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MANAGING THE BANKING AND MONETARY CHALLENGES OF 1989

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Managing the Banking and Monetary Challenges of 1989

Confucius expressed the hope that one may live in interesting times, but tempered that wish with the qualification that the times should not be too interesting.

I am quite certain that 1989 will be more than interesting because our agenda is already filled with demanding challenges that will stretch our managerial capabilities.

In the United States we face a major crisis in the savings and loan industry and we must continue our efforts to further strengthen our banking system. We also have to make further progress in reducing our federal budget deficit. In the international arena, we have to tackle the existing trade imbalances and enhance exchange rate stability. The debt problems of the developing countries are also still very much with us. And I can assure you that we in the United States will remain most interested observers as you progress toward greater European integration. Let me address these issues in turn.

The savings and loan crisis is a key issue confronting our policy makers. The dimensions of the problem are awesome. If the estimates of $85 to $105 billion in potential losses prove to be correct, this implies a financial burden of about $400 for every American.

The roots of the savings and loan problems lie in the inflationary excesses of the 1970s, that were followed by the high interest rates and recession of the early 1980s. For institutions that funded 30-year fixed-interest loans with short-term deposits, and whose assets were heavily concentrated in the cyclical housing sector, these economic circumstances were ominous. The S&L problems were compounded when many managers reacted to these circumstances by "doubling the bet" and moving into ever more risky assets.

The solution to the problem cannot consist of a simple financial bailout. Instead, we must reform the system to assure that the problem will not recur. Foremost is the need for adequate capital, not only to provide a safety cushion, but to establish proper prudence on behalf of management. Furthermore, the institutions must have greater diversification both as far as asset range and geographic coverage are concerned. A financial institution making nothing but housing loans in one town is not likely to generate a portfolio with sufficient resiliency to carry it

through good and bad times. Needless to say, proper standards of prudence must be observed.

Fortunately, the American banking industry is in much better shape than the S&L industry. Under pressure from the regulators, American banks have increased their capital to asset ratios from about 5 percent in the early eighties to over 8 percent at present. We have also taken steps in conjunction with our fellow-regulators abroad to establish a comprehensive risk-based capital standard. 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.

To further strengthen our banking system, 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 would be helpful in further insulating American 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 many more likely to do so in coming years. The removal of the interstate banking barriers will also allow American banks to serve their customers on an integrated basis at home and abroad.

Turning to domestic policy, we all agree that further progress in reducing the federal deficit is needed. But let me note that the consolidated U.S. government deficit now amounts to 2-1/2 percent of GNP, and lies actually below the average for the Western European countries. That, however, should not be grounds for complacency. The Administration budget now before Congress calls for a $93 billion deficit for next year, which would represent welcome progress, indeed. Let me also remind you that if the Gramm-Rudman-Hollings target of a $100 billion deficit (plus a $10 billion error margin) is not achieved, automatic budget cuts will be triggered. The same legislation calls for a balanced budget in 1993.

Thus, both a working document and a strategic plan is in place to assure that our feet will be held to the fire and progress must continue to be made.

Reducing the budget deficit would have many salutary consequences. It would reduce the financing needs of the federal government and thus permit lower interest rates than would otherwise prevail. It would also help reduce our

current dependence on foreign capital. By reducing the government's utilization of resources, it would also release real and financial resources for domestic investment purposes, thereby helping to build additional capacity to keep inflation in check.

Needless to say, this would be a most welcome development as it would widen the path between inflation and recession that we must travel in the years ahead. Thus, we would have more room to maneuver. The additional margin of safety would assure further economic growth in a noninflationary environment.

Let me now turn to the international challenges facing us. Overall, the process of policy coordination now undertaken under the umbrella of the G-7, as well as the ongoing discussions at the BIS, the IMF, and the OECD has been most helpful in reducing incipient imbalances and has helped to provide a greater degree of exchange rate stability. These institutions will also foster an ever continuing adaptation to new developments.

In the developing world, the debt overhang continues to be one of the unresolved issues of the 1980s. It is unrealistic to expect that a problem of such magnitude, which was caused by a multitude of factors operating over time, can have a single magic solution. Its resolution

requires a confluence positive macro and micro factors. Certainly, the performance of the world economy will have a bearing, and there will be no real progress without sound economic management on the part of the debtors. Confidence in the economic policies of the debtor nations needs to be restored, so that flight capital will be repatriated. In addition, the problem calls for a commitment of all the parties to work together toward mutually acceptable arrangements which broaden the range of options for both debtors and creditors. In this regard, voluntary market-based approaches can make a significant contribution.

This brings me to my last point: the exciting effort to further integrate the economic and financial life of Europe.

You all know that we in the United States applaud the efforts to establish a fully integrated market in Europe. But care should be taken to remove any doubt that this elimination of barriers inside the Community will not result in greater barriers toward the outside. In that connection, it is important that the principle of national treatment, which assures equality of competition for insiders as well as outsiders, is firmly embodied in the new treaties.

This is particularly true for the banking and financial service industry. To establish a quagmire of reciprocal arrangements would be a step backwards. It would result in

an impenetrable web of treaties that will create special conditions for every conceivable country pair. Just imagine, in a world of about 150 nations, reliance on reciprocity might result in up to 22,000 reciprocal treaties. No businessman could possibly prosper in that kind of world!

Much of the recent discussion has focused on the desirability of establishing a central bank for Europe. In the United States, it took well over a century after the formation of a central government until a permanent central bank was established. Earlier efforts failed because regional and sectoral interests could not be sufficiently reconciled. Even today, the Federal Reserve System provides for the representation of a wide range of regional and sectoral interests, thereby assuring a broad representation of various viewpoints in the policy-formulation process.

Rather than moving toward the immediate establishment of a unified European currency and central bank, I have often thought that certain advantages might be obtained by taking a first step toward greater currency integration by simply revaluing all European currencies in such a fashion that one German mark would be equal to one French franc, one Dutch guilder, one British pound, and so on. Pretty soon, hotels and shops across the continent would accept the various national currencies at par, thereby obviating the need for

constant calculations and currency exchanges. In effect, one would establish unitary exchange rates for the entire European Community.

For Europe, unitary exchange rates would be nothing totally new as the coins issued by various kingdoms and states circulated freely throughout the continent in past centuries.

This step toward unitary exchange rates could be taken within existing EMS arrangements. The changes suggested would have to be taken anyhow if a truly common currency were to be established at some future date. But in this way, one would be able to proceed one step at a time.

You may well argue that such a step would be largely symbolic in nature. That is true. But perceptions and symbols of European unity are important and may well help increase public acceptance of the integration movement.

Thus, the adoption of unitary exchange rates would represent a positive movement toward greater European monetary integration, and may well be an option worth considering.

I believe we all agree that the challenges before us are formidable, but I also believe that together we can manage the task ahead and continue to make progress.