light of my talks in Europe. But I do at the outset want to make clear that this was not the only topic of concern—specifically, the problem of inflation was very much on the minds of the leaders with whom I spoke.

Inflation is the number one economic problem facing the world today. All of Europe is experiencing inflation rates unacceptable by past standards. And in a world grown increasingly interdependent through rapid growth of international commerce, it is increasingly recognized that we all share a common interest in the success of each other's anti-inflationary policies.

Inflation rates are too high everywhere. But they differ widely from country to country. Our record has not been good. But consumer prices have been rising even faster in Italy, in the United Kingdom and in France. And even those countries can feel some relief that they are not experiencing the extraordinarily rapid increases that Japan has been suffering.

It was the German experience which particularly drew my attention. That country has within living memory suffered most severely from uncontrolled inflation and accordingly one finds there a low tolerance for inflation and strong support for policies of restraint. The German authorities have for an extended time followed firm policies of demand management. I am convinced that these policies explain why inflation in Germany is less virulent than in other countries in a fundamentally similar situation.

Our discussions in Europe did focus on the problems of financing oil surpluses and deficits and the ability of private financial markets to handle the anticipated vast flows of funds. Let me make clear at the outset that there was general recognition that the private markets face a serious challenge. But no one was talking about impending failure of financial markets generally or of the monetary system. Nor was there worry that oil monies will be capriciously shifted from one market to another thereby disrupting the foreign exchange and financial markets. All of our experience confirms that the financial authorities of the Arab countries intend to manage their oil revenues in a conservative and responsible manner.

The problems of re-cycling oil revenues do not arise from this source. They derive rather from the very large magnitudes involved and the abrupt adjustments required to handle such magnitudes. OPEC oil revenues are presently running at an annual rate of some $100 billion. That is on the basis of present oil prices, and subject to a great many uncertainties. Some of these revenues are spent on imports and other current consumption, and the balance is available for investments and loans and so on. There are uncertainties here, too, but again it is convenient to think in terms of perhaps some 60 percent of total OPEC oil revenues available for investment in one form or another—roughly $60 billion at the present annual rate. By any standards, this represents a lot of money to be re-cycled.

I should caution very strongly, however, against extrapolating these figures into the future. You know already my views about oil prices. In addition, there are estimates which suggest that the OPEC countries may be able to make rapid strides toward expanding their imports and spending their oil revenues. Given these prospects, there is in my view no basis for some of the extreme projections of OPEC investments exceeding the trillion dollar level within a decade or so.

But no one should ignore the potential difficulties facing both the private financial markets and governments in dealing with the large flows expected this year. That is the matter which we discussed in Europe.

As far as the private markets were concerned, we were careful to approach this question quite apart from the difficulties of a few individual banks which have over-extended themselves in trading primarily in the forward exchange markets. Forward trading is important to the proper functioning of the foreign exchange markets, but clearly some of these institutions simply got in over their heads.

Apart from these cases, we observed that the private financial system was doing a remarkable job of handling very large expanded operations. The financial intermediaries are, of course, adjusting their practices in the face of changed circumstances, in particular proving themselves unwilling to pay the same rates for short maturity deposits they cannot easily use as for longer-term deposits they can re-lend prudently. They are also becoming more active as brokers, arranging direct placements. And the lenders are exploring other channels for their funds, thus easing the pressures on the financial intermediaries. I refer here not only to the talks we have been having with Middle Eastern financial authorities about possible purchases of U.S. Special Securities but also about such developments as the recently announced Iranian advances to France and the U.K., and investment in the Krupp concern in Germany.

It is true, of course, that world capital markets are very large even in comparison to prospective OPEC oil monies. To take the U.S. market alone: U.S. corporate assets are estimated at well in excess of $2 trillion, and equity and debt securities outstanding at the end of last year amounted to some $1.8 trillion. Even the relatively young "Euro Currency" market had at the end of last year, before the new oil prices had much impact on capital flows, grown to over $150 billion. Today, that market probably approaches $200 billion.

As for the role of governments in facilitating the flow of money through private markets and directly in the re-cycling process, the first responsibility of governments is to maintain those economic and financial conditions that are conducive to sound economic activity. In the present circumstances, this means firm policies to deal with inflation and the avoidance of sharp turns in policies. I can see nothing but trouble if we yield to inflation.

A second area of governmental responsibility involves the surveillance and supervision of banking practices. Cases of faulty management in the foreign exchange dealings of some banks, for example, suggest it is a time for careful attention by supervisory authorities to the practices of individual institutions. In my talks in Germany, I was interested to have an explanation of the steps being taken there to obtain better control of bank activities.

Yet another role of governments, or more commonly, of central banks, is that of assuring the smooth functioning of the financial system as a whole. The public authorities cannot be asked to provide compensation for the mistakes of management: They can properly be asked to see that the solvency problems of one institution do not snowball into severe liquidity problems for the entire system.

Beyond facilitating flows of funds through the private markets, there is also a proper role for governments directly in the re-cycling process.

Here I think first of the problems of the poorest countries most seriously affected by the oil price increases. I am encouraged by the evidence that the oil exporting countries are recognizing their responsibilities by expanding their assistance, both drectly AND indirectly, to those hardest hit countries.

But there remains an urgent need to organize the necessary assistance for these countries. Progress toward that end was initiated at the June meeting of the Ministers of the Committee of 20 when it was agreed that a new development council would be established and that it would give priority attention to the problems of these most seriously affected countries.

That C-20 meeting also agreed on another important step involving governments in the re-cycling process, by establishing the special oil facility in the International Monetary Fund. That facility will provide a very useful supplement for those countries which can afford its near-market terms but which are unable to obtain adequate financing through private markets.

Governments and central banks of the main countries have, in addition, an extensive network of swap arrangements developed first in the 1960's. Although not appropriate for long-term financing of oil deficits, they can serve usefully to assist in dealing with short-term pressures in the exchange markets.

The responsibility of governments does not end with these steps. In my conversations abroad, we were very keenly aware of the need to follow closely developments in the markets and, if necessary, develop new mechanisms to channel oil funds. We will be working on contingency plans which will allow us to act quickly and positively should need arise.

The breadth and diversity of U.S. capital markets suggest that we will attract a substantial share of OPEC funds. My European colleagues expressed some concern, in fact that these flows to the U.S. would exceed levels needed to finance our increased oil bills. Although they recognized there was no evidence that such excessive inflows to the U.S. were in fact occurring they were interested in what our reaction would be.

Our reaction to this potential problem is already a matter of record. Earlier this year we removed our capital controls and opened our markets to foreign borrowers again on the basis prevailing before imposition of restraints over a decade ago. Under these circumstances, should there be substantial investments in U.S. Government securities, this would reduce our official borrowing from domestic sources and free resources for lending abroad. We have offered OPEC nations an opportunity to place a portion of their funds in special U.S. Government securities, and there is deep interest on their part in such placements. But this is a matter of convenience, not an attempt to attract excessive investments here. No special inducements are offered—merely the opportunity of government-to-government transactions which enable the investor to transact very large sums without influencing the market against himself. It is a facility we would offer—and have offered—a number of foreign nations holding very large dollar balances.

To a large extent, I returned from my meetings in the Middle East and Europe reassured that a firm basis exists for dealing with the critical problems of the day in a cooperative framework. We have put the mechanisms in place that will enhance economic development and at the same time establish closer relationships with these countries. Strengthening their economies is in the best interest of the entire world. I believe we have taken the necessary first steps in that effort and now we must work together to implement these initiatives. I am confident that we have the will and the resources to succeed in this critical task.

Senator BYRD. The next witness will be Governor Wallich of the Federal Reserve System.

We are very pleased to have you before the subcommittee this morning, Governor Wallich.

May I say at the start that I was very much impressed with a piece which appeared in the Los Angeles Times of July 29, written by you. It was captioned "Are We Willing To Pay the Price of Fighting Inflation?" It impressed me as being one of the soundest pieces that I have read. At the conclusion of this hearing, I will ask that this be made a part of the record.

Governor, you may proceed as you wish.

STATEMENT OF HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. WALLICH. Thank you very much, Mr. Chairman.

