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CURRENT ISSUES CONFRONTING MONETARY POLICY

Remarks by

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I am pleased to have the opportunity to speak with you on current issues confronting monetary policy.

In many respects, today's economic conditions are extremely favorable. The current recovery has been one of the strongest of the postwar era and recently has shown signs of moderating to a sustainable phase. Accompanying the impressive gains in production, household income has advanced substantially and unemployment has dropped sharply. At the same time, inflation has fallen well below its earlier double-digit pace and indicators suggest that near-term inflationary pressures will remain subdued. The restraint on labor costs resulting from moderate wage increases and healthy productivity gains has been especially encouraging.

A number of financial factors also point to an optimistic outlook. Growth of the monetary aggregates has been broadly consistent with our goal of gradually reducing monetary expansion over time to promote the ultimate attainment of reasonable price stability. The narrower monetary aggregates, M1 and M2, remain well within their target ranges for 1984, and M3--although boosted by strong credit growth--is running at about the top of its range. Interest rates not only have come down significantly from their 1981-1982 peaks but also have moved lower in recent months, perhaps in part reflecting a further ebbing of inflation expectations.

Despite these promising developments, much remains to be done. There is certainly scope for further employment gains. Unemployment is still well above a range that might be considered consistent with "full employment" and is distressingly high among blacks and teenagers and in certain industries and areas of the country. Interest rates, though much lower, have stayed high by historical standards, especially when compared with current inflation rates. Pressure on interest rates has been maintained by outsized credit demands, bolstered by substantial federal borrowing. The stronger dollar, while reinforcing the slowing of inflation, has boosted our trade deficit, retarded recovery in our export and import-competing industries, and increasingly led these industries to seek protectionist relief. And the higher current account deficit has fostered increased dependence on foreign capital inflows to fund domestic borrowing.

These aspects of today's economic situation raise questions about the permanence of the recent more favorable developments. The issue at hand is whether the needed adjustments will be aided by constructive public policies or whether events will take their own course--with the accompanying strains on the financial system and risks to the economy.

For our part, the Federal Reserve intends to continue to provide sufficient liquidity to promote sustainable economic growth without rekindling inflation. Of course, monetary policy alone can not guarantee such an outcome. Although encouraging steps have been taken to reduce the substantial federal deficit, further progress in aligning federal expenditures with receipts would make our task much easier. Our job also is complicated by continuing imbalances in many sectors of the economy as well as by the rapid pace of financial innovation and deregulation of recent years. In the remainder of my remarks, I'd like to give my assessment of these issues.

As you well know, the progress we've made toward price stability has been at great cost, including a severe economic contraction. To be sure, if inflation had not been reduced, the ultimate dislocations would have been still more severe. Even with the robust recovery, lingering effects of the recession are still evident on our financial system and many sectors of our economy have not yet shared in the recovery. To a degree, these problems are the unavoidable side-effect of a transition from a period of high inflation and elevated interest rates to one of reasonable price stability and more moderate credit costs. Wage and price contracts had embodied expectations of continued high inflation and disinflation was accompanied by considerable loss of employment and output when these expectations were not realized. Borrowers also had locked in contracts on the assumption of continued high inflation, and the adjustment toward price stability has impaired their ability to repay.

The debt burdens of certain developing countries are of particular concern. Some countries found it increasingly difficult to generate enough export revenues to service their debt obligations, as sensitive commodity prices fell following cyclical increases and the effects of the worldwide recession spread and persisted. The increase in interest rates that has accompanied the recovery added to their payment difficulties. In light of the progress that has been made by certain countries in reducing reliance on external sources of funds and rescheduling loan payments, the problem seems manageable over time. Nevertheless, there remains some distance to go before we can feel sanguine about this situation and strains would intensify if interest rates were to rise much above current levels, given the floating-rate nature of this debt.

Similarly, softness in the price of oil created problems in this country for small energy-related firms, particularly those that had invested heavily in marginal fields and new equipment on the assumption of ever-rising energy prices. These borrowers in many cases found it impossible to repay their debt on schedule as the value of their output failed to keep pace with expectations based on previous trends.

Farmers and others in the agricultural sector also have been adversely affected. Many of these producers, particularly those just starting out, had acquired very heavy debt loads in order to expand production in what was seen as an era of upward-trending prices of agricultural products and rising land values. But instead, agricultural prices stabilized, land values fell, and both the ability of farmers to service their debt and the value of the collateral for these loans deteriorated. The higher interest rates also reduced their ability to repay. With many producers of farm commodities heavily dependent on the export market, the strengthening international value of the dollar and the lagging recoveries in major foreign markets have compounded their difficulties. Moreover, should the U.S. turn increasingly protectionist, foreign retaliation could further depress farm export markets. As with the developing countries, conditions in the farm sector would erode further in the event of a backup in interest rates.

