Remarks by

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Many years ago, in the early 60's, I was a member of the Florida House of Representatives. I got to the House at a time when there was a speaker who was pretty tyrannical. He ran the place with an iron hand. The fellow who sat next to me on the floor of the House was part of the speaker's inner circle, and he and the speaker used to get together every morning and decide what was going to be done in the House that day. Unfortunately, my friend failed to attend the meeting one day when there was a bill coming up on the floor in which the speaker was very interested. So when the bill hit the floor, my friend took a look at it, decided he didn't like it, grabbed the microphone, and moved that the bill be laid upon the table, which is a very unfriendly motion in that it kills the bill. The speaker, as he usually did when he was interested in a bill, had put someone else in his chair and was in the back of the room patrolling to see that everything was going to come out all right. He heard this motion and jammed that big green cigar he used to smoke in his mouth and came down the middle aisle like a destroyer under full steam. He wheeled around the front row, and he wheeled around in front of this friend of mine and jammed his finger up under his nose and said, "No, no!" The place reverberated, and my friend stood there for just a minute and then he lifted the microphone and he said, "Mr. Speaker, now that it's

been explained to me, I withdraw my motion."

I'm going to try to explain monetary policy this morning, and I will try to be simple -- but perhaps not quite <u>that</u> simple -- in what I'm going to talk about.

I would like to call this speech "Common Sense and Monetary Policy" because there are a lot of very interesting, attractive ideas running around Washington and elsewhere these days that have some validity, that certainly are worth considerable thought, but that I'm afraid have led to some rather simplistic statements that are worrisome. Let me just talk about a few of those.

First of all, there is the idea that the Federal Reserve controls the money supply. I'm sure you've all heard that. Unfortunately, it has some validity, but not much. The fact is, in the first place, it's very difficult to know what money really is. What is the money supply in this country? We publish a series of "M's" with different components, but what is the money supply? Is it transactions balances or time deposits? In which M do you put money market funds, overnight RP's, Eurodollars, and so on? Furthermore, what is the dividing line between money and credit? Where do you put credit cards? Do they deserve to be wholly in credit or are they, in fact, a money substitute in a good many ways? These are serious questions about exactly what money is, and that's one of the reasons we publish so many different "M's" and don't target on a single number. The British made that mistake last year, they targeted on M-3. Unfortunately, they did worse with M-3 than they did with all the other monetary aggregates and now everybody points to what a terrible job they did, which isn't really the fact; they simply forgot that different developments will effect different monetary aggregates.

We're having that sort of situation right now. With the advent of NOW accounts, which are in M-1B, M-1A is going down like a stone and M-2 is rising. M-1A is obviously going down because demand deposits are being changed into NOW accounts. But why is M-2 going up very rapidly? Some people are pulling money out of savings accounts and putting them into NOW accounts, which decreases M-2, but at the same time the money market funds, also in M-2, are growing very rapidly. All of which indicates and illustrates why we look at a lot of different aggregates. Although our operating techniques are based, as you know, on nonborrowed reserves, we think it's important to look at a number of different aggregates to get a better idea of what's happening in the real world.

Even if we knew what the money supply was, could we really control it very accurately? As a practical matter, the answer is no. If you want to be entirely theoretical about it and ask whether we could devise a system for holding the money supply very, very close to a target on a monthly basis, the answer is that we could come fairly close, _if_ we went to contemporaneous reserve accounting and _if_ we closed the discount window; that is, if we forced you to come up with reserves the day after we announced them rather than with a two week lag and if we forced you to go to the market to get the money. I, for one, don't happen to think that that's a very good way to run monetary policy. It doesn't take a genius to figure out that if you think you've seen volatility in interest rates up to now you ain't seen nothin' like what you'd see under that kind of a situation; clearly the interest rates would vary enormously.

Aside from going to such an extreme, how closely can we control the money supply? The fact is not very closely. We did some studies last year

indicating that two-thirds of the time there will be a variance of plus or minus $3.3 billion in the reported M-1B figures on a weekly basis. That's an enormous amount of variation and is a totally unexplained kind of variation. That's what we call "noise." That sort of thing evens out over a monthly basis and gets much better over a quarterly basis.