I appreciate what you said about my article. Would you like me to read my statement, or do you think it is better to summarize?

Senator BYRD. It might be well to summarize it, and then your statement will be published in full in the record.

Mr. WALLICH. One set of points of departure for my remarks is the wave of disturbances we have had in the international economy, including the increased price of oil; and prior to those increases, the dramatic upward movement in commodity prices, notably the rise in food prices due to bad crops. Those accounted for part of the inflation.

In addition, we have had an excess of aggregate demand in many important countries, with the business cycle peaking simultaneously. All that unfortunately hit at the same time and has landed us in the very serious inflation that we have in this country and elsewhere. But at the same time, we have had considerable gains in trade. One must not overlook the fact that international trade rose contemporaneously with this period of disturbances relative to national GNP's. This is a positive factor, and the United States has shared in it.

During at least part of this time, our trade balance also improved. Its underlying strength is still there. This improvement is now overlaid by the effects of the rise in the price of imported oil. But after the dollar devaluations of 1971 and 1973, we had a significant improvement in nonoil and also in nonfarm trade. That continues and makes our balance of payments better now than it would otherwise be.

The outlook for the trade balance in the next 12 months is uncertain. Much depends upon harvests here and abroad. In 1973, following poor crops abroad, our agricultural exports rose to 25 percent of total merchandise exports. In 1974, this percentage is likely to decrease.

We have been helped to some extent by the flexibility of rates that came about as a result of the end of the Bretton Woods system of fixed exchange rates. But these flexible rates have created new problems of their own. In order to cope with this, the Committee of 20 which was established by the IMF has proposed guidelines for floating exchange rates. These, if adopted, should help to prevent extreme fluctuations and to help prevent official intervention in the markets at cross purposes.

Flexible exchange rates present other problems, such as greater dangers of speculative losses. Market swings and rates have been perhaps unnecessarily wide. A declining rate tends to contribute to inflation, and there is good evidence that most countries now do not want to see their rates go down. They are aware of the inflationary impact involved. The concern about competitive depreciation connected with floating rates so far has not been validated. Of course, one cannot tell what would happen if the world situation changes and world demand for exports was not at the high levels that it is at today.

With respect to the oil-exporting countries, we have a recognizable problem: They cannot import as much as they export. They will therefore run a very large surplus, $50 or $60 billion. The oil-exporting countries, as a group, will recycle this automatically to the importing countries. But this will not necessarily be true of any single country, so the recycling, which is automatic for all the oil-importing countries, is by no means assured for each importing country. That can raise serious problems for individual countries.

Likewise, it is not clear through which channels the flow of capital will go. It can go through banks. It can go through direct investment. It can go through international institutions. If the flow focuses heavily on banks, this can create a problem for banks. It can strain their capital position if deposits become very large. It can strain their liquidity position if the deposits are all in very short-term form. In this case, the banks must be able to find short-term outlets for these funds.

But there are various factors that mitigate that situation. One is what the OPEC countries themselves can do. If they spread their investments in a way that doesn't focus on the banks alone, nor on the short-term sector of deposits alone, they will ease the situation. If they place their funds in countries that need them, they will ease the borrowing problems of those countries.

In addition, the market itself will do a good deal to abate the financial problems presented. For instance, the banks have an answer to the problem of both excessive funds and funds excessively concentrated on short-term deposits. They can reduce rates they pay for deposits that are not attractive to them. They can stop taking the deposits.

Countries whose balance of payments suffer as a result of inadequate receipts of OPEC funds can borrow these funds from other countries. That is, there can be recycling that goes through foreign markets. This is not an ideal situation, and it is limited by the credit capacity of the borrowing countries.

Consequently, there are situations that the market may not be able to handle. These instances would be more frequent if the price of oil remains at anything like its present level.

Facilities other than those of the market may be required to meet the needs of some countries in need of funds. Some things are being done now of that kind on the international scale. There is the IMF oil facility, and there has been a drawing on a loan established by the European Economic Community for Italy. Those are only examples, of course, of the kind of thing that might be needed where the market does not cover all needs.

A problem arises concerning how balance-of-payment deficits due to oil imports should be allocated, as it were. Countries, of course, should try to eliminate that part of their international deficit that does not result from oil imports. To eliminate that part which comes from the rising price of oil is not going to help the oil-importing countries as a group, because the trade surplus of the OPEC countries cannot be reduced in the absence of reduced use of oil. This deficit must wind up somewhere. If one country balances its accounts, it is only cutting some other country's exports or increasing its imports. A competitive effort to improve our trade balances would be at the expense of one another. This would involve some danger of disruption. It would be more helpful if the oil-deficit countries were prepared to accept balance-of-payments deficits in some degree.

Now, in what proportion should the overall-oil-price deficit be distributed? There has been international discussion, but no agreement. I would simply say that it would be unwise for any one country, including the United States, to get itself in a position where it got committed to accepting any excessively large trade deficit. That would mean it would become less competitive and would be importing heavily. We have been through that situation in 1971, and we know the consequences.

If I may summarize the international part of my remarks. I think we can say we have got good institutions, and most of them are well managed. We have got good and well-functioning markets. We have freedom of these markets from restraints on international capital movements. We are, therefore, fundamentally in a well-prepared position. But one cannot be sure that the situation will in fact be manageable unless there is a substantial reduction in the price of oil.

Now, may I briefly turn to the domestic side of the picture. The problem looks somewhat different for the developing countries and for the industrial countries. A number of developing countries have a quite difficult problem. They are already operating at a very low level. They now have a problem of how to import oil, fertilizer, food, the means of producing food, and their situation can become very serious.

Among developed countries, there are a few that have large payments deficits, and they may experience problems. For the developed countries as a group, the situation is somewhat better.

As one looks at the international effects of this oil price increase, there is an analogy to a tax on oil, quasi-excise tax paid to foreigners. Foreigners may invest this revenue in the country where the revenue originates. This can bring about an increase in the rate of investment, and that would be highly desirable. It would mean the country receiving the investments would be building up resources which it could use to generate income to pay the debt that it is building up. Such a development would possibly accelerate the rate of economic growth and take care of mounting capital needs for investment.

Other countries are experiencing even more inflation than we are at this time. Therefore, what I would like to say about inflation goes for everybody. This is a primary problem which needs to be solved. When we solve it, it will help us on the oil front, in achieving balance in international trade, and in greater stability in exchange rates. It is a key problem both domestically and internationally. In some countries, the rate of inflation has now reached as much as a 25-percent annual rate. This is a rate that forces one to wonder whether democratic institutions can indefinitely survive under the social and economic pressures generated by the inflation.

I believe that the widespread effort to cope with this problem will slow the rate of growth around the world, and that, at best, a moderate rate of growth is ahead for a while. But I do not see these policies leading to a serious decline in the world economy. Neither do I see them leading to a crisis in our financial system. We do have severe difficulties, but we also have good institutions. We know what the right policies should be, and given the will, I am confident that the way can be found.

Thank you very much, Mr. Chairman.

Senator BYRD. Thank you, Governor Wallich.

Incidentally, I had dinner last evening with your chairman, who I feel is outstanding in every respect.

Mr. WALLICH. He certainly is.

Senator BYRD. Governor, your associate, Andrew Brimmer, recently indicated that in the first 5 months of this year, U.S. banks sent abroad $8½ billion. Why? Is it because of the higher Eurodollar market rates?

Mr. WALLICH. Well, interest rates in the Eurodollar market would undoubtedly have played a role. Those rates would probably reflect, in turn, the borrowing needs of countries hit by the oil situation. As you know, a number of countries went ahead and prepared financially for the oil deficits before they had actually materialized. There may have been loans directly to those countries. U.S. banks had been pent up by capital controls for a while.

It is worth noting that while U.S. banks made loans abroad, they brought in a very large amount of funds. I believe this was on the order of $7 billion, so that the next outflow was on the order of $1½ billion.

Senator BYRD. There are indications of increased foreign investments in the United States, and many OPEC dollars may be invested here. Do you see any effect on domestic money markets?

