Remarks by

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to

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It is a genuine honor to have been invited to address this distinguished group. Your hospitality outdoes even Ireland's reputation for warm welcome to visitors. And this is a special treat for me inasmuch as my Grandmother LaWare was born Margaret Quinn in Cashel. Her mother was a Fitzgerald. My grandfather was French from a French Canadian family. On my mother's side the stock is all German, and Prussian at that. So I guess I am a bit of a mongrel, but at least a good solid quarter of my bloodline is Irish, and my middle name is Patrick, for my father's favorite uncle. This is my first trip to ireland, but based on these last few days, it surely won't be the last.

I propose, today, to comment on three subjects of current interest in the United States which, because of their nature, may have some importance here in Ireland as well as in the assortment of lesser countries that lie some miles east of here.

I will discuss the current state of the U.S. economy and my personal expectations for the next year or so. Then I want to give you a brief update on the banking industry in the United States and some recent legislative initiatives. Finally, a few words about the current storm raging in my country over derivatives and their use and abuse.

The economy comes first as I guess it does inevitably for any central banker. The good news is that we are experiencing solid growth across the economy in general with a particularly good performance being turned in by steel, autos and capital goods. The bad news is that it may be growing a bit too fast. That worry has prompted us to snub the brakes a bit by raising short interest rates five times this year for a total of 1-3/4 percent on the federal funds rate and 1 percent on the Federal Reserve discount rate.

The conventional estimate is that the capacity of the economy is growing at about 2.5 percent at an annual rate. But the economy itself has been cooking along for the last two years at about a 3.5 percent growth rate, well in excess of increases in potential. A recovering economy can certainly grow faster than capacity increases for ten or twelve quarters, but if that condition goes on much longer than that, shortages begin to appear, creating just the right environment for price increases. Price increases inevitably lead to wage demands and then the inflation pot really begins to bubble.

This recovery from our 1991 slump has been a powerful one. There has been a genuine boom in capital spending with business fixed investment growing at an annual rate of 12 percent over the past two years. And there is an investment flavor in household or consumer spending as well. Construction of new homes is up 9½ percent and motor vehicle sales are up 8½ percent.

The effect of this healthy recovery on the labor market has been dramatic. From the second quarter of 1992 to the end of July 1994, nearly 4½ million new jobs were created and unemployment dropped from 7½ percent to 6.1 percent -- which we calculate to be at or near the natural rate of unemployment.

At the same time consumer price inflation has fallen from 6¼ percent in 1990 to a bit under 3 percent most recently. And the core rate of inflation, that is excluding food and energy, is a bit under 3 percent for the first time since the mid-1960s.

Another favorable feature of the recovery has been the strengthening of corporate and household balance sheets. Tremendous debt had been taken on by individuals and businesses during the booming '80s and the servicing of that debt had become a real drag on economic growth. At the same time, banks were having loan problems which resulted in hundreds of bank failures and even threatened the survival of some of the very largest institutions.

Household debt service burden peaked in 1989 at 18 percent of income on an annual basis. That ratio has now been worked down to 16 percent through modest growth in incomes and more restraint in borrowing. However, in the past several months the increases in consumer debt have been robust reflecting increased confidence and the pressing need to satisfy pent up demand, replace old cars and appliances, and upgrade housing facilities.

On the asset side of the household balance sheet, housing prices are beginning to rise modestly and the recent interest rate structure has fostered mortgage refinancing, enabling many households to convert increased equity in real estate into cash.

The gains in other asset values over the past several years have fortunately not been seriously offset by the decline in stock and bond prices in 1994.

While consumer spending over the past two years has increased at about a $3\frac{1}{2}$ percent annual rate, some of the urge to spend has undoubtedly been dampened by anxiety over job security. The United States has been experiencing an unprecedented wave of corporate restructuring -- or re-engineering as it is now called -- characterized by very large staff reductions. Unlike previous episodes of lay-offs, this one is not confined to production-line workers. To the contrary, this episode is characterized by a drive to improve the operating efficiency of corporations by reducing the number of management layers and broadening the span of control of managers from five or six direct reports to as many as eight or nine. Directors, at the same time have become less tolerant of lackluster performance by senior managers. So the casualties in the job market include chairmen, presidents, managing directors and chief financial officers in unprecedented numbers.

I believe the uncertainty about future job security may well have dampened to some extent consumer spending that might otherwise have been recorded. Indeed, retail sales have been sluggish in recent months, and I suspect this is particularly true of purchases which might require long-term commitments to financing. One indicator of that is the increasing popularity of leasing autos instead of purchasing. A two-year lease doesn't involve tying up a large amount of cash in a down payment, and you have the option of getting a new car every two years.

