For Release on Delivery
15:00 Central European Time
9:00 A.M. Eastern Standard Time
Friday, January 29, 1988

U.S. MONETARY POLICY AND INTERNATIONAL BANK REGULATION

H. Robert Heller

Member, Board of Governors of the Federal Reserve System

World Economic Forum
Davos, Switzerland
January 29, 1988

U.S. MONETARY POLICY AND INTERNATIONAL BANK REGULATION

It is a great pleasure to speak to you on the topic of "U.S. Monetary Policy and International Bank Regulation" because it combines the two main responsibilities of the Federal Reserve System. I have been allotted 10 minutes for my remarks, but I trust we all recognize that this is barely enough time to introduce topics of such enormous breadth and depth.

Let me therefore summarize some of the key issues to kick off the debate -- which I trust will be lively indeed.

First, I believe that U.S. economic growth will exceed two percent this year. This is not at all unsatisfactory for an expansion that is now over five years old. Although a recession is not evident in the numbers, the quarterly pattern may well be a bit uneven.

Second, the economy is becoming more balanced because the sectors that were leading the growth parade in years past are slowing down markedly, while the formerly sluggish sectors are now expanding more vigorously.

Looked upon in a different way, we must shift resources from the domestic sector to the international sector, and our domestic growth will have to be somewhat subdued to free these resources for international sector expansion. That is the game plan.

Among the sectors that are slowing down are governmental and consumer spending. Also the construction sector is showing considerable sluggishness.

The key growth sector is now foreign trade. Agriculture and energy are also showing new life, and business investment soared in the second half of last year. Let me briefly highlight these developments.

<u>Government Spending Slows to Cut Deficit</u>

The current restraint in governmental spending is desirable for several reasons: one, governmental spending grew too fast during the early eighties and had begun to absorb an increasing percentage of GNP. Two, the budget deficit needs to be further reduced, and three, the entire domestic economy must slow down to make room for export expansion.

The key to budget consolidation has been strict spending discipline. Last year, the federal deficit was reduced by one-third to $148 billion. Of course, we all agree that even that deficit is still too large and must be reduced further. The Gramm-Rudman legislation ensures that we will continue to hold our feet to the fire.

It is also important to keep in mind that we are now in the last year of a federal income tax reform of unprecedented magnitude. Marginal income tax rates were cut from 80 percent in 1980 to 28 percent this year. The top corporate tax rate is now 34 percent. It stands to reason that these tax rate reductions helped in the creation of 14.5 million new jobs during the current expansion. These important long-term incentives to work should not be sacrificed to achieve short-term goals.

Better Domestic Economic Balance

Consumer spending is slowing considerably after a rapid expansion during the last few years. The result of this spending boom was that the personal saving rate dropped below 3 percent in the fall. We all agree that a slowdown in consumer spending accompanied by higher savings rates is needed for domestic as well as international financial reasons -- and such an increase now seems certain. The other sector that shows a significant decline in activity is the construction industry.

Agriculture and energy are two domestic sectors that were rather depressed and are now doing better. Agriculture, in particular, has benefitted from federal spending programs, so that real farm income is now at the highest level in over a decade.

Energy prices are now declining somewhat as a result of unused OPEC capacity, but we expect that the contractionary phase in energy should be largely behind us. While one should not expect a return to the boom conditions of the seventies, there is again room for well-planned and carefully implemented energy projects.

Foreign Trade Stimulus to the Economy

The key growth sector is now foreign trade. About half of the overall growth impetus in 1988 should come from this sector alone.

Much of the rejuvenation of foreign trade is due to the exchange rate changes that we have witnessed since the spring of 1985. We are now in a position where the average exchange rates prevailing in 1979 and 1980 have been approximately restored. As you will recall, in those years the U.S. current account was balanced, and it stands to reason that U.S. producers are no longer as handicapped in world markets as in recent years.

Our non-agricultural exports are now growing near 20 percent annually in volume terms. While this is an encouraging development, it is clear that the legacy of the dollar overvaluation is still with us in the form of record trade imbalances. The U.S. is now running an estimated current account deficit of $160 billion, while Japan runs a surplus of about $85 billion and Germany shows a $45 billion surplus.

It should also be kept in mind that our export growth rate has to be about two-thirds higher than our import growth rate just to keep the trade deficit from rising in absolute dollar terms. We still have a long way to go to rectify the existing imbalances, but we are determined to do so.

I stated earlier that the exchange rate changes that have already taken place will help to restore a better balance in the international accounts. But it would be wrong to assume that this process will be entirely automatic and painless.

For the United States, this implies enormous domestic adjustments that include a sharp reorientation of the entire economic structure towards the foreign trade sector. For many American producers -- especially the small and medium-sized manufacturers -- this will be a period of unprecedented challenges. Some of them may even have to learn a few foreign languages to succeed in the new environment.