Mr. WALLICH. I think it could influence the structure of interest rates. If the money flows mainly into one sector, say Government securities, it presumably would have a depressing effect on rates there and affect other sectors differently.

But if the oil money is spread fairly evenly I would not see an effect, because the total supply of money is not influenced thereby. What happens is that the OPEC countries buy dollars already in existence, from Americans who want to sell dollars, or from foreign central banks that have dollar reserves and want to sell them. Thus the money supply is not changed, and so the overall monetary policy of the Federal Reserve would not be affected.

Senator BYRD. Is it likely to have an effect on interest rates?

Mr. WALLICH. It could have, in particular sectors, in that if the oil money were to focus—say—on short-term Government securities it would tend to lower rates there, that is, drive up the price of such securities. Other investors may then move out of that sector and move into other investments. Thus, in overall terms, the market is likely to compensate for the initial impact of that money in one area. But changing the structure of interest rates, yes, I think that might happen, since some rates would fall and others rise.

Senator BYRD. For awhile 3 or 4 months ago, it is not correct that most of the Middle East money which came into the United States went into what you might say callable funds, overnight funds in the United States banks?

Mr. WALLICH. Yes. It did that particularly in the Eurodollar market, chiefly London, where a lot of this money went.

Senator BYRD. Isn't that pretty dangerous from the point of view of the banks involved?

Mr. WALLICH. It is if the banks then take that money and put it into—say—medium-term loans. Sound banking policy says that one must not do that.

Senator BYRD. But they can't pay 10 percent or 12 percent and not do something with that money, I don't think.

Mr. WALLICH. Well, I think sound banking policy says don't pay 10 or 12 percent, pay a lower rate. I think this is beginning to happen. At least, we are getting some reports that banks are less eager to reach for these deposits and pay these high rates. Also, it is often possible to find a short-term investment that pays a good rate and is highly liquid.

Senator BYRD. It appears to me to have a good bit of danger to it, but I am not enough of an expert to be sure. But it seems to me to have a danger to it.

Mr. WALLICH. They need to watch it, yes, sir.

Senator BYRD. Would you say that the investment of Middle East dollars here would free up money for borrowing by other individuals, such as homeowners and businessmen?

Mr. WALLICH. Yes.

Senator BYRD. It would be a beneficial effect?

Mr. WALLICH. It would be a beneficial effect. The oil money goes into some sectors and pushes money into other sectors, including, hopefully, housing finance.

Senator BYRD. Will the transfer of moneys to the oil-producing nations increase the Eurodollar market to the point of endangering the world's financial structure?

Mr. WALLICH. I think that danger, while it cannot be completely ignored, is not great. For one thing, the size of the Eurodollar market last year increased by about $50 billion, which is about the total of the OPEC funds in the aggregate. So that market has great capacity to absorb funds.

Senator BYRD. But that was about a 30 or 40 percent increase, wasn't it?

Mr. WALLICH. It was a very large increase. It is necessary to specify whether one is talking gross or net, because there is a large amount of interbank deposits in that market.

There is, of course, a tendency that if too much money goes into the Eurocurrency market and the market cannot use it effectively the money will spill out again and go to national money markets. Hence I see a need for institutions in the Eurocurrency market to watch their step, but I do not see that the market as a whole is overloaded.

Senator BYRD. David Rockefeller and others have said that we must walk a tight line between tight money and a money crunch. Would you comment on this and suggest a rate of growth in the money supply that you feel would be appropriate?

Mr. WALLICH. Well, I think Mr. Rockefeller is quite right. A degree of monetary restraint is needed, and that has been exerted. The money supply in the last 3 months has been growing at something like 4 (5)* percent at an annual rate. Before that there was a period of 3 months when it grew much more rapidly, around 11 (9)* percent. Before that again there was a lower period, about 6 percent. If you average these successive 3-month periods you arrive at something like 7 percent.

Senator BYRD. Seven percent over a period of a year would it be?

Mr. WALLICH. The 9 months ending July.

Senator BYRD. What was it, 11 (9)* percent?

Mr. WALLICH. That was during 3 months, February, March, and April 1974. That level was reached only temporarily and it followed a low period. The movements of the money supply month-by-month reflect a great many influences that are of a random sort.

Senator BYRD. Why would you have such a tremendous change from 6 percent to 11 (9)* percent and down to 4 (5)* percent?

Mr. WALLICH. Short-run disturbances occur in the market. The demand for money may rise, tax payment dates occur, dividend dates arrive, holidays increase demands for cash, and so forth. All of these factors have short-run effects on the money supply, as do fluctuations in Treasury balances, although they are not in the money supply. Consequently, month-to-month fluctuations in the money supply are not very meaningful. One has to look at this over the longer period.

Senator BYRD. On the subject of our banking system, it has been suggested that many banks overextended and have paid more attention to profits than sound and fiscal management. Do you feel this to be the case?

Mr. WALLICH. I think banks are on the whole well managed. We have had a period of inflation and that creates problems for all financial institutions. Inflation involves a rapid rise in the money supply. That means a rapid rise in bank liabilities. So the size of banks builds up. Something must be done with the money. Many of the problems that particular banks have had are related to that situation.

Senator BYRD. Do you think that the Federal Reserve and the FDIC is sufficient protection to the public against the financial—I won't say collapse, because I think that is too strong a word—but the financial difficulties the banking industry might fall into?

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*Figures in parentheses reflect revisions published shortly after the date of this testimony.

Mr. WALLICH. Yes, I think the means are available and the techniques are known. I think they can be properly used.

Senator BYRD. Can you tell us why the large West German bank, Herstatt, and the 20th largest U.S. bank, Franklin National, got into such serious trouble?

Mr. WALLICH. Yes. Take Herstatt first. According to the information I have seen, it seems to be a case of difficulties arising out of flexible exchange rates. Rates moving up and down give great opportunity for speculation. Evidently they thought they would be making big profits. Instead they made big losses.

In the case of Franklin there have been other circumstances, in that not only were there exchange losses but at times they weren't even on the books. Besides, I want to differentiate the situation of the two banks. Herstatt was declared insolvent, whereas in the case of Franklin the bank was declared to be solvent.

Senator BYRD. It gets back to undue speculation on the part of both those banks?

Mr. WALLICH. I think this certainly must have been the critical factor in the case of Herstatt. In the case of Franklin there may have been other factors. It was not a very profitable bank for some time, to begin with.

Senator BYRD. I have other questions and would like to get back to that but first I would like to yield to my colleague, Senator Metzenbaum.

Senator METZENBAUM. Thank you, Senator Byrd.

I just have a few questions, one of which is in Secretary of the Treasury Simon's area. I am concerned with the question of recycling funds. Do you see any danger to the American financial structure from a situation in which the Arab nations may be willing to lend their dollars to us, though they may be unwilling to make loans to Britain, Italy, and France. In such a case, we would provide credit facilities to the Arabs and then lend the money to those nations to the Arabs themselves won't lend the money to?

Mr. WALLICH. This is a recycling process in which the United States becomes the intermediary between the OPEC countries and foreign borrowers. To some extent I would expect the market to handle that automatically. If the funds were deposited here and if the main demand came from abroad, borrowers from abroad would take the money and it would be recycled in that way. If the banks act as bankers should, they will not make unsound loans and so their liabilities will be 100 percent and so should be their assets.

Senator METZENBAUM. But the Treasury Secretary actually assured the European bankers 3 weeks ago that the United States would prevent any serious liquidity shortage in the international banking system and that really made a major commitment of our policy that we would get the money from the Arabs and then we would in turn give it to the European nations. Now, it just seems to me that that is really not necessarily a free market, but rather it is a question of the United States becoming the guarantor of the credit of the European nations; does that make good sense for this country?

Mr. WALLICH. I think I see what you mean, Senator Metzenbaum. I think the basic idea is that this happens through the market, that it doesn't happen through any kind of Government guarantee. Now, even when it happens to the market, this includes American institutions and they should be safeguarded, and, in turn, they ought to avoid making loans that could go into default. On one side there is the need for adequate supervision of the banking system, which I think we have. On the other side, there is the question, what if the banks say they can't lend as much as other countries want to borrow. Then a different sort of problem arises, not for the banks, but for the market as a whole. How can the borrowing countries raise the money they need? If the market in general can't do it, banks or nonbanks, then it becomes a problem for governments and for international institutions.

