

FOR RELEASE ON DELIVERY
TUESDAY, OCTOBER 14, 1975
7:00 p.m. (E.D.T.)

THE SEARCH FOR FINANCIAL STABILITY

Remarks of

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before the

Financial Executives Institute
(Dallas Chapter)

Dallas, Texas
October 14, 1975

The Search for Financial Stability

With more than half of the decade of the Seventies in the history books it is apparent that financial conditions have been highly unsettled and, with current prospects, this instability may continue. If this is correct, it behooves us to seek out the primary forces of instability and review what can be done to mitigate them. Of course, as in any speech, I speak only for myself, and the thoughts expressed should not be attributed to the Federal Reserve or any of my associates.

If one thinks back over the past five and one-half years, there are certain highlights in the financial field which led to uncertainty and volatile movements in key variables. The breakdown of the international monetary mechanism led to the substitution of one type of uncertainty for another. Before generalized floating began in March 1973, there were frequent crises over whether countries' par values would be maintained or changed. Since March 1973, there have been, at times, substantial movements in market exchange rates that were bound to create uncertainty for international trade and investment. The trade-weighted value of the dollar against other major currencies moved down about 4 percent from March to September 1973, then sharply up by about 12 per-

cent under the impact of the OPEC decision to quadruple oil prices, then down again by more than 12 percent from early 1974 to June 1975 and since then up by almost 10 percent, as U.S. interest rates rose relative to rates abroad.

In addition to this fundamental disruption, international turmoil was heightened by the yield and price uncertainties in agricultural crops. The foreign crop reductions which forced new demands on U.S. supplies created a surge of prices which ramified into the costs of other products. But the greatest international price pressures arose from the actions of the Arab oil producers. With foreign oil prices rising nearly four fold, the costs of energy and transportation advanced sharply. These in turn were reflected in the costs and prices of most other goods.

These external abnormalities were compounded by financial problems at home. Government deficits amounting to \$110.4 billion from Fiscal Year 1970 through Fiscal Year 1975 are now heading toward a new record in 1976. These deficits have stimulated our economy while further expanding the supply of dollars both at home and abroad. Perhaps one of the most serious aspects of this excessive Government spending was the substitution of public for private expansion, including the impact upon capital expenditures and the availability and cost of funds. Extensive Government competition

for raw materials and labor have built up costs for both public and private sectors.

Partly because of the Government deficits, monetary expansion has been more than needed for balanced non-inflationary growth. In my opinion and I stress this, the enlarged monetary growth in part could be a result of over-concentration of policy formulation upon the narrowly defined money supply. The attention in the central bank, academia, and Congress to this singularly statistical measure of monetary policy may have led to a lessening of monetary discipline.

Simultaneously, structural changes in financial institutions and shifts in financial transactions have been developing which appear to be reducing the influence of the central bank over the expansion or contraction of credit. Not only were credits being handled by nonbank organizations but the growth of time deposits weakened the correlation between money supply and demand deposits. The extension of third party payments to thrift institutions may have also marginally weakened the response to aggregate controls.

At the same time, fiscal policy has contributed very little to the efforts for economic stabilization. Tax changes were primarily stimulative and Government spending continued to expand despite a lower rate of revenue increases. Under the pressure of a heavy financing load, even Treasury debt management policies have on occasion been counter-productive to financial stability.

These forces pushing toward uncertainty were accentuated by the growth of human expectations fostered by political promises and a widening disparity between the rich and the poor. Between all these pressures, inflation accelerated and business and consumer decisions appeared to be made with the expectation of even higher prices.

Inflation itself was a primary force in creating imbalances and instabilities over a wide range of financial inter-relationships. Among the more important results of inflation has been the high interest rates which investors demanded to seek some inflation coverage before lending their money. Application of aggregate controls limiting the growth of new lendable funds also contributed to the new record interest rates but the primary push came from the inflation.

Other inflationary impacts on financial conditions were the great enlargement of the credit needs of business, the paralyzing effect of increased costs of carrying new debt, the disruptive imbalances between producers and retailers, the costly increase in import prices and the loss of purchasing power as wages and profits failed to keep pace with prices. All of these and other impacts of inflation caused major shifts in the sources and uses of lendable funds. The relative movement of funds to and from other nations was impacted by the comparative rate of inflation.

With all these economic and financial problems, the nation resorted, in 1971, to direct wage and price controls. But these merely dammed up the price pressures and, given their particular configuration, also created massive distortions among raw material producers, processors, and final sellers. The failure of such direct controls added a deferred stimulant to prices and through uncertainty of application may have been a part of the financial unrest.

Finally, both as results and causes of financial instability, were the faltering business and financial firms, especially the large ones. The highly visible problems of Lockheed, Penn Central, Franklin National, and Security National, increased uncertainties in the financial markets and raised questions of confidence in the banking industry.