<u>Complementarity in Global Adjustment Needed</u>

We should also keep in mind that the restructuring of

American industry towards the foreign trade sector and the complementary reorientation of Japanese and European industries will be much easier to accomplish in an environment of economic growth -- rather than stagnation. Instead of fighting over market shares, growth will permit everyone to move forward.

In that connection it is important to emphasize that the adjustment of the trade imbalances should not be brought about by protectionism or a recession in the United States. While this would surely lower U.S. imports, it would also lower European and Asian exports. That would be the prescription for global stagnation and maybe even global recession.

Instead, the global adjustment should come about through a surge in imports by the surplus countries -- a surge brought about by growth and market-opening measures.

But time is passing and with it opportunities for forward-looking and growth-oriented measures on behalf of the surplus countries are being foregone. As a result, the pressures for adjustment by the deficit countries are mounting and are becoming increasingly difficult to resist and to cope with.

In particular, it is important that the current period of dollar stability is not seen as an excuse for complacency, but as an opportunity to put economic policies in place that will bring about the needed adjustment in the trade accounts and thereby alleviate exchange rate pressures.

Monetary Policy Carefully Balanced

In such an environment, U.S. monetary policy needs to be carefully balanced. On the one hand, we need to supply enough liquidity to sustain the economic expansion; on the other hand, domestic growth needs to be sufficiently constrained so that resources can be shifted to the foreign sector.

At the same time, we have to be mindful of the inflationary impetus emanating from the foreign trade sector in periods when foreign currencies -- and with it foreign goods -- are becoming more expensive. We must avoid the spreading of these price pressures to the domestic economy.

That inflation can be successfully contained during periods of currency depreciation has been demonstrated by Japan and Germany, which managed to cut their respective inflation rates during the period from 1980 to 1985 from 8 percent to 2 percent and from over 5 percent to 2 percent.

I believe that U.S. monetary growth last year has been appropriate to support this complex set of objectives of continued growth with price stability and room for external adjustment.

But it is also clear that monetary policy alone cannot be held responsible for the achievement of these multiple objectives. Other policy tools and, in particular, fiscal policy, must carry their proper share of the adjustment burden as well.

In sum, I am convinced that our monetary policy stance has been appropriate, and we will do our best to continue this feat.

Banking Reform Needs To Be Implemented

Let me close with a few remarks about banking reform. Two highly significant changes in the regulatory environment for banks are now in the offing.

For one, the U.S. Congress is now considering a far-reaching modification and modernization of our banking laws. The draft legislation submitted by Senators Garn and Proxmire will permit the linkage of commercial and investment banking activities within the United States for the first time in over 50 years. I realize that for most of the European members of this audience this is a just a catch-up to your everyday practices. But for us in the United States it represents a most significant reform that was unthinkable only a few years ago. This reform will finally allow American banks to compete across the same product spectrum to which you have long been accustomed. Needless to say, I wholeheartedly support this reform legislation and hope that it will be enacted speedily.

The second regulatory change is truly global in scope. I am speaking, of course, of the new international risk-based capital standards that were agreed to in draft form by the supervisory agencies of 12 industrialized countries meeting at the Bank for International Settlements in Basle. Given the complexity of the topic and the various national practices involved, this accomplishment is truly extraordinary.

The draft agreement, if ultimately adopted, will go a long way in harmonizing regulatory practices in the 12 countries and thereby contribute significantly to a high degree of competitive equality among virtually all internationally active banks. There are three key elements to the agreement.

First of all, there is agreement on a common definition of capital. The role of common stockholders equity capital is given central importance. This equity capital can be supplemented at the option of the national authorities by various types of preferred stock, perpetual and subordinated debt, mandatory convertible securities, general loan-loss reserves, and even unrecognized capital gains in buildings and stock holdings.

Second, there is a general framework for assigning assets and off-balance sheet items into several broad risk categories. The classification scheme recognizes the varying degree of risk involved in holding cash, Treasury securities, interbank claims, and regular bank loans and assigns various weights to these asset classes. The scheme also converts off-balance sheet items, such as forward foreign exchange contracts, standby letters of credit, performance bonds, and various types of credit facilities into balance-sheet equivalents. The key accomplishment here is to adjust the banks' exposure for the actual risk involved and to remove the disincentive to hold liquid and secure investments.

Finally, the proposal specifies a minimum risk-based capital ratio of 8 percent, of which 4 percent must be in the form of shareholder equity, by year-end 1992. Banks are expected to achieve minimum interim targets of 7.25 and 3.25 by the end of 1990.

While such ratios will be easy to achieve for banks in some countries, there will be other countries where banks will have to add considerably to their capital in order to be in compliance. As a result, competitive equity should be greatly increased and the safety of the international banking system further enhanced.

Just two days ago, the Federal Reserve Board voted to put these proposals out for public comment prior to final implementation.

Conclusion

To sum up, both on the monetary policy front and the regulatory front we face numerous challenges in the year ahead. The necessary decisions will have to be carefully considered, but there is no reason why we should not succeed in maintaining non-inflationary growth and a healthy and competitive banking system.