Again, it's very difficult to know what money is; it's very hard to control it; and, the fact of the matter is, in my opinion, that it is not very good public policy to attempt to control it too closely. I think it is clear to almost everyone that money is like any other commodity: if you attempt to control the price, the supply is going to fluctuate; if you attempt to control the supply, the price is going to fluctuate. We've changed to a different kind of operating technique, and so, in trying to hold the supply much closer to a targeted range, clearly the price is going to fluctuate more.

I think you would certainly agree with me that the volatility of interest rates creates a great many problems. We were talking earlier about why we've had such very high real interest rates in this country. Why have we had 20 percent interest rates in the United States? I think part of it is risk premium, and part of it is an inflation premium -- with underlying inflation at roughly 10 percent at an annual rate. So it seems to me that it isn't the wisest thing in the world to try to stick to simple, mechanical ways of carrying out monetary policy.

Another thing you hear is that monetary policy or supply side policy can work immediately. Let me say, first of all, that I think of myself as something of a monetarist. Henry Kaufman would probably call me a pure monetarist and Milton Friedman would probably discount me. However, I do think

that monetarism has been of considerable importance to us. It has been clear, I think, that we got carried much too far to one side with Keynesianism, which in essence says that fiscal policy makes all the difference. Milton Friedman and others have done us a great service in pointing out that monetary policy and the money supply are important. I believe that and agree with it, and I think that, given the kind of inflationary environment we've had, it was crucial that we go to the new kinds of techniques that we're using which mean that we're looking much more at the growth of the money supply than at interest rates or anything else. I believe that we're practicing flexible monetarism.

I think I'm a supply sider, too. I think it is vital in this country that we have a situation in which we are adding to our productive capacity and to our productivity and can thereby restimulate real growth. I am amazed, though, at how far some of these theories have been carried. Some monetarists will tell you, for instance, that the Fed caused the big drop in economic activity last year. They said it was obvious how it happened: the Fed made the money supply go down, and that made the economy fall off the cliff. That just wasn't the case at all. What happened was that the credit controls came on and changed everybody's way of thinking and of doing things. People took money out of their transactions balances and paid off their loans. The economy went down and the money supply went down. The cause and effect imputed by the monetarists is all wrong. What amazes me is that monetarists have always admitted in the past that there was a considerable lag between a policy action and its effect on the real economy; they've always said that there was at least a two quarter lag. In today's world, I suspect that's shorter, because in a highly inflationary environment these time lags do tend to shorten. But now suddenly

you hear monetarists saying that monetary policy had an immediate effect. I think that not only flies in the face of all past theory, but it also flies in the face of common sense; it doesn't work that way. Monetary policy works through interest rates. If you restrain monetary policy, interest rates have a tendency to go up, and that has an effect on how people do things. You do get a lag; common sense indicates that to you.

The supply siders also fascinate me with the idea that things are going to happen immediately: first, that you're going to have a tax cut which is going to go immediately into savings rather than into spending; second, that it is immediately going to create more productive capacity so supplies will go up and prices won't. It has always seemed to me that there is some lag between the time that you give people an incentive to build manufacturing plants and the time they can get them built. Somehow these time lags seem to have disappeared. Frankly, I think some of supply side thinking is based on the idea that you can change the way people do things with rhetoric, and I have great doubts that that's the case. It would seem to me that the American people have gotten very cynical and that it's going to take more than mere rhetoric to change the way they want to do things.

Another statement that you hear is that steady, stable growth in the money supply will mean lower interest rates. I am fascinated by that one. Over time, I am certainly willing to admit that. As a matter of fact that is the predicate on which we have formed our policy; that is, that inflation is heavily a monetary phenomenon and that to get inflation down you must reduce the growth of the money supply to non-inflationary levels <u>over time</u>. We have said that's what we're going to do; it is what we are going to do. But it doesn't solve all the problems very quickly, and the idea that that kind of a

policy will automatically and immediately mean lower interest rates and less volatility of interest rates is very interesting to me.