A number of banks and other lenders also have been caught in this transitional squeeze. So long as commodity and oil prices continued to trend upward, loans in these areas appeared quite sound. However, as the conditions facing these borrowers deteriorated, lagging payments on interest and principal in a number of cases have led to increases in nonperforming loans, loan loss reserves and chargeoffs. At the same time, the increase in interest rates in the early 1980s raised funding costs and, although rates have since come down, the removal of various deposit rate ceilings has limited reductions in the cost of funds. Nevertheless, banks on the whole have adjusted remarkably well, owing in large part to the strong recovery, which by itself tended to boost credit demands and bank profits. Even so, earnings at many banks remain depressed, particularly among those with a concentration of energy and agricultural loans. Also, certain banks with heavy foreign exposure have experienced swings in investor confidence, at times causing them to pay a premium over market rates for their funds. The asset quality of many banks has not improved significantly, even though the ability of some borrowers to repay has been helped by lower interest rates and reschedulings. Indeed, 48 commercial banks failed in 1983 and 65 have closed so far this year, the largest number since the 1930s. It will take some time for banks to restore fully their financial health, and this process would be made more difficult should the recovery stall or interest rates increase sharply.

Thrift institutions too were adversely affected during the transition to lower inflation. During the 1970s, as home prices escalated, many of these institutions acquired large volumes of fixed-rate mortgages and funded such long-term assets with short-dated deposit liabilities. Some institutions were particulary aggressive, and funded rapid growth with substantial issuance of jumbo CDs and other purchased funds. However, as mortgage rates climbed in 1980 and 1981 and real estate values stagnated, thrift asset quality declined. Moreover, with the rise in market rates, these lenders found their costs of funds rising faster than returns on their mortgage assets and thrift earnings were severely depressed. Indeed, the industry as a whole registered sizeable losses in 1981 and 1982. With the decline in interest rates from their cyclical peaks, thrift earnings have improved somewhat. In addition, the increased popularity of adjustable rate mortgages has better positioned these institutions for weathering future interest rate volatility, although unless appropriate standards are followed in extending such loans, this reduction in interest rate risk may be traded off for more credit risk. Additionally, with the long maturities of the mortgages still on the thrifts' books, any such balance sheet restructuring will take time. In the meantime, the substantial overhang of low-rate mortgages in thrift portfolios will continue to depress earnings in this industry. And, the removal of many deposit-rate ceilings has made thrift liabilities increasingly rate sensitive.

Nonfinancial corporations also face certain imbalances in their debt structure. As credit demands strengthened with the recovery, these firms relied principally on short-term borrowing or on term loans with floating rates. The spate of merger activity this year has created further leveraging as a substantial volume of equity was retired. Although gross issuance of long-term bonds and equities has picked up in response to the recent decline in long-term rates and the rally in the stock markets over the summer, this period of balance sheet restructuring has been brief. Without substantial further adjustments, businesses in general will remain vulnerable to interest rate upswings.

All of these factors have reduced the capacity of our economy and financial system to absorb further shocks. Certainly the Federal Reserve and other agencies have carefully considered the strains on our financial institutions in determining appropriate financial supervisory and regulatory policies. Increased attention has been paid to the capital adequacy of banks and other depositories as well as to the credit quality of their loan portfolios. Assessing maturity imbalances of depository balance sheets also has been emphasized. While these regulatory and supervisory efforts help assure the soundness of the financial system, these problems can best be addressed over time by prudent management decisions on the part of the institutions themselves. Their task would be facilitated by a sustained period of growth in the economy and stability in financial markets. In my view, such a period of stability can not be ensured without a continuation of monetary policies designed to prevent a resurgence of inflation.

Unfortunately, there are no clear-cut rules that we can follow in designing such policies. Policy strategies that focus exclusively on a single target depend for their success on a stable relationship between that target and the policy goals. In the case of the monetary aggregates, the rapid pace of financial innovation and deregulation has made less certain their relationship to economic activity and prices.

High inflation and accompanying high interest rates in the past prompted some of the financial innovation and deregulation. As interest rates rose above deposit rate ceilings, the financial system brought forth a wide array of financial assets free of these restrictions and with different characteristics than traditional deposits. Money market mutual funds, for example, which combined investment and transaction capabilities, grew rapidly in the 1970's as deposit rate ceilings became increasingly restrictive. In turn, as the new instruments attracted funds from those deposit accounts included in the monetary aggregates, the relationship between the aggregates and nominal economic activity deteriorated. This problem was addressed to a degree by redefining the aggregates to include the new deposit substitutes. However, the hybrid nature of many of the new instruments suggests that any such redefined aggregate will take on new and uncertain behavioral characteristics compared with the one it replaced.

In response to erosion of the competitive position of depository institutions and to enable depositors to earn market rates on their funds, deposit-rate ceilings were gradually lifted over time and new types of accounts were authorized. This process is now nearly complete; as a result of the Depository Institutions Deregulation and Monetary Control Act of 1980, all deposit-rate ceilings except for the statutory prohibition of interest payments on demand deposits are scheduled to be eliminated by early 1986.