Senator METZENBAUM. Are you saying you support a policy in which our Government would act as guarantor of European credit?

Mr. WALLICH. No; as I said, it is not a question of guaranteeing European credit. It is a question of the Europeans borrowing here from the private market.

Now, going beyond that——

Senator METZENBAUM. I am not asking about the private market. I think you did acknowledge that there is a distinction between American bankers and American Government. I am talking about a guarantee from the U.S. Treasury Secretary who gave assurances that the United States would prevent any serious liquidity shortages in the international banking system. I am talking about a major commitment of U.S. policy made by the Treasury Secretary and I am questioning you as representatives of the Federal Reserve Board whether or not you think that this makes economic sense for this country?

Mr. WALLICH. I think this has to do with the lender of last resort concept—not the longrun problem of how to finance the Europeans during the period of the oil payments deficit, but the question, will American banks in this country and abroad be backstopped by the Federal Reserve if they should get into a liquidity squeeze? The answer, of course, is that the Federal Reserve is the lender of last resort to American banks, and that includes American bank branches abroad. So one may take the example of the Franklin Bank: they had a liquidity problem, and the Federal Reserve acted.

Senator METZENBAUM. But you are not the Federal Reserve Bank of the world. You don't really provide guaranteed liquidity of all nations of the world. You guarantee or try to provide liquidity for American banks. Are you saying the Federal Reserve Board does have responsibility beyond that?

Mr. WALLICH. No, the Federal Reserve has responsibility for American banks, and each country has a similar responsibility for its banks.

Broadly speaking, I think one can say that each bank is covered by a lender of last resort, either in its home country or, if we are speaking of branches abroad, then the lender of last resort is still the central bank of the country of the head office of that branch. This may leave out some areas of finance, but by far the greater part of each national banking system and of the branch system of national banking systems is covered by this kind of national lender of last resort arrangement.

Senator METZENBAUM. I asked Mr. Simon a question and I shall ask you a similar question, which is, do you now have any way of knowing who owns what assets in American corporations? Do you know whether ownership is Government or private? In other words, if Saudi Arabia were to purchase 20 percent position in General Motors or A.T. & T., is there any way that the Federal Reserve Board could learn this fact under the present law?

Mr. WALLICH. I cannot give you a simple answer, because I don't know. But I can make some distinctions. If a well known corporation were involved, this would be known very quickly through the usual channels by which stock ownership becomes known. Therefore, I would say yes, in general, if they bought 20 percent of General Motors, that would become known. Now, with respect to closely held corporations, of which there are not very many—but there are some—or in the unlikely event that this were done in a very cleverly concealed way, that might be a little more difficult. But by and large, very large movement of funds do not remain concealed very long.

Senator METZENBAUM. You would know of the movements, but you wouldn't necessarily know who was causing it.

Mr. WALLICH. I think this could happen but I think most of the time it would be the other way and that you could tell.

Senator METZENBAUM. I really think that in the present state of our laws, Mr. Wallich, it would be almost impossible to find out. In fact, I don't think the American public today knows who holds controlling positions in most of our major American corporations. I think that we have a national interest, a right to be concerned if control of our major companies shifts from American hands.

Mr. WALLICH. The main area that I can distinguish where transactions would not be known would be those cases in which stocks are in the name of a nominee, such as a broker.

Senator METZENBAUM. That is, in fact, typical of the way in which stocks are held today.

All right. Thank you.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Senator Metzenbaum.

Governor, as a follow-on question to one of the earlier ones by Senator Metzenbaum, the Wall Street Journal advertised recently that the Bundesbank of West Germany, its central bank, will not protect banks the same way we do because they feel that guaranteed protection encourages sloppy management. In other words, the West German Socialists seem to depend on the free market to a greater extent than our Nation does. Would you comment on that?

Mr. WALLICH. I think their experience has been different. They had to deal with a bank that was insolvent, in other words, bankrupt. There was no easy way—and perhaps there should be no way—of saving an insolvent bank.

Actions as a lender of last resort deal with a liquidity problem.

Senator BYRD. But does not that tend to protect sloppy management or mismanagement, bad management?

Mr. WALLICH. No single institution should be assured that it will be safe or that its stockholders will be safe or that its management will be safe. The purpose of the operation is to protect the market—the liquidity of the market—and the payments system, and to prevent a kind of domino effect.

Senator BYRD. Yes, I see the reason for it and I don't quarrel with the reason. I don't even quarrel with the action. I am wondering whether it does not have the effect, though, of tending to protect the—somewhat encourage mismanagement or bad management.

Mr. WALLICH. I would agree with you, Mr. Chairman, that to give a blanket promise that everybody will be bailed out no matter what he does and how poorly he manages his affairs will be counterproductive because it encourages bad management. So in the nature of things, one cannot give absolute guarantees. On the other hand, one has to assure the participants in a market that if they act properly, this market will be there, they can rely upon it and the payments system will function.

Senator BYRD. Is there accuracy to the published report that the Federal Reserve System provided a billion dollars to bail out the Franklin?

Mr. WALLICH. That is true. Of course, our loans are secured by collateral.

Senator BYRD. That is a gigantic sum of money. I assume there would be a limit to the number of billion-dollar bailouts that you could go into.

Mr. WALLICH. There is in this sense, that the central bank has to be able to remove from the market the money that is put in through the operation. This has to be done by appropriate open market operations in Government securities. The money that went out through the discount window has to be brought back in through the open market window. In the case of Franklin National, monetary policy was not affected and therefore no constraint was placed on monetary policy. A more likely constraint upon the central bank's ability to help a weak institution would come from doubts about that institution's solvency. But if the loan is security collateralized it is a secure loan.

Senator BYRD. Are many other large banks in serious financial difficulties?

Mr. WALLICH. I don't know of any.

Senator METZENBAUM. Would the chairman yield for 1 minute?

Senator BYRD. I yield.

Senator METZENBAUM. What about the savings and loans, are they not experiencing real difficulties at the moment in making commitments to housing mortgages? And particularly, did not this development occur after the Government issued its 9 percent Treasury notes?

Mr. WALLICH. The savings and loan associations are experiencing the familiar pressures of disintermediation, although less severely so than they have had it at some times in the past. This is the result, as you know, basically of an inflationary situation in which interest rates rise very high. Whether it is the Government or somebody else who makes the funds available, there is a tendency for depositors to leave the thrift institutions. One must sympathize with depositors at least to some extent, because their money is losing purchasing power and it is natural for them to wish to receive an interest rate that more or less protects them again inflation. However, since the inflation premium that is built into interest rates is taxable, many depositors that convert into something that yields 9 percent still do not receive, after taxes, a return equal to the rate of the inflation. What is the answer to this difficulty? Fundamentally and in the long run, I think we need a restructuring of our institutions so that the housing industry isn't too heavily dependent on an arrangement where the savings are deposited in short-term form and are lent out in long-term form. That immobilizes the portfolio of these institutions. When interest rates rise they have to pay more on deposits while they do not get any more on existing mortgages. We have to find a way of improving that structure.

In the short run, I think the way to deal with it is through the means that the Government may be using, that is, making loan funds available to the associations so they can meet their commitments. They can thus continue to lend on mortgages, even if they do suffer net withdrawals, in some cases.

Senator METZENBAUM. I don't think you quite answered the chairman's question which I put over into the savings and loan question and that is, are some of the savings and loans experiencing financial difficulty at this moment?

Mr. WALLICH. If you have in mind whether they are getting into liquidity or solvency difficulty, I am not aware of it. As you know, savings and loan associations are regulated by the Home Loan Bank Board. But I am not aware that there is that kind of a problem as distinct from the disintermediation problem I have described.

Senator METZENBAUM. Thank you.

Senator BYRD. Recently it was suggested that the Federal Government take over the Franklin National Bank as a yardstick bank. Would you comment on that?

Mr. WALLICH. I don't quite know what that proposal means. I would like to see banks remain as private enterprise institutions. I see great problems arising from Government operation of any kind of business institution. The Government has its functions and the private economy has its functions. I see no advantage in the Government reaching over and taking a bank and running it as a Government bank.