I suggest to you that that is not the case. It will over time have the effect of getting inflation down, and when you get inflation down you're going to get interest rates down. But I guess where the monetarists tend to go wrong is in the cause and effect relationship. They seem to think that changes in the money supply have the strongest effect upon the economy. I think the opposite actually tends to be true: the money supply will tend to react to changes in economic activity. You're seeing that kind of thing right now. The economy is quite volatile; we've had very considerable ups and downs; these have had a very considerable impact on the money supply. We have just gone through a period when the money supply hasn't grown very much but the economy has been quite strong. Why? Because people change their demand for money; high interest rates have a tendency to do that to them, and we've had a period of very high interest rates. People have accounts like NOW accounts, which give them a transactions balance and pay them interest. As a consequence, the money supply has been affected very sharply. We have had an enormous increase in velocity in this particular quarter; you are seeing a high rate of economic activity supported by a rather low money supply growth.

At any rate, these relationships are quite different from those which people would lead you to believe exist. The fact is that if you try to hold the money supply fairly stable, interest rates are going to be volatile, they are going to fluctuate. They're not going to do what they did last year. I think it's very clear that last year's volatility was primarily caused by the credit controls. When we put them on, economic activity dropped; when we took them off, we hadn't done a thing about inflationary expectations, which were

still very high. People went back to doing things the same way they had before; the economy surged; the money supply surged; and interest rates went up. Interest rates are going to fluctuate more sharply under the kinds of technique we are using now; that's part of the trade-off. Interest rates will not be as volatile as they were last year, but they will be more volatile than they would have been under the old techniques.

You also hear that monetary policy can control inflation. A lot of people say, "Look, all you've got to do is have a good, firm monetary policy; that'll take care of inflation. Then you can do anything you want to on the fiscal side. You can spend whatever you want to spend." I regard that as a very dangerous statement. You can make a theoretical argument that monetary policy can control inflation, but as a practical matter that is a dangerous approach to the problem, because monetary policy is a very rough tool. It does not fall equally on all sectors of the economy. It falls much more heavily on small business and housing and autos and the thrift industry and farmers and public utilities -- on all of those sectors of the economy that tend to be very interest rate sensitive. It seems to me that we have already gone through two bouts of very high interest rates which have had a debilitating effect on a lot of those areas of our economy. If you want to depend on monetary policy alone to try to control inflation, you're going to have more bouts of very high interest rates, probably higher than you've seen up until now. Frankly, I don't think that there are a lot of sectors of the economy that can stand that. It seems to me that what you will have is a large number of bankruptcies; I thought that that was what we were trying to avoid.

Inflation has frequently existed in industrialized countries. We've had it in this country before. It's always been cured, in the past, by a depression or a serious recession.

In every country that I know of inflation has been cured by going through a very tough period. I don't think we're going to get out of this period without some pain, but I do think it's possible for us to get out if we have the right balance of policies. That does not, in my opinion, mean putting the load on monetary policy; if you do that, you're going to cure inflation, but you're going to cure it by having waves of bankruptcies that create a liquidity crisis in the country. That'll get inflation down all right, but that's a hell of a way to do it.

One final comment. Some people I talk to say that budget deficits don't count. They come up with some interesting arguments; for instance, that 30 years ago in this country we had budget deficits and very low inflation. They say, "look at Germany, look at Austria, look at Japan; they continue to run deficits every year and yet their inflation rates are low." In other words, they say there is no connection between budget deficits and inflation. Of course, you have to look at each particular situation. Thirty years ago we didn't have any inflation problem in this country. We weren't dealing with the same kind of environment; we weren't dealing with the kind of "momentum inflation" we have in this country today. That's really our problem: not demand pull or cost push, but momentum inflation. It's expectations, the way people anticipate things. We're living in a different kind of a world today. As far as Germany and Austria and Japan are concerned, in the first place, they have an entirely different kind of pool of savings to draw from. Japan has a savings rate of 20 percent; Germany has a savings rate of

14 percent; ours is less than half that. In addition, if you analyze their budget deficits, you'll see that they're heavily caused by subsidies to savings and investments. I could live with budget deficits in this country if that were the cause, but that's not what's causing our budget deficits today. Putting that argument aside, the fact is that people in this country believe that budget deficits cause inflation, and until you can change their expectations -- until you can change the way they think and the way they do things -- we're not going to get inflation under control.