This deregulation has been largely beneficial by promoting a more efficient allocation of funds, by allowing depository institutions to compete on an equal footing and by expanding the variety of market-rate instruments available to the public. Even so, it has further complicated the Federal Reserve's interpretation of the monetary aggregates. The deregulation of existing accounts and the introduction of new ceiling-free deposits can cause sudden shifts of funds into these instruments. If these funds are attracted from outside the aggregate containing the new deposits, estimating the amounts involved and interpreting movements in that aggregate can be difficult. Two recent examples of this phenomenon are the introduction of NOW accounts nationwide in early 1981 and the creation of money market deposit accounts in December of 1982. NOW accounts grew very rapidly during 1981 and boosted M1 that year by an estimated 2-1/2 percent. MMDAs were phenomenally attractive and grew to over $320 billion by March of 1983. The amount of these funds that came from outside M2 is difficult to estimate but there can be little doubt that MMDAs boosted this agggregate substantially during this period.

The authorization of new accounts also can have more lasting effects on the underlying behavior of the aggregates relative to economic activity and interest rates. These effects as well impair the usefulness of the aggregates as guides to monetary policy. For one thing, deposits such as NOW accounts and the more recent Super NOW accounts and MMDAs can perform both savings and transactions functions. Including the fully transactional NOW and Super NOW accounts in M1 and the more restricted MMDAs in M2 thus tends to blur further the distinction between the narrow and broad aggregates. In addition, as investment motives come to play a larger role in determining the demand for narrow money, the relationship between M1 and income is likely to change. Finally, demands for money over time are likely to become less responsive to movements in market interest rates as deposits increasingly bear competitive rates of return.

The relationships among money, interest rates and economic activity may stabilize upon completion of the transition to the deregulated environment. But these linkages are likely to remain uncertain during the period of adjustment. Although M1 recently appears to be behaving more in line with historical norms, it may well be some time before full confidence in this aggregate can be restored. Looking ahead, the removal of all rate restrictions on regular NOWs by early 1986, not to mention the possible elimination of the statutory prohibition against payment of interest on demand deposits, will create new uncertainties. Under these circumstances, the conduct of monetary policy will continue to require analysis of a broad range of economic developments and careful judgment.

Allowing depository institutions to compete for liabilities with market rates has tended to raise their funding costs, of course, particularly for smaller depositories that previously relied most heavily on retail deposits subject to rate ceilings. And, as I mentioned earlier, this upward pressure on funding costs occurred during a period when earnings were already squeezed. To a degree, more efficient pricing of credit and deposit services should limit the impact of deregulation on bank profits over time, as banks and other depositories increasingly compete through price rather than nonprice means. In the near-term, however, increased funding costs may continue to reduce net earnings, particularly if public pressures develop that constrain depositories from passing on costs through explicit pricing of services or from eliminating unprofitable activities. These factors, along with the possibility that bank asset powers likewise will be further expanded, point up the continuing importance of strong supervision to ensure the safety and soundness of the depository system as deregulation proceeds. This need is heightened by the current strains affecting the asset portfolios of many of these institutions.

Sizeable federal budget deficits now and in the foreseeable future add to these concerns. Although fiscal policy provided an important stimulus during the recession, the continued large shortfall of receipts from expenditures during the expansion raises certain risks. At present, large structural deficits are putting upward pressure on interest rates, as the government competes with private borrowers for a limited savings pool and as market participants fear that such federal deficits will ultimately prove inflationary. Such pressure further contributes to the strains I spoke of earlier--on borrowers, depository institutions, and firms in need of balance sheet restructuring. In addition, to the extent that real interest rates are boosted, the dollar is strengthened and a correction to our sizeable external deficit delayed. The federal deficit also complicates the implementation of monetary policy; to reduce the risks of a resurgence of inflation, the Federal Reserve must avoid monetizing the substantial federal debt issuance, even as it deals with the uncertainties currently surrounding the monetary aggregates.

Over a longer horizon, prospective large federal deficits raise the potential problem of reduced capital formation due to crowding out, particularly if uncertainties caused by a burgeoning current account deficit retard the willingness of foreign investors to hold U.S. debt. Any lessening in long-term capital formation also would jeopardize further improvements in labor productivity and unit labor costs. And if concerns by foreign investors about potential debt monetization and long-run U.S. inflation prospects were ever to induce a sharp erosion in the dollar's exchange value, added price pressures would emerge in a self-fulfilling process.

I believe that the best way to forestall such outcomes would be further and timely actions to reduce the imbalance between federal receipts and expenditures. I would not take it upon myself to make detailed recommendations on fiscal policy matters to Congress or the Administration, of course, but I would hope that in addressing this issue, ways can be found to preserve and promote strong incentives to produce and invest. Progress in this area can only strengthen the foundations of our economy and financial system.

In conclusion, I would like to reiterate that many reasons for optimism can be advanced. Although attaining price stability has been difficult, we have achieved great progress in the last few years. I am confident that sound public policies can promote the period of economic and financial stability necessary to sustain and extend this progress.