Senator BYRD. It would be quite a departure from our present system, would it not?

Mr. WALLICH. It would be a great departure even though the U.S. Government has become a very large lender, and I think in some respects has been crowding the private financial market quite hard, I do not believe the Government has run a retail operation. I can see a great many reasons why the Government should not do so, and might not do a very good job if it tried.

Senator BYRD. When the Federal Reserve Board puts as much as $1 billion into one bank, do you, as a Board, exercise additional controls over the management and activities of that bank?

Mr. WALLICH. The principal responsibility in the case of a national bank, as you know, Mr. Chairman, is that of the Comptroller of the Currency. The Federal Reserve is of course kept very closely informed of daily developments.

Senator BYRD. What could happen if the Federal Government does not get our financial house in order within the next several years?

Mr. WALLICH. In that case, it will be that much harder, Mr. Chairman, to deal with the inflation and everybody will pay the price. An improved fiscal policy is one of the keys to ending inflation. If the Government has a smaller or no deficit, there will be less borrowing, or, in the case of a surplus, replacement of debt. This will ease demands on the credit market. It would mean lower interest rates and would be desirable from that point of view, among others.

Senator BYRD. I assume you agree that the Federal Reserve Board cannot do the job alone that needs to be done in bringing inflation under control. The monetary policy has to be supplemented by a fiscal policy and by fiscal restraint?

Mr. WALLICH. That is right. The Government's borrowing operations, of course, have a strong influence.

Senator BYRD. To me, it is rather astonishing, and I would like to get your view, that of the lendable funds, 62 percent is borrowed by the Federal Government, including the Government-sponsored agencies. Do you regard that as a very high percentage?

Mr. WALLICH. Yes; I regard that as a high percentage indeed. It is very troublesome, because it takes away from other borrowers the opportunity of raising capital in the market. Such a large share of lendable funds taken up by Government or under some form of Government sponsorship—62 percent if that is the correct number—weakens the market's ability to allocate funds according to needs.

Senator BYRD. It seems to me that one does not need to be a professional banker or professional economist to realize that the more the Government goes into the money market the more it competes for the available funds, the higher the interest rate is bound to be.

Mr. WALLICH. I think that is certainly so, Mr. Chairman. This happens at a time when the savings of the economy are quite depressed; namely, the savings of the corporate sector. Profits look very high, but if you eliminate inventory profits and eliminate profits accruing abroad, then savings are surprisingly small for nonfinancial corporations in their domestic operations. They are practically zero. These corporations are paying out almost everything that they make, excluding inventory profit, in dividends. That means, of course, they have got to go to the capital market, to raise funds. Thus, instead of being a supplier of capital, they become a demander. Everybody is making demands against what seems to be a shrinking supply of savings.

Senator BYRD. We hear a good bit about it, and you just mentioned a moment ago inventory profits. When will the inventory profits cease? It is not a continuing thing, is it?

Mr. WALLICH. I hope not, Mr. Chairman, because if it were continuing it would mean that prices would be continuing to go up, since inventory profits are the result of rising prices. I would assume that this would come to an end when prices level off.

Now, there is one other possibility. It may have to do with the accounting method. When firms use LIFO, they generally don't show large inventory profits, but only about 25 percent of the big firms that have been surveyed with this in mind use LIFO.

Senator BYRD. Do you find any feeling among bankers or others with whom you are associated that there could be a possibility of a repeat of the 1930's?

Mr. WALLICH. I don't believe that I have heard a reasonable man, not speaking in anger, say anything like that, Mr. Chairman. People are apprehensive, Mr. Chairman, and sometimes they express themselves strongly, but the differences between 1929 and the present situation are so many that I can see no parallel.

Senator BYRD. Some economists say that the country must put up with a higher rate of unemployment if we are to get inflation under control. Do you concur with this and if so, how much and how long?

Mr. WALLICH. That is a very awkward problem because a person who says we have to tolerate more unemployment seems to be lacking in social consciousness. I would draw your attention to the fact that the average unemployment rate, now 5.3 percent, is not a sufficient meaningful figure because it obscures the facts as to married males who are the core of the labor force. They have an unemployment rate of around 2.6 percent, in other words, less than half the overall average. The overall number also embraces a figure of 30 percent unemployment for nonwhite teenagers. The combination of these figures into one rate is not a meaningful number, because each deals with a problem that is important in its own right. We would very much like to see the press and others begin to quote what are the relevant figures, that is, the detail, and within that detail—as the single most indicative number—mainly the married males and the heads of households.

Senator BYRD. It is really not a realistic figure, what you are saying?

Mr. WALLICH. It is not a realistic figure because it combines two extremes. It includes the results of very special and very unfortunate situations, which affect teenagers. We ought to look separately at what is the core of the labor force and what mainly determines the condition of the labor market, and that is the employment situation of heads of households.

Senator BYRD. Do you think it is important to provide incentive for savings and if so, how?

Mr. WALLICH. I think it is very important to get people to save because the Nation needs the capital for many reasons: To deal with the oil situation and to invest to create other sources of energy, for environmental investment and for social investment. All this calls for more saving than we have had in the past. But how to encourage more saving is not clear. We don't know whether higher interest rates add greatly to people's motive to save. They may just pocket the additional income and not save much more. So I am not enamored of particular devices, subsidies as it were, to saving. I think it is certain that something can be accomplished by providing stabilized prices and a reliable environment in which people know that the value of what they save will be preserved. I think you can do something at the corporate level. Corporate savings are very low. Corporate savings, therefore, could be strengthened by something that could be done, be it on inventory profits, on investment tax credit, be it on the corporate tax rate. There are many ways which one could do this.

Individual savings might be stimulated by tax devices that would have to do with the capital gains tax. The tax on capital gains is a tax which falls very heavily on savings. It is paid out of the gains that one investor realizes by selling his assets to another investor. That investor is investing his savings, so indirectly through the tax the buying investor's savings are diverted in part to the Treasury and merged with general Government consumption. That tax is very antisaving.

Senator BYRD. Do you feel that the two devaluations of the U.S. dollar were a major cause of our present inflation?

Mr. WALLICH. I think it may have contributed quite significantly, more so than one realized at the time. We used to think that since this country does not import a great deal in relation to total consumption the price of imports do not make a great deal of difference. But it turns out differently, because of competitive effects. When the price of imports goes up, this reduces competitive pressure on many domestic prices. So the effect of devaluation can be quite significant.

Senator BYRD. So you are saying in your judgment the two devaluations did have a significant impact on inflation?

Mr. WALLICH. Yes, sir, particularly as the inflationary effects were reinforced by large increases in the prices of oil and a number of other imports.

Senator BYRD. Governor, who regulates and what steps are being taken to regulate international banking in the following categories: U.S. branch banks abroad, foreign banks with U.S. branches, and thirdly, consortium arrangements abroad?

Mr. WALLICH. Well, U.S. banks, of course, are regulated by the familiar authorities: The Comptroller of the Currency for national banks, the Federal Reserve for State member banks, and the FDIC for insured nonmember banks. The foreign branches of national banks are examined by the Comptroller of Currency. Foreign branches of State member banks are examined by the Federal Reserve. I believe there are hardly any branches of insured nonmember banks abroad, so the problem arises for the FDIC only on a minimal scale.

Senator BYRD. But the branches abroad of U.S. banks are audited by the Comptroller?

Mr. WALLICH. Yes, national banks are examined by the Comptroller.

Senator BYRD. What about foreign banks with U.S. branches?

Mr. WALLICH. Foreign banks with branches in the United States would fall under the State supervisory authorities in the United States. That is, their branches being, say, in New York State, the superintendent of banks of New York State would examine them.

Senator BYRD. What about consortium agreements? How would they be handled?

Mr. WALLICH. Those would be looked at, if at all, by the authorities of the country where the bank is chartered. So if the bank involved were chartered in London and if it were a consortium bank, owned by other banks or possibly nonbanks, it would be the Bank of England that would be looking at the consortium.