It is, I believe, vital that we have broad, deep budget cuts. Paul Volcker spent a morning with Margaret Thatcher and Geoffrey Howe a month or so ago, and Mrs. Thatcher kept pressing the point that in her opinion the great mistake made in Britain was not getting budget cuts broad enough, deep enough, fast enough. If you don't, you get into the kind of downward spiral that they find themselves in today. They've got a very weak economy, with unemployment over 10 percent, and yet they have to raise taxes. The way to avoid that is to get your cuts early so that you begin to change the process.

I for one, think tax cuts are important. I think they're important, though, because taxes in this country are too high. I don't believe they're needed for a stimulative effect. The feeling I get is that there is tremendous latent demand out there and, if you could get interest rates down, you could have a considerable stimulative effect. I think that that's the way we ought to try to move.

I think that it's vital that we get the budget cuts because I think the budget deficit is crucial -- crucial because we've got to get liquidity into the private sector in this country. Short term debt is much too high at banks; the debt structure of our corporations is much too high; they need to

be able to get to the capital markets. They can't get to the capital markets as long as the government is taking at least 25 percent of all the credit in this country, and that's the fact today. If we are going to get "reliquified," it is absolutely crucial that we get the budget deficit down and that the government stop crowding out the private sector so that the private sector can get to the capital markets and the big corporations can get some money and so that that can filter down through the system to the smaller corporations. It is, I think, clear that if you're going to change expectations, you've got to get the budget deficit down.

People are all from Missouri now: they want to be shown. They've heard administration after administration tell them that they're going to get inflation under control and no such thing has happened. The only overt act that's going to change expectations is for the Congress to pass substantial budget cuts. I've asked people all over the country: "On the basis of what you have heard are you going to change the way you're doing things? Their answer was "no." I said, "If you see the Congress pass the budget cuts, will that change the way you think?" The answer was "yes."

One final reason for getting the deficit down is that interest on the public debt in this country is now running above $80 billion. If people in this country see the budget deficit begin to come down, if they see a credible program of reducing those deficits over time, I believe that interest rates will be much lower and then interest on the government debt would be much lower. If we don't get the kind of cuts that I'm talking about, or if the tax cuts are bigger than the budget cuts and the deficit continues to rise, I think interest rates are going to be higher and that will add tremendously to the interest paid on the public debt; the swing, either way, could

easily amount to as much as $20 billion. I believe very sincerely that if we can begin to get the budget deficit down in this country, we can take the load off the Federal Reserve, interest rates will begin to come down, and the problem will begin to unwind. If the budget deficits remain high and go higher, I think we're in for some very tough times.

On that happy note, let me end with another story. There was a fellow who won the Nobel prize in astro physics. He was in great demand as a speaker and the university that he worked for provided him with a car and driver. They were traveling around to about the 30th speech and the chauffeur said, "You know, doctor, I've heard you make that speech so many times that I can make it word for word. The physicist said, "You're kidding." The chauffeur said, "Nope, I can do it absolutely word for word." The Nobel prize winner said, "That's remarkable. You know I would really rather spend the time in the back of the room with a drink in my hand than get up and make that speech again so why don't you try it?" The chauffeur got up and sure enough delivered the speech word for word, and when he finished the master of ceremonies got up and said, "Doctor, that was a marvelous speech. I know you don't ordinarily answer questions but that was such a marvelous speech and some of the people here are so interested that I know you won't mind answering at least a few questions. There happens to be an astro physicist on our faculty and he's just dying to ask you a question." This man then stood up and delivered himself of a question complete with differential equations lasting for about five minutes. The chauffeur stood there and when the fellow was finished, he looked at him and said, "You know, that's a stupid question. And just to show you what a stupid question that is, I'm going to let my chauffeur in the back of the room answer it."