Current conditions have added other elements of instability to the financial scene in the United States, but the elements specified above have largely continued with varying degrees of emphasis. Heavy government deficit financing, renewed external pressures on oil and agricultural prices, unstable exchange rates, inflationary expectations, and uncertain and somewhat contradictory government action in the field of economic stabilization policy, have all added to the financial unrest of 1975. In addition, however, the threat of a default on the securities of a major urban city in the United States

has added a new dimension to the unknowns plaguing the financial markets. It is, of course, too early to measure the impact of a real default on such securities, but the hint of such an impact is already evident in the declining prices and rising yields in the municipal securities market. One could speculate that a real default could be contained within limited bounds for the specific securities affected by the default or, similarly, one could speculate that such a default would call into question all securities issued by the related governmental entities and spill over into a hesitant and perhaps even disorderly market for all municipal securities. Regardless of the special impact on the particular city, it seems clear that this is no time to add another dimension of uncertainty to the financial markets of the nation. And yet to place the strength of a United States Government guarantee behind such securities would limit the disciplinary force on excessive spending and clearly open the door toward greater control of local affairs by the central Government.

Recent events have added a further questioning element in the financial markets in the form of government action to force disclosures of financial information from both financial and non-financial corporations. Especially important in this area have been the forced disclosures of internal actions by corporations and the disclosure of debtor-creditor relationships within certain financial institutions regarding the financing of real estate investment trusts.

Over the summer months, Congressional pressures have mounted through the Securities and Exchange Commission and in the sub-committees of Congress to force even further disclosures of debtor-creditor relationships covering not only the level and changes in loans which are on a non-accrual status or classified by the examiners but also the relationship of the United States' banks to large depositors or borrowers abroad. While one may sympathize with the objective of disclosure in the sense that disclosure does provide the investor greater information upon which to make an informed judgment about investing in a particular corporation, one must also be considerably concerned that the United States does not go too far in forcing disclosure which might create a loss of confidence on the part of either borrowers or lenders and thus a move to foreign financial institutions which still protect this creditor-debtor relationship. Similarly, one can sympathize with the need to prevent the problems characterized by the background of failure on the part of some corporations and even officials in government to be totally honest in their dealings with individuals and the American public. But one still must maintain a sense of balance in disclosing information which might threaten the competitive environment within which such institutions must operate, as well as protecting depositors and lenders from disclosure beyond that necessary in the public interest.

A subset to this element of disclosure is the more recent pressure of the accounting profession for a rather significant move toward "current value accounting." This move, although not yet formally adopted, has already been imposed on a few major financial institutions, bringing their records into a current value basis and, given the present market, sharply enlarging the transfer to loss reserves out of current earnings. While this may seem to be a relatively innocuous move on the part of the accounting profession, it does trouble the financial institutions greatly because of the impact upon the current earnings status of the financial institutions and thus upon the prices of their stocks. Moreover, there is something artificial and almost unrealistic about a demand to maintain a market value level for investment and loan portfolios of financial institutions when most such institutions provide a means of retaining their assets over the maturity or life of the asset. Also forced write-downs for temporary market aberrations can do little good and will create rather violent swings in current income and reserve levels.

Another subset to the disclosure problem, although somewhat remote, is the shift in structural competitive balance within financial institutions. For some time now the thrift institutions in the United States have been slowly accumulating additional authorities in their move toward bank lending and deposit powers.

While this is desirable in the long run if accompanied by parallel responsibilities, pursuing the move today seems an unnecessary further burden to the harassed financial markets and institutions. Such moves create considerable uncertainty on the part of the financial institutions, not knowing how far the competitive balances will shift nor knowing the regulator's reaction to such moves. All in all it seems that this might be an especially poor time to push for structural reform in the midst of the other uncertainties and pressures which the financial markets must sustain.

Given this long recital of the problems and the elements creating financial instability over the past five and a half years and more particularly since the mid-1974 period, one could legitimately question if the sun is shining anywhere.

Let me assure you that there is a silver lining behind these dark clouds of uncertainty. The sunshine in the situation takes the form of a developing recovery from recession and the implied promise of better days to come. While our problems are manifest, and solutions are difficult, the underlying strength of our economy is showing through those man-made mists of uncertainty. I have an abiding faith in the inherent power of our economic system and in the ultimate ability of our people to overcome adversity. Despite the possibility that these elements of uncertainty will persist, I believe there are steps which rational, careful, and

courageous leaders can take to set us on the course of a return to stability.

From my present viewpoint, it does not seem likely that all the fundamental forces generating instability will be fully corrected in the near term, though some amelioration is probable. Those of us seeking financial stability certainly must face the long run problems of the real estate industry, especially the credits under non-accrual status for the real estate investment trusts. Such credits are largely in a holding position and progress toward improving the cash flow from the underlying collateral or removing the loans from such a non-accrual status appear to be slow and hesitant. The market's judgment would appear to say that such corrections may still require a substantial period into the future. Similarly, despite the actions which might be taken concerning the municipal securities of a major U.S. city, it would appear that the problems of restructuring that debt and redeveloping confidence on the part of investors in buying such securities, will be an extended affair. No action has been taken to develop a new international monetary mechanism, and while floating rates have acted as a buffer against speculation between other major currencies and the dollar, the fluctuations in exchange rates continue at a rather volatile pace. Though actions are under way to try to smooth out some of the impact of crop-short nations in buying the surpluses of

the United States grain crops, it is likely to take some time before stability re-emerges in this field. Certainly, the heavy U.S. Government deficits of the past appear likely to continue.