Senator BYRD. Is the Federal Reserve Board involved in the discussions as to the stance our Government will take as to foreign banks establishing branches in various financial centers of the United States, thus bringing about interstate banking which is denied banks in our country?

Mr. WALLICH. Well, there has been a continuing study of this, leading to proposals for legislation and possibly, to legislation. There are a couple of bills before the Congress. Broadly, I think everybody is aiming at national treatment: That is to say, foreign banks should be treated in each country the way banks at home in that country are treated. We would treat foreign banks the way we would treat our own. That country should treat our banks the way they treat theirs.

Senator BYRD. First, who would make the recommendation in the executive branch, would it be the Federal Reserve Board?

Mr. WALLICH. In this case, yes, it would be the Federal Reserve Board.

Senator BYRD. Is that the view of the Federal Reserve Board, what you have just expressed?

Mr. WALLICH. Yes, that is the view that I have just expressed but is not yet a fully settled matter.

Senator BYRD. If that view prevails, would it not permit foreign banks to do in this country what U.S. banks cannot do, namely, cross State lines?

Mr. WALLICH. No, Mr. Chairman, the idea is precisely that if foreign banks establish branches in the United States they would not be allowed to do anything that American banks are not allowed to do. That would, of course, include a prohibition against crossing State lines.

There is a problem with respect to foreign bank branches that are already here, and that have already crossed State lines.

Senator BYRD. Do we have banks now which have crossed State lines?

Mr. WALLICH. There are a few foreign banks that have branches in different States. This happens to be feasible the way the law is now structured. Quantitatively, so far as I know, this is not very important. One of the ways one could deal with this in a way that did not provoke retaliation abroad is to grandfather such cases, but not to allow branching of foreign banks across State lines for anybody who comes thereafter.

Senator BYRD. Let me see if I understand the position of the System. The position of the System is that foreign banks establishing branches in the United States would need to conform with the requirements imposed on the U.S. banks?

Mr. WALLICH. That is the position that has been reached by a Federal Reserve System Committee, for new branches.

Senator BYRD. For example, they could not cross State lines?

Mr. WALLICH. Yes.

Senator BYRD. But then you say that there are a few banks now which do do that, foreign banks, and by grandfathering them in you would not create problems of retaliation in other countries insofar as those grandfathered in are concerned but what about those new ones and that regulation was established. Would that bring about retaliation in other countries?

Mr. WALLICH. Well, this is an important question, but I would think that national treatment means that new ones in new instances, foreign banks could not do anything that American banks cannot do. The whole proposal is still under review and fluid, so I am just giving you what is one aspect of the present state of the discussion.

I do want to draw your attention to the importance of avoiding things that are likely to lead to retaliation. Those, I think, are things that are contrary to the interests of established enterprises. I think when one tells an established foreign firm that it has to conform, perhaps involving divestitures in one form or another, a great deal of feeling may be created. Of course, we have far more interests abroad than other countries have here. I would think that not to allow something that isn't allowed to us is a fairly reasonable principle that ought to be recognized anywhere.

Senator BYRD. Yes. As a matter of fact, it seems to me if you adopted the other principle of permitting foreign banks to do what U.S. banks couldn't do, you would be in a very awkward position, very untenable position.

Mr. WALLICH. That would be the opposite of national treatment. That would be home country treatment and as far as I can see that would produce chaos. Every foreign bank would be under a different kind of legislation.

Senator BYRD. To what extent would you recommend help to American banks because of past foreign operations? Do you see more bank problems induced by—well, let's put it this way: What steps do you feel appropriate and what help should be given by the Federal Reserve Board to foreign banks, or to American banks because of foreign operations, the problems they run into because of operations in foreign countries?

Mr. WALLICH. When an American bank has a loss because it has a branch abroad that has made a bad loan, the bank as a whole has to stand back of it. The branch is an integral part, legally, of the bank. Therefore, it is the solvency and liquidity of the whole bank that is at issue. The bank would normally have much larger domestic operations than foreign operations. So it would be important to save a bank that had a liquidity problem of that type.

Senator BYRD. I wonder, Governor, if you could supply for the record the way the Eurodollar market has grown in the past 5 years, just to go back to say, 1970, 1969 and 1970?

Mr. WALLICH. I will be glad to supply those numbers. These are principally produced by the Bank for International Settlements and by the Bank of England and we would have to use those data because these are the primary sources.

[The following information was subsequently supplied by Mr. Wallich:]

MEASURES OF THE SIZE OF THE EURO-DOLLAR MARKET

[Billions of dollars; end of year]

	1969	1970	1971	1972	1973
I. Market area as defined by bank for international settlements:					
(A) Narrow definition [1]	46.2	58.7	70.8	96.7	130.5
(B) Broader definition [2]	54.3	68.8	83.1	111.8	153.7
II. United Kingdom component of market [3]	25.8	31.3	36.2	48.2	69.2

[1] External liabilities in dollars of banks in Belgium, France, West Germany, Italy, Netherlands, Sweden, Switzerland, and the United Kingdom, as reported by the BIS.

[2] External liabilities in dollars of banks in the countries mentioned in footnote (1), plus Canada and Japan, as reported to the BIS.

[3] External liabilities in dollars of banks in the United Kingdom as reported by the Bank of England.

Senator BYRD. In concluding, could I ask you a question which really draws on history and you are a student of these matters. I have never fully understood just why the German inflation of the 1920's developed to the severity it did. As I understand it, it did not occur before and it hasn't occurred since to the same extent. What was the main reason for that terrific German inflation of the 1920's?

Mr. WALLICH. Well, I believe that in a sense it was that they kept printing more money and as the price level went up, the government's resources weren't adequate—I suppose it goes back to a fiscal deficit—they kept filling that gap with a higher and higher denomination and finally ended up with a situation where—I believe—1 trillion marks was equal to what 1 mark had been originally, in other words, 1,000 billion.

Now, this was, of course, at the end of a war that Germany had lost, and there was a specific reason why it happened in 1922 or 1923. The French occupied part of Germany because Germany wasn't paying its reparations debt. They didn't see that they could raise government expenditures or raise taxes. However, when they reached these absurdly high rates of inflation, suddenly they stopped printing money, the government had to meet its own expenses from taxes, and suddenly they had a stable currency.

Senator BYRD. Well, I certainly did not mean to suggest in any way that this country is facing anything like German inflation, but I have always been intrigued by the German inflation as to how it could have risen to the degree that it did. I think that has caused all of us to keep in the back of our minds that German inflation, although it is inconceivable we could ever get anything like that in this country. But I am concerned just as you are about the inflation we are having. I think the Federal Reserve Board is doing its part. I do not think the Congress is doing its part. I do not think the executive branch of the Government is doing its part. I was well pleased with our new President's speech of Monday evening with the great emphasis that he put on the need to control spending, the need to get inflation under control.

My own belief is that we are not going to get inflation under control, we are not going to get the cost of living under control until we first get the cost of Government under control. That is not the responsibility of the Federal Reserve Board. It is the responsibility of Congress. It is the responsibility of the administration.

I must say, I was greatly disappointed in what the general public considers to have been a conservative Republican administration recommended deficits never before known in this country except during World War II when we had 12 million men under arms and fighting a war in both Europe and the Pacific. During the Nixon years, six Nixon budgets, the accumulated Federal funds deficit was $133 billion which represents 25 percent of the total national debt. To me it is rather logical that with such huge deficits we are going to have severe inflation. So I hope that the Congress and the Ford administration will help the Federal Reserve Board on the fiscal side and do as good a job on that as I think the Board has done on the monetary side.

Thank you very much, Governor, you have been most helpful today.

Mr. WALLICH. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Wallich and an article from the Los Angeles Times supplied by Senator Byrd follows:]

STATEMENT BY HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I am glad to have this opportunity of discussing international economic problems and their domestic repercussions before this distinguished subcommittee.

If a broad-brushed picture of the international economic scene in recent years is drawn, several major features stand out. The international economy has been upset by a number of severe disturbances. Foremost among the recent disturbances have been the oil embargo and the jump in the international price of oil. More broadly, the international prices of commodities have moved dramatically, rising particularly rapidly during late 1972 and early 1973. The rises in the price of oil and other commodities have contributed to the worldwide inflation which is currently raging, but inflation can by no means be exclusively attributed to the commodity sector. In recent years, aggregate demand in many countries has become overheated; too many have tried to do too much too quickly.

But if disturbances and change have been major unsettling features of the international economy in recent years, its resilience has offered some reassurance. In spite of the disturbances, there have been solid gains in the volume of trade and other transactions among countries. For the United States, for example, exports of goods and services have increased more rapidly than total GNP, rising from 5.9 per cent of GNP one decade ago to 7.8 per cent of GNP during the past year. Looking at goods only, foreign markets have become even more important to U.S. producers, since exports of goods last year amounted to more than 10 per cent of our domestic goods production, compared to 8.2 per cent in 1964. These gains in international trade reflect elements of strength in the international economy—the reductions in tariffs which have been painstakingly negotiated in recent decades, the highly developed and continuously improving system of transportation and communication, and the rapid growth in world production.

While the over-all level of international transactions has expanded rapidly, the trade balance of the United States has moved unevenly in recent years, sliding into deficit in 1971 and 1972, and then temporarily recovering to a small surplus in 1973 as agricultural exports boomed and as the effects of the devaluations of the dollar began to have their effect. Elements of strength continue to benefit U.S. export trade, but they have been overwhelmed by increases in the price of oil, with the result that our trade balance is now back in deficit. During the second quarter, the deficit amounted to $6.8 billion at an annual rate (seasonally adjusted). During that quarter fuel imports were running at an annual rate $20 billion above last year.

It seems unlikely that the trade balance will improve very much, if at all, over the next 12 months. Much depends on the size of the harvests here and abroad and on the price of oil. In 1973, following upon poor crops abroad, our agricultural exports rose to 25 per cent of our total merchandise exports, compared to a figure of 19 per cent in 1972. In 1974, this percentage is likely to decrease.

The degree of exchange rate flexibility which has developed in recent years has contributed to the ability of the international economy to withstand shocks. Indeed, it is difficult to see how the disturbances of the past few years could have been absorbed as smoothly as they in fact were if exchange rates had been pegged and rigidly defended. As a result of the negotiations recently conducted by the Committee of 20 of the International Monetary Fund, the evolving system of exchange rate flexibility can be put on a more systematic basis. A major feature of the reform effort has been a set of guidelines for floating, which define what countries should and should not do in the way of intervening in foreign exchange markets. The development of guidelines for intervention should limit potential conflicts among nations over exchange rates and limit swings in rates, and this tends to ease some of the concern that we may feel with respect to the system of floating rates.

But while exchange rate flexibility has increased the shock resistance of the international economy, it has produced problems of its own, such as the speculative losses that have affected some financial institutions in recent months. Market swings have been unnecessarily wide, and have from time to time permitted declines in the value of the dollar which have contributed to inflationary pressures. In any event, exchange flexibility can at best make only a marginal contribution to the very real longer run difficulties engendered by the increase in the price of oil. The difficulties with which I specifically want to deal in this testimony are balance-of-payments problems, financial strains, and domestic repercussions.

When the oil-exporting countries receive their huge additional payments, they basically have two ways of using their great windfall. They can import additional goods; or they can acquire assets in the oil-importing countries. Insofar as they do the former, a course of action which is limited by their absorptive capacity, the total current account deficits of the oil-importing countries are reduced. Of course, this partial solution of their balance-of-payments problem cannot be considered a painless outcome for the oil-importing countries, since they will of necessity then have to give up the resources needed for the production of their additional exports to the oil producers, with a consequent reduction in their living standards. Insofar as the oil exporters take the second option—acquiring assets, and in a broad sense, investing in the oil-importing countries—they are automatically recycling the oil receipts to the oil importers as a group. In general, money not used for imports must be deposited or invested somewhere, and wherever it goes, it is available to the oil-importing countries.

But the automatic recycling occurs only with respect to the oil-importing countries as a group. For individual countries and institutions serious problems may nevertheless arise. First, the oil-exporting countries may want to hold their funds in only a limited number of large banks. A great increase in deposits, for instance, could strain the capital positions of these banks. A desire for high liquidity on the part of the oil-exporting countries, causing them to hold their funds in the form of short-term deposits, would strain the banks' liquidity positions. Second, some countries may suffer severe financing difficulties if their ability to finance imports by drawing on reserves or by borrowing them falls short of needs.

Both problems can be mitigated to the extent that the oil exporters are prepared to make appropriate financial arrangements. To the extent that the oil-exporting countries decide to hold some of their assets in forms other than bank deposits, the problems of the financial institutions will be lessened. If, further, oil exporters were willing to acquire assets in the importing countries in approximate proportion to the need of the importing countries to pay for oil, the danger that some countries may not get enough recycling would be obviated. We are beginning to see encouraging developments along these two lines. As of this time, however, one cannot expect that the problems of financial institutions and of balances of payments will be fully met by developments such as these.

The normal workings of the market will ease some of the problems growing out of the vast payments to the oil producers. If the OPEC countries, like other recipients of windfalls, initially hold most of their new wealth in liquid bank balances, they will compel banks to tighten up the conditions on which they will accept these funds. This would give the Organization of Petroleum Exporting Countries (OPEC) an incentive to look for other investments, either of a debt or equity nature. If a country receives less recycling than needed to meet its current deficit, it may be able to borrow from countries that receive more than they require. The market has a major role to play in redistributing funds according to need. This applies both to the Eurodollar market, and to the national capital markets of countries. The ability of capital markets to fulfill their function as intermediaries between countries with plentiful and relatively scarce supplies of capital has been enhanced by recent moves towards freer capital markets.

Situations may develop that the market cannot handle, however. Such situations will be more frequent if the price of oil remains at anything like the present level. For instance, where credit risks are perceived by private financial intermediaries as excessive, facilities in addition to those that the market can supply may be required. Some international steps are now being taken to make financing available to needy countries, most notably through the IMF oil facility. The financial facilities of the European Economic Community have been drawn upon by Italy. As strains on the international financial system are to a large degree attributable to the actions of the OPEC countries, it is urgently desirable that they contribute to the easing of the situation by lowering the price of oil, and by making funds available increasingly for official financing arrangements.

Potential strains on the international financial system can be reduced if steps are taken to keep some fair balance among the current account positions of the oil-importing countries. As a group, the oil-importing countries will run large current account deficits into the foreseeable future—unless the oil problems are reduced by a major price rollback. How these deficits should best be distributed has been a matter of concern, both within international organizations such as the Organization for Economic Cooperation and Development (OECD) and within national governments.

It must be borne in mind that the oil deficits are occurring in addition to deficits and surpluses that particular countries were already experiencing as a consequence of domestic policies and other factors. Where good policy calls for elimination of these deficits, every effort should now be made to eliminate them. But a country cannot eliminate its oil deficit without increasing the deficit of some other country, since the surplus of the oil-exporting countries, for reasons already stated, cannot be eliminated in the short run. Individual countries might, of course, nevertheless attempt to eliminate their oil deficits. But such attempts, if pursued too vigorously, could lead to general contraction—since the standard ways to eliminate a deficit are to restrain aggregate demand, restrict imports and other payments, and possibly depress exchange rates. The danger, so to speak, is that the oil-importing countries may be lured into a game of musical chairs with their combined deficit. The deficit will remain, but the game itself can become mutually destructive.

But while mutually contradictory attempts to eliminate current account deficits represent a danger, there is no fully satisfactory basis for agreeing on how the deficits should be distributed. It is frequently suggested that countries should attempt to balance their current account receipts and expenditures exclusive of the deficits attributable to the increase in the price of oil. Alternatively, it has been suggested that countries adjust their trade balances in such manner that each oil-importing country accepts a deficit proportionate to its GNP. Neither of these criteria provides an adequate guide, if only because some countries may be unable to borrow enough in the market, and then would have to cut down their deficit unless they receive aid.

It is appropriate that countries that face both large current account deficits and strongly inflationary domestic conditions should take firm steps to control domestic demand. Each country, of course, should frame its policy in full awareness of the fact that, collectively, large current account deficits cannot be avoided by the oil-importing countries. But the prospective oil deficits do not mean that countries should ignore the prudent fiscal and monetary policies needed to put their domestic house in order.

In summarizing this review of the financial repercussions of the high price of oil, I would say this. We have good markets and institutions, and public policy makers are not without guides as to what to do in the face of this situation. But one cannot at this time be sure that the situation will in fact be manageable unless there is a substantial reduction in the price of oil.

I now turn to the second group of problems set out earlier, relating to domestic repercussions of international events. Among the oil-importing countries, by far the greatest problems are encountered by the less developed countries (LDC's). Facing an uncertain future at best, a number of them have been put in a grim position by the increases in the price of oil—upon which depend their transportation, their nascent industries, and their supplies of fertilizer. Indeed, unless the price of oil is reduced, or unless the LDC's receive large flows of capital or aid from the OPEC or OECD countries, the outlook for some of them is very difficult indeed. The adverse effects of high oil prices on the supply and cost of fertilizers and therefore on the price of food is particularly troublesome.

For the economically developed countries, increases in the price of oil also have important domestic implications. Representing a strong autonomous increase in costs, they have exacerbated the already grave inflationary problems of the United States and other countries. The increases in the price of oil have frequently been compared to a large excise tax paid to foreigners, having both an effect of pushing up prices, but also tending to drain real disposable income from the economy, thereby increasing the dangers of weakness in economic activity. This source of softness of demand has, however, tended to be offset by new demands for capital investment.

Several aspects of the changes in the international economy have contributed to the need for additional capital, of which the need to develop substitute sources of energy is only one. Another is the fact that, as the current accounts of the United States and other oil-importing countries show large deficits, there will be an accumulation of liabilities to the oil-exporting nations. In order to ease the future problems of debt repayment, we should encourage the growth of our capital stock and productive capacity.

Fortunately, one of the effects of the higher price of imported oil is to create an opportunity for increased investment in each oil-importing country's economy. As already mentioned, the increase in the price of imported oil, like an excise tax, removes purchasing power from the domestic economy. The resources thus released can advantageously be channeled into investment. Such an increase in investment could come about, for instance, if the oil-exporting countries recycle the funds to the importing countries and acquire assets there.

Nevertheless, until the present inflation has been brought under control, increases in investment must be accompanied by determined restraint on aggregate demand. It is here that restraint in the government budget has a crucial role to play. Cutting of government expenditures and a reduction in the volume of government financing will have desirable direct effects in restraining inflationary forces. Furthermore, given the over-all monetary restraint applied by the Federal Reserve, more fiscal discipline will mean less government borrowing and hence lower interest both here and abroad. The relaxation of pressures on institutions which finance the housing industry would be especially beneficial. Indeed, a strong case for budgetary restraint can be made on the grounds that, in present circumstances, government expenditures are directly competitive with home construction.

In our domestic fight against inflation, we must not expect quick success; perseverance has become the key note. If we are to be successful in our anti-inflationary fight—and it is imperative that we achieve success—then we must be determined to fight inflationary pressures over an extended period. And, just as the international prevalence of excess demand in recent years has meant that national inflationary problems have tended to reinforce one another, so, on the other side, the unwinding of inflation will be less difficult for each country if there is an international determination to exercise restraint.

The problems of inflation as well as those of international finance and balances of payments would be greatly eased by a decline in the price of oil. There are reasons for expecting such a decline, not only on the grounds of a current excess of supply over demand, but on the grounds of the long-term economic self interest of the oil-exporting countries who undoubtedly will want to protect their markets. But a decline to the prices of past years cannot be expected.

Efforts to cope with inflation are needed almost everywhere. In the OECD countries, inflation currently rages at rates which range between 7 per cent and 23 per cent. Inflation has reached a stage in which fears are being expressed openly about the survival of democratic institutions. Germany, which took anti-inflationary action earlier in the cycle, has been rewarded by the lowest rate of inflation among the major industrial countries. German restrictive actions in the past year have kept domestic demand approximately flat in real terms, with the expansion of German economic activity being completely accounted for by the buoyancy of its exports. In many countries, the combination of a rapid rate of inflation accompanied by softness on the real side of the economy have added to current difficulties. In the United Kingdom, real GNP in 1974 is not expected to be above that in 1973. In Japan, a 25 per cent rate of inflation during the first quarter of this year was accompanied by a fall of 5 per cent in real GNP—both developments being due in significant part to Japan's heavy dependence on imported oil.

Given these conditions and policies, the outlook seems to be for a period of at best moderate growth abroad, as it is at home. I do not, however, see policies that are deliberately designed to restrain inflation leading to a serious decline in the world economy, as prophets of gloom sometimes predict, anymore than I see a crisis of the world's financial system ahead. We must not deceive ourselves about the fact that we face severe difficulties. We shall be sailing in uncharted waters part of the time. But our institutions are strong, the right policies are at hand, and given the will, I feel confident that the way will be found.

[From the Los Angeles Times, July 29, 1967]

ARE WE WILLING TO PAY THE PRICE OF FIGHTING INFLATION?

(By Henry C. Wallich)

"Prices are something terrible," says the woman rolling her shopping cart up the aisle. "Lucky that my husband just got a good raise, so I guess we're still ahead."

That is one side of the story of inflation. But if the lady has a neighbor who is retired, he may have a different version to tell. If he is living on a pension or on income from savings, his income buys less every year. And on top of that, the principal of his savings is losing value unless he is in on some inflation hedge that works.

Somewhere else in the economy, of course, there is a business or a family that has borrowed from the bank where the retiree keeps his savings. Their debt gets less in terms of real purchasing power. They are ahead, too, in the inflation game. The economist adding it all up finds that the net effect of inflation appears to be zero. Some incomes rise faster than prices; others more slowly. Savers lose;

borrowers gain. On average it washes out both for income receivers and for savers and borrowers. This leads some economists to the peculiar conclusion that inflation doesn't hurt.

Unemployment, on the other hand, plainly is a demonstrable evil. The family loses income; the nation loses output. The family also suffers emotionally from loss of security, loss of self-esteem and fear of the future. The nation suffers political strife and discontent. Then why, some economists are tempted to ask, shouldn't employment be pushed as high as it will possibly go, regardless of how much inflation it may cause?

The answer is that averages don't mean much where individuals are concerned. Suppose it is true that the gains and loses from inflation wash out. The same can be said for burglary. Anyone wanting to defend burglary could say it usually works in the direction of evening out income distribution, which cannot be said with certainty about inflation.

The simple fact is that for individuals and families inflation does not wash out. Some are gainers, some are losers—even though many families may be both to some extent, for instance if they own a home while also owning an insurance policy.

We hear a lot these days about not fighting inflation too hard because that could land us in a recession. A recession, with all its sufferings and losses, is too high a price to pay when a better way is available—slowing down inflation gradually. While the battle against inflation is going on, unemployment cannot be pushed down as low as it might be if there were no inflation.

The families of America, therefore, must decide how hard they want their government to fight inflation. If they want it to be fought hard, they may get back to approximate price stability fairly soon—but at a cost. If they want to avoid this cost altogether, they may have to live with an inflation that gets worse instead of better.

All families and all individuals must weigh the pros and cons of inflation. The risk of being a loser is pretty high, virtually sure for people on incomes that are fixed or get adjusted slowly. And the loss may be substantial at recent rates of inflation.

On the other hand, there is the risk of unemployment. About 95% of the labor force is employed at present, but this does not represent as high a degree of job security as might appear. The same people are not in this 95% all the time because unemployment rotates. For that reason, the average spell of unemployment is relatively short, at present about 10 weeks. However, the average loss from unemployment is considerably less than 10 weeks' income because a large proportion of temporarily unemployed people draw compensation and because many families have more than one wage-earner.

The choice is between the relatively high risk of loss of income and savings through inflation and, the relatively low—but not negligible—risk of loss of income through becoming unemployed. These are the choices people must make and, by design or default, they are making. The outcome of their choice will determine whether inflation is halted or not.

[Whereupon, at 12:25 p.m., the committee was adjourned, subject to the call of the Chair.]