I have some of my chauffeurs up here in the front of the room. At any rate, if you have any questions, I'll be glad to try to answer them.

QUESTION: You mentioned the necessity of private industry to raise capital and that, of course, includes the banking system. We have spent a good deal of time thinking about capital adequacy as well we should. We want to improve banks. At the same time that this is very much on your mind and on ours, we have visitors from abroad who do a good deal of business on our shores but they seem to have different rules and perhaps for some no rules. In any event, while perhaps initially this was a problem for the money-center banks, it seems to be all over the country today. I wonder if you might address the question or should I withdraw it.

GOV. SCHULTZ: When you hear the answer, you may wish you had.

QUESTION: I'll sit down. I wonder if you would care to comment on your thinking or what thinking the Board may have done on it.

GOV. SCHULTZ: We are concerned about capital adequacy. We're concerned because of the inequity that's involved in the money center banks having very low capital ratios and the smaller banks having very high ones. Clearly the smaller banks under those circumstances have to work a whole lot harder to get the kind of return on equity that the big banks can get.

More importantly, we are very concerned about the question of capital adequacy in the country today, rather than about the competition from abroad. I think we've heard the argument that there are only three American banks in the top twenty or so these days and, "Isn't that awful." I don't think that we necessarily think that so absolutely terrible. I think we would much rather see our banks be the best rather than the biggest. Furthermore, when we look at the foreign banks, we don't find that they have as low capital ratios as

many people would think because they have so many hidden assets. You have to leave the French banks out; the French banks have very low capital ratios because they are primarily owned by the government and there's not much you can do about that. As best we can judge at this point -- and we're doing some studies -- the indications are that the other foreign banks are not really out of line with the kind of capital ratios in this country.

We're very concerned about capital adequacy. We are very concerned about the very low capital ratios of the large money center banks. I understand the argument that they're much better diversified and can operate on lower capital ratios. We think the trend has gone too far. We are very concerned about it and are looking at it.

QUESTION: Sir, with respect to inflation and expectations, budget deficits, how can control over any of these things bring down inflation as long as we have union wage contracts and the big industries with 10 and 12 percent wage increases for three years out?

GOV. SCHULTZ: I think that this is, again, one of the fallacies that you may be hearing. Let me say I think the President is a great communicator, and he tends to be a very up-beat kind of a guy, and maybe that is what the country needs; it needs to have the enthusiasm and the American spirit and approach. But I'm afraid that he has given a lot of people in this country the idea that we can get through this without a tough period ahead of us, and I don't think that's possible. I don't see how you can get prices and wages down in an ebullient economy. It seems to me fairly clear that we are going to have to endure a period of at least slow growth, because as long as it is easier for businessmen to raise prices than it is to try to hold down the wages they pay, we are going to continue to have an inflationary period. As long as businessmen

think that the line of least resistance is to raise prices, and as long as labor thinks the line of least resistance is to get more in the way of wages, we're not going to change things.

I'm very much afraid that part of the process is that there's going to have to be a period when there is restraint on the economy so that there is pressure on wages and prices. I think that that has to be combined with the sort of thing I've talked about: a monetary policy that is clear, that says that we are going to bring down that growth of money supply over time; a fiscal policy that says we're going to get those budget deficits down over time; and a regulatory policy that gets rid of some of the many impediments that we have to the way the free market ought to work in this country. I am not promising you a rose garden, because I don't think it's possible. I think '81 is going to be a difficult year. I happen to think that we have a real chance of getting through most of that difficulty in 1981 and that it is entirely possible that you will begin to see inflation starting to come down towards the end of this year.