One of the most impressive and significant developments in the U.S. economy has been the surge in investment spending by businesses. Improved balance sheets, better profits and stronger cash flows have helped to increase equipment purchases at nearly a 17 percent annual rate over the last two years. Since much of this spending is for high technology equipment, it has helped raise productivity and increased efficiency. In fact, high tech office and computer equipment increased at a 60 percent rate last year and is expected to continue to increase this year although at a somewhat slower rate. This capital spending boom also includes more traditional types of industrial machinery and equipment as well. In fact, order backlogs for industrial machinery continue to grow.

The ability to finance these investments has been helped materially by the decline in our budget deficit from $300 billion two years ago to what will probably be about $200 billion this year. This, in turn, reduces the crowding out of private sector enterprises from capital markets to make room for the risk-free obligations of the government. That makes more capital available to the private sector.

With the dollar relatively cheap and United States products more competitive in world markets, in a quality sense, the export sector of the economy is likely to expand strongly in the next year or two as the economies of our principal trading partners move from recession to expansion. Canada, Japan, the U.K., Germany, France and Italy are important markets for U.S. products and their economic outlook is for better growth ahead albeit at markedly different rates. However, our trade deficit in goods and services won't be reversed in the near term because we have a tendency to consume more than we produce and growing prosperity will support consumption of imports at ever higher levels.

To sustain this favorable picture and keep inflation under some degree of control, the Federal Reserve has been attempting to anticipate future developments and apply restraint before inflationary forces take over. The lag in the effect of monetary policy changes is thought to be at least 10 to 12 months. Therefore, current monetary policy moves are taken in light of our projections of economic conditions in the future. This posture tends to make the Fed very unpopular when we are tightening because the reasons are not yet apparent in the current statistics. To be sure, monetary policy is an art thinly disguised as a science, and it alone cannot achieve and maintain economic equilibrium. Fiscal policy is also an important element, and in a global economy and global marketplace, events and conditions elsewhere are increasingly important variables in the equation.

In my view, not necessarily shared by my colleagues, the rather robust rate of growth in the first half of 1994 will slow somewhat in the second half, but for the full year I expect real GDP growth to be about 3¼ percent. Inflation will remain constrained during this year at a shade under 3 percent. My guess about 1995 is that the effects of 1994 monetary policy moves will slow the economy to a growth rate closer to potential and therefore less inflationary. That means real GDP growth for 1995 of about 2¾ percent. In that scenario, inflation may still creep up to about 3 percent due to forces already at work. But, there is, I think, a good chance that a growth pattern in that range can be sustained for some time without setting off an eruption of inflation.

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Let me switch now to banking. An important element in any healthy economy is a sound banking and financial system able and willing to finance economic expansion. I will not take your time to recite yet again the devastating effects of the collapse of much of the thrift industry in the United States. It has been an Augean Stables mess that will cost perhaps $150 billion when all is said and done. But, it is substantially behind us now. Also behind us are the related troubles in the commercial banks resulting from bad commercial real estate loans, made in the euphoric days when no one believed real estate values could do anything but continue to rise at a brisk pace. In the feeding frenzy to get and keep market share in that sure-thing environment, overconfidence resulted in compromised lending standards, inadequate equity in projects and overestimated markets resulting in badly financed gross overbuilding. Only now, five years later, is there any sign of real revival in commercial real estate construction.

Foreclosures, provisions and charge-offs wreaked havoc on bank operating statements and capital accounts, and just at the time we were phasing into compliance with the Basle risk-based capital standards. Several hundred banks failed and some of the very largest teetered on the brink of failure before regaining their balance.

In their efforts to rebuild their balance sheets and revitalize their income statements, banks significantly tightened credit standards and loan terms. The resulting contraction in bank credit probably contributed to the recession which, in turn, reduced demand for credit as businesses worked down inventories and reduced receivable ledgers in the face of shrinking sales.

The banking industry not only survived, but it has roared back to record profits and the strongest capital positions in thirty years. The largest 50 bank holding companies, which account for roughly two-thirds of the assets of the entire industry, are a useful proxy for industry-wide performance. For the first half of 1994, these banking organizations had a return on assets calculated on an annual basis of 111 basis points compared with 115 basis points in the first half of 1993. However, a new accounting rule, which caused banks to eliminate grand-slