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THE UNITED STATES ECONOMY AND FINANCIAL SERVICES INDUSTRY

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Thank you for inviting me to talk about the United States economy and financial services industry. In an increasingly interdependent world, an exchange of views among policy makers and finance executives of different countries can play a significant role in reducing uncertainty and promoting global economic stability. So I welcome this opportunity to share my views.

ECONOMIC SITUATION

As you know, the United States is enjoying one of the longest economic expansions in its history. Since 1983, real growth has averaged 4.2 percent, while the unemployment rate has steadily come down to 5.4 percent from nearly 10 percent early in the decade. The progress in reducing unemployment is even more remarkable when considered in the context of an expanding labor force. Since 1983, the economy has created 17 million new jobs.

In its early phases, the present recovery was fueled by strong consumer demand, boosted by rising disposable income and falling interest rates. As consumption spending outpaced gains in real disposable income, it was financed in part by increased borrowing and lower personal savings. However, in 1987, consumption slowed substantially, falling in line with advances in disposable income. Despite some acceleration in consumption in 1988, it has not exceeded income gains.

This shift away from consumption is encouraging for a number of reasons. First, it is clear that as the U.S. economy approaches full resource utilization levels, domestic demand has to be contained if inflationary pressures are to be prevented. Since consumption is the largest component of domestic demand, a slowdown in consumption is essential. Second, in many sectors of the economy capacity constraints are becoming apparent and can be alleviated only through new investment. This requires that growth in consumption be held in check so that resources are made available for investment. And third, a moderation in consumer demand should facilitate the necessary adjustment in our external accounts through reduced import growth.

While consumption is moderating, investment in producers' durable equipment has been strong during the last couple of years. Good corporate profits, along with high capacity utilization, have provided the primary impetus for more investment activity. We expect this strength in investment activity to be maintained in the near future, as both business confidence and capital appropriations remain buoyant.

Due to this resurgence in investment and a significant improvement in net exports, the U.S. economy remained strong in 1988, producing 2.7 percent growth in real output. Moreover, this growth occurred against the backdrop of a serious erosion in financial wealth stemming from the October 1987 stock market drop, a reduction in agricultural output owing to severe drought conditions, a stagnant construction sector, considerable difficulties in the savings industry, lower government purchases, and monetary restraint through most of 1988. This shows clearly the impressive strength and resiliency of the American economy.

Sustainable Growth Through Increased Potential

In view of the higher level of economic resource utilization, the monetary policy in the U.S. has turned increasingly cautious. Excesses in aggregate demand that do not augment the economy's productive potential can, at the current levels of resource utilization, lead to pressures on wages and prices which would be costly to reverse. Consequently, we are determined to prevent such excesses from emerging in the first place.

But this does not mean that economic growth must be completely stifled. At present, the conditions that have traditionally precipitated a recession are not visible. Labor market conditions, though tighter, have not triggered a wage-price spiral.

Capacity utilization, while high, is below its previous peak. But further noninflationary growth requires an expansion of capacity. Capacity can expand only through an increase of labor and capital resources or their more efficient use. The availability of labor resources in any economy is constrained by demographic and social factors. On the other hand, the productivity of labor and capital depends on the efficient use of these resources. Hence, the key to high growth with price stability is high investment by the private sector and supportive government policies.

Let me mention three policies of the American government that have been most helpful in fostering a healthy investment climate. One, low marginal tax rates which preserve economic incentives and rewards for enterprising people. Since 1980, federal marginal tax rates have been reduced from 80 percent to 28 percent. Two, deregulation has created a business environment where entrepreneurs are free to innovate. The government focuses on establishing rules of conduct that foster equality of opportunity for all competitors rather than on rules that restrict competition. And three, a monetary policy geared toward attaining overall price stability, so that businessmen and consumers do not have to contend with the uncertainties attendant to an inflationary environment. We still envy your record in this regard but we have made substantial progress in containing inflation in this decade.

The policy posture in the United States in recent years has mirrored these principles. I am therefore optimistic about the prospects for the continuation of the current expansion. In addition, I am encouraged by the recent shifts in the composition of growth, a significant proportion of which is now attributable to investment activity and strong export performance. Increased investment, especially for plant and equipment, will augment much needed capacity and also enhance productivity.

The Budget Deficit

Any discussion of the U.S. economic situation these days is incomplete without mention of the fiscal deficit. The federal deficit peaked in 1986 (CY) at $206 billion, accounting then for 5.5 percent of GNP. Since then it has been on a downward trend, and in 1988 (CY) amounted to $138 billion, or about 3.5 percent of GNP. At the same time, the state and local governments ran a surplus of about $50 billion, so that the consolidated government deficit amounted to only 2.5 percent of GNP - about equal to the European average. While this is an encouraging trend, the deficit is still substantial in relation to domestic savings and it uses up funds that are needed for private sector investment.

Thus far, the U.S. economy has enjoyed the confidence of foreign investors, preventing a serious private sector "crowding out". Foreign investors have flocked to the U.S., not only in pursuit of higher returns, but also because of the fundamental strength of the American economy, the size of the market, and a relatively unencumbered regulatory environment.
But this reservoir has its limits, even though we believe that we are far from reaching them. Moreover, as more and more American assets are owned by

foreigners, returns to them will also accrue to foreigners, constituting an ever increasing mortgage on our future.

In recognition of the potentially adverse consequences of the budget deficit, the Gramm-Rudman-Hollings legislation was enacted which calls for a deficit of $100 billion in fiscal 1990 and a balanced budget by 1993. In accordance with this legislation, President Bush has outlined a budget proposal to the Congress calling for a $93 billion deficit in 1990. Reflecting domestic socio-economic concerns and the changing world situation, budgetary priorities have been realigned. The administration's proposal thus serves as a good base case around which a bipartisan consensus can form. Not only does the budget proposal conform to the mandatory targets of the Gramm-Rudman-Hollings law, it does so without burdening the economy with additional taxes. In the interest of continued health of our economy, progress on the deficit front will be crucial and it will be important to stick to a course which progressively closes the fiscal gap. However, instant action should not be expected. Not only is there a detailed timetable and legislative process that has to be followed, but any budget agreed upon would only start to affect actual spending at the beginning of the new fiscal year on October 1. Thus, patience is in order.

External Situation

A strong improvement in our external accounts began last year, and despite some faltering in recent months, the U.S. trade deficit narrowed by $33 billion in 1988. So far, impressive gains in exports have led this improvement, reflecting the considerably greater U.S. competitiveness. Our performance with respect to relative unit labor costs and manufacturing productivity has been positive, so there is good reason to be optimistic that the trade deficit can be further reduced at prevailing exchange rates. On the import side, the performance has been somewhat more erratic and further moderation is needed. In this regard, we expect our slowing domestic demand to have beneficial effects.

While the American trade imbalance with Germany and Europe as a whole has been considerably reduced, further adjustment in the global imbalances must entail progress in the reduction of surpluses in Germany and Japan. Both nations continue to post ever increasing surpluses, and, as a result, new imbalances are now emerging in the world economy. To quite an extent, these deficits are concentrated in Europe, where they are likely to create new tensions just as Europe is ready to embark upon its historic integration effort.

Monetary Policy Geared Toward Price Stability

Since early 1988, Federal Reserve monetary policy has leaned toward greater restraint in order to forestall any pickup in inflation. One reason for the moderate degree of price pressures in the U.S. economy has been the commitment of the Federal Reserve to the goal of price stability and its determination to move quickly to prevent any acceleration in inflation. Thus, in recent months, as inflationary flickers appeared, we restricted reserve availability and raised the discount rate. Short-term interest have risen over 3 percentage points since last spring, and growth in the monetary aggregates has slowed to the lower half of our monetary target ranges.

The goal of price stability is an appropriate guide for monetary policy, for in the long-run, it is also the path to sustainable and stable economic growth. In a market economy, price stability prevents the distortion of price signals essential for an efficient allocation of resources. In addition, by reducing uncertainty, it promotes productive investment and stability in financial and foreign exchange markets.

That price stability is conducive to economic growth and efficiency is also evidenced by our historical experience. During the 1950s and 1960s, the industrial countries enjoyed moderate inflation accompanied by strong economic growth. In the 1970s, inflation accelerated, partly because of the oil disturbances, but also on account of undue monetary accommodation. The result was anemic growth in the face of high inflation. Evidence from this period also suggests that in countries where policies concentrated on price stability, supply disturbances were quickly adjusted to and the adverse consequences on the price level and economic growth were of a short duration. Elsewhere, the situation was the reverse. Throughout the 1980s, reasonable price stability has been a primary goal for monetary policy in the U.S. Once again, this has also been a period of robust economic growth.

Looking to the future, our resolve to contain inflation and to make progress toward achieving price stability will guide the course of monetary policy during 1989. This implies continued restraint on the expansion in money and credit. Accordingly, the Federal Reserve has lowered the target ranges for the growth of the monetary aggregates for 1989. Compared to last year, these target ranges have been lowered by a full percentage point to 3 to 7 percent for M2, and by 0.5

percent to 3.5 to 7.5 percent for M3. The Committee also lowered the monitoring range for the domestic nonfinancial sector debt by 0.5 percent to 6.5 to 10.5 percent. These reductions are in line with our commitment to lower monetary growth over time, so that it will be consistent with our goal of price stability. As a matter of fact, for the last two years monetary growth in the United States has been lower than in Germany, and for 1989 the monetary growth path in both countries is centered around a 5 percent target.
I believe that this underscores our mutual commitment to price stability.

While U.S. macroeconomic policies are aimed at reducing the internal and external imbalances and sustaining noninflationary economic growth, serious problems have emerged in the financial sector that demand attention. So let me turn now to a discussion of recent developments in the U.S. financial services industry.

DEVELOPMENTS IN THE FINANCIAL SERVICES INDUSTRY

Savings and Loans Problem

The savings and loan crisis is a major problem confronting us in the U.S. The dimensions of this problem are enormous. If the estimates of $85 to $105 billion in potential losses prove to be correct, it would mean a financial burden of about $400 for every American.

The causes of the savings and loan problem are numerous. They include: the inflationary excesses of the 1970s, followed by high interest rates and the recession of the early 1980s; an initially very restrictive regulation of the industry and a lax supervision of the subsequent deregulation; increased competitive pressures from a more dynamic and innovative non-thrift financial sector; poor management which was ill equipped to cope with the new competitive environment; and outright fraudulent practices in some cases. For institutions that funded 30-year fixed interest loans with short-term deposits, and whose assets were heavily concentrated in the cyclical housing sector, the inflation-deflation cycle of the late 1970s and early 1980s proved to be ominous. Their problems were compounded when managers reacted to these circumstances by "doubling the bet" and moving into ever more risky assets.

Comprehensive reforms to deal with the problem have been outlined by the President in his recent initiative which is fully supported by the federal regulatory agencies.

The President's plan encompasses several elements. First, it fundamentally changes the way the savings and loan industry is regulated and insured. The Federal Home Loan Bank Board, the savings and loan regulatory body, is put directly under the oversight of the Secretary of the Treasury. The savings and loan insurance authority, the Federal Savings and Loan Insurance Corporation, is to be administratively attached to the Federal Deposit Insurance Corporation - the insurer for bank deposits. While the two insuring agencies are being merged to maximize administrative effectiveness, the insurance funds for commercial banks and savings and loans will not be commingled. Premiums from each industry will be used to support that industry only. Furthermore, insured bank and savings deposits continue to be backed by the full faith and credit of the United States government.

Second, the plan will tighten the regulatory standards for savings and loan institutions to those applicable to commercial banks. As a consequence, savings institutions will be required to double their minimum capital.

Third, the plan will increase insurance premiums to strengthen the financial basis of federal deposit insurance. The insurance fund for the savings and loans will be substantially recapitalized through higher premiums, which will rise from 0.208 percent of deposits to 0.23 percent. Similarly, commercial bank deposit insurance premiums will increase from 0.083 percent to 0.15 percent by 1991 in order to boost the financial resources of the Federal Deposit Insurance Corporation.

Fourth, the plan will broaden enforcement authorities, increase penalties for fraud, and increase funding for law enforcement personnel and prosecution proceedings.

Finally, the plan will create a new private corporation to seek a financial solution to the problem of currently insolvent savings and loans. This corporation will be funded with $50 billion in capital to deal with the ailing institutions.

Banks on Sounder Footing

It should be emphasized that the President's plan seeks to bring the savings and loan industry to the same degree of safety and soundness as that of commercial banks without compromising the financial strength of the banking system.

Fortunately, U.S. banks are in much better shape than the savings and loan industry. Under pressure from the regulators, they have increased their capital asset ratios from 5 percent in the early eighties to 8 percent at present. We have also taken steps in conjunction with our fellow-regulators abroad to establish a comprehensive risk-based capital standard that will be applicable to all American banks. When fully implemented in 1992, the new risk-based standard will assure a risk-adjusted capital cushion of 8 percent for both on- and off-balance sheet exposures. In effect, these standards will apply to all internationally active banks, thereby equalizing competitive conditions as well as safety levels.

Let me now turn to the potential problems posed by the increased leveraged buy-out activity. In recent years, corporate restructuring in the U.S. has proceeded at a rapid pace, as observed in considerable mergers, acquisitions, divestitures, and leverage buy-out activity. The motivations for such restructuring are many, but they primarily reflect profitable opportunities for investors in undervalued firms. A potentially troublesome aspect of this, however, is the high degree of leverage associated with such transactions. We at the Federal Reserve have been especially concerned about the implications of the involvement of lending institutions in highly leveraged corporations. Such firms are more exposed to interest rate risk and are vulnerable to economic downturns. These risks in turn carry over to their creditor banks.

In order to minimize the risk to the financial system, we have recently issued new guidelines to our bank examiners for the evaluation of bank participation in highly leveraged financing. In addition to the normal examination standards, examiners are asked to carefully scrutinize such loans with regard to their sensitivity to adverse economic conditions, adequacy of returns in relation to the risk involved, sufficiency of management control and reporting systems, and the "in-house" exposure limitation procedures. More careful surveillance of banks' exposure in this area will enable us to ensure that banks exercise due prudence with respect to leveraged buy-out lending without restricting or controlling the lending itself.

To further strengthen our banking system in the future, we need to move on several fronts: we need to broaden the range of services that banks can offer to their customers and widen the geographic base of their operations. These steps are needed to allow the banks to serve their customers better and to provide new earning sources for them. As part of that process, we recently granted banks limited powers to underwrite and deal in corporate debt securities.

Greater geographic diversification through interstate banking would help to insulate U.S. banks against regional and sectoral economic problems. We are making considerable progress on that score, with 45 states now permitting some kind of interstate banking, and others are likely to do so in coming years. The removal of interstate banking barriers will also allow American banks to better serve their customers on an integrated basis at home and abroad.

As you can see, we face numerous challenges both at the national and industry levels. Our policies are geared toward solving the existing problems, and to prevent new ones from emerging.