A number of studies have been done to try to tell how restraint on the economy works. How much does it work to bring inflation down and how much does it work to increase unemployment? Art Okun did some studies that indicated that he thought that 90 percent of economic restraint worked to increase unemployment and only 10 percent to lower inflation. I think some recent studies -- some economists that I've talked to recently -- feel that those percentages are not that bad, that it's probably more like 75/25. But even more important, I'm a rational expectationist, and I believe that those percentages change over time, and I think 1981 is the crucial year. If we do the kinds of things that we're talking about, I think when we get into 1982 inflation will

begin to come down more rapidly at much less cost in restraint on the economy. As a matter of fact, in my opinion, the only way that you can get back to good, real growth in this economy is to get inflation down. It all has to work together, but I certainly would not say that it's going to be easy.

QUESTION: There are a lot of unregulated people that are in the banking industry and do I see any change?

GOV. SCHULTZ: I certainly hope so. Obviously, the best case in point is money market funds. What we have is a situation in which unregulated, non-depository institutions are taking deposits; to me, that ain't fair. I don't want to use the term, "level playing field," because I created what we call the Thrift Advisory Council at the Fed, and when they were in the other day and one of them said he really didn't want to hear any more about the level playing field because he was reminded that the Christians and the lions were on a level playing field, too. At any rate, there clearly is an inequity.

What do you do about it? Philosophically I think we would very much like to deregulate the depository institutions, but the fact of the matter is the thrift industry can't stand it at this point in time. They are under tremendous pressure, and it is just not possible to deregulate further because of the impact on them. On the other side, you can regulate the non-depository institutions. Then you have to ask how? That gets you into a morass. It's difficult at this point to figure out what it is that we can do that's going to have any real impact. If you put reserve requirements on money market funds, is that going to solve your problem? Our analysis says probably not. It may be one approach, but I don't know how much impact it's going to have because all they have to do is say that instead of having check writing capabilities, they'll just allow three transfers a month out of the money market

fund into the checking account at the bank; that gets them out of the definition of transactions balance and out of the reserve requirement. Is the check writing capability a crucial marketing tool to the money market fund? We don't really know. There are a lot of other proposals, like forcing them to put a certain amount of their funds into Treasury bills, for instance. At the present time about a quarter of their money goes into commercial paper, about a quarter of it into CD's, around 20 percent into Treasuries, and the rest of it into RP's and Eurodollars and various instruments like that. One idea has been to pass a law which says you've got to put 50 percent of your investments into Treasuries, the argument being that that will bring the rate on Treasuries down. I don't really think so. Money is too fungible. You may get the money market funds to put more money into T-bills, but that will merely mean that some people who presently have their money in T-bills will turn around and put their money in commercial paper and CD's because the interest rates will change. So I don't think that's going to help very much. It would have some impact on the amount that they're able to pay; it would bring down the yield on the money market fund. Of course, that gets you into some rather serious problems, too.

You know I've made some comments about the inequity, and the fact that something needs to be done to erase that inequity regarding the money market funds. I sure do get a lot of mail on that subject, none of which is very supportive. Almost all of it is from every association of retired people that you can think. They are saying, quite logically, "We didn't do anything to cause inflation. Now you're going to prevent us from protecting ourselves against it by limiting the amount of yield that we can get."

It's going to be a very difficult problem. My judgment is that the balance of the equities at this point points to doing something about the

money market funds until such time as we can deregulate the depository institutions further. I will have no problem at that point; banks will compete in that market when we just let them.

QUESTION: Could you speculate on what DIDC's reaction might be to the FHLBB proposal of yesterday to allow interstate mergers of problem S&L's? Do you think that FHLBB is pushing the interstate idea a little too fast?