While Congress and the Administration talk of a continuation of the tax cuts of 1975, almost the only change which has developed over the past few months has been the lessening monetary stimulation to the financial markets. Over the long haul, this will be a salutary development. But in the short period, it is likely to add pressure both in financial markets and interest rates which in turn could cause some crowding out of borrowers as the U.S. Treasury continues its major financing programs. The latter is especially likely if our recovery gains widespread dimensions and encourages the growth of business loan demand to finance new inventory accumulation and meet the rising costs of production.

Given these problems faced by the financial markets of today and tomorrow, what can be accomplished by government and the private sector to reestablish equilibrium and balance in these markets? One of the primary enemies of investor oriented finance markets is uncertainty or the fear of the unknown. Uncertainty plagues the investor and makes him cautious in placing his funds into new endeavors. Uncertainty breeds caution on the part of the consumer and he conserves his funds in savings or other short-term investments. Uncertainty makes the businessman unwilling to reach toward new capital spending to enlarge plant capacity or improve

productivity in a market where unknowns generate questions on sales and profits. So in the short run through early 1976, government and business, and indeed the consumer, need to reach for a period of certainty, taking decisions and actions which will counteract those forces of instability.

Of special importance today is a government decision on taxes for 1976. The market and the consumers need to know whether tax cuts will be continued into the future. While we each may have a view on the desirability of such action, at least a determination by the governmental leaders on the tax question seems eminently desirable in the very near future. Second, an early settlement of the New York default threat is almost mandatory to re-establish confidence in our municipal securities market. Whether the settlement comes by New York State and City action or moves on the part of the Federal Government, we may each again have our own preferences, but an early settlement is required. Thirdly, the Federal Government needs to announce its program of financing to meet the Federal Government's deficit. While announcements have been made concerning the magnitude of the financings in the fall of 1975, further announcements should be made on the schedule of financing for early 1976, the methods to be used and the type and maturity of the new issues. Fourth, it might be wise for Congress temporarily to suspend its efforts to restructure the financial institutions.

It scarcely seems to me to be a good time for Congress to be developing new structural changes in the midst of an uncertain and instable market situation. This, of course, does not alter the fundamental need for such restructuring, nor the desirability of making such a restructuring in the future. Finally, as a short-run policy action to improve the stability of financial markets, I would suggest that the United States announce its intention to provide for cooperative intervention in the exchange markets toward limiting the volatility of exchange rates structure and to work cooperatively with the other major currency nations in developing a program of international monetary reform. These suggestions will not handle all of the problems which the markets face today, but should go a long way toward improving the climate of investment and provide an environment of stability within which investors can make their decisions.

In a longer range context there are several developments which need early commencement and which should provide even greater long-run confidence in the financing markets. Certainly, a reordering of national priorities for long-run financial balance is a "must" if we are to maintain equilibrium in our economic and financial arena. This will require competitive balance among financial institutions, greater emphasis upon capital formation, and encouragement to business for new plant capacity. Secondly, the establishment of energy and agricultural plans to deal with the

short-run aberrations and external pressures on these markets by a program of research, tax stimulants to experiment, stockpiling, and dedication to free market principles. Third, it seems to me that the United States needs to restructure policy responsibilities to return to local and State levels solutions to essentially local problems and with them the needed revenue sources for such solutions. Fourth, I would suggest that we review our national economic stabilization procedures and policy control to ensure policy response appropriate to the parameters of economic and financial variability. Such a review would stress the need for adequate monetary control over the full range of financial transactions and institutions as well as a useful reappraisal of fiscal policy objectives and coordination with other tools of stabilization. While aggregate monetary and fiscal controls can be improved, they are not likely to be able to handle the full job of economic stabilization and thus I believe there are structural changes to which national policy must be addressed. Among these might be broad suggestions in the form of wage, profit, and productivity guidelines, a restudy of markets to insure competitive foreign market capabilities on the part of our domestic producers and home market studies to assure that regulation and market intervention are kept to a minimum for free market activity. It is difficult for me to believe that this nation must surrender its

economic or financial flexibility to the intemperate and volatile decisions of a foreign group. At the same time, we have basic responsibilities in the field of international financial relationships which require the United States to move with care in developing or changing its internal or external policies.

Reviewing this speech, it seems to me that the tone is unduly bearish and that one might leave this room feeling that the financial markets are in for a long period of disruption, harassment and uncertain governmental and political intervention. Actually, I am quite optimistic that we can develop the equilibrium necessary to advance our economic well-being in this nation. The suggestions I have made merely point to the need for greater certainty for businessmen, investors, and consumers.

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