GOV. SCHULTZ: No, I think that what is coming about is the realization that we have a difficult situation out there and that we need to have laws on the books that allow us to take care of mergers and consolidations in institutions that are in some difficulty. There are those who would say to you that that's letting the camel's nose under the tent, that that's the first move toward interstate banking. I doubt it. I don't think that that's where the great pressure is coming from. The great pressure for interstate banking is coming from competition. The fact of the matter is that banks can do everything but take deposits nationwide and are doing so, so there are a lot of competitive pressures that are forcing us towards interstate banking. I, for one, hope it comes very slowly, and I, for one, hope it comes with the kind of safeguards that I believe we need to end up with a financial system in this country that doesn't differ too much from what we have now. I do not want us to have a financial structure like most other industrialized nations with a small number of very large banks. I don't think our economy or our policy is geared for that. Furthermore, some of the studies we've done indicate that small banks can be very, very competitive and very innovative, particularly in the area of marketing. It seems to me that what we want to try to do is to create a system which gives small banks the opportunity to be viable and to be good competitors down the road.

I don't think you can do that rapidly. I think that takes some time to do. But I think there will be legislation in the Congress this year that will allow this problem of failing or troubled institutions to be addressed interstate, so that I think that the action of the Bank Board yesterday is not going to be unusual. I think that you will see that kind of an approach throughout the industry, whether it's banks or thrifts. I don't see that as the camel's nose under the tent for interstate banking, but I suppose there are those who might.

QUESTION: Mr. Schultz, many of your remarks addressed the questions of supply of and demand for credit. It seems to me that a tremendous influence on the supply of credit today is the relative attractiveness of world investment in dollar denominated securities. Would you agree with this and what effects on the relative attractiveness do you foresee from monetary policy, tax relief and spending cuts?

GOV. SCHULTZ: There isn't any question that the world's getting a lot smaller from a financial point of view. We've tried to impede the flow of funds across national boundaries and the fact is that it just doesn't work very well. Money is too fungible and, unfortunately, some of you people out there are too creative, so I think that that trend will continue.

That leads to a number of conclusions. One of them is that you can no longer carry out domestic monetary policy just by looking at what is happening inside your own country. You are seeing that to a greater and greater degree. Look at what is happening to the Germans right now. The German economy is very weak, but their current account went into deficit last year; they are having more of a problem with inflation than they've had for some years; they have got to protect their currency; and, as a consequence, they

have had to raise interest rates by about 400 basis points in the last few weeks. They've had to go to a totally different kind of lombard facility which raised their short-term rates literally overnight by 400 basis points. That was exactly the opposite of what they would have liked to do for their domestic monetary policy, but it is very clear that the inter-relationship of countries has become so important and that they, more than anybody else, understand how important it is to have a strong currency if you're going to try to hold down inflation. That's true of every country, but particularly of a country like Germany or Japan whose energy comes almost entirely from outside the country. You must remember that all international oil transactions in the world are denominated in dollars, and when you have a period in which the dollar has been very strong vis-a-vis the mark -- in a period of less than a year it went from 174 up to about 220 -- the Germans can't stand that kind of depreciation in the mark because it increases their cost so much and adds tremendously to their inflation rate. They've had to step in with a monetary policy just the opposite of what they would have liked to have done from a domestic point of view.

I see nothing that's going to stop the trend towards international banking. The fact is the United States hasn't done too badly. We talk about this terrible invasion of the foreign banks in the United States; they presently hold something over $200 billion in assets. But American banks hold something over $300 billion in assets of other countries, so we're still considerably ahead of the game. The impact is felt in so many ways. The kind of international lending that you have seen is not going to stop. I think it has some dangers to it. We are concerned about Brazil and Korea and the Philippines and Mexico in terms of their ability to repay their loans.

Fortunately, our banks don't have very much in Poland, less than $2 billion. Most of that credit is held in Germany and it is likely, I think, that the Poles will have a moratorium. But one of the more interesting aspects of that is that no Eastern European or communist country in that bloc has declared a moratorium up until now on their credit, and I think that there is considerable evidence that the Russians are constrained in what they can do and will do in Poland by the amount of Polish credits that are outstanding. After all, the Russians have got to finance an enormous pipeline, which is going to cost many billions of dollars, so that at this time they're concerned about their credits. The whole question of money flows, in my opinion, has become not only much more important from the point of view of the flows back and forth between countries, but because I think it will have a very lasting effect on the politics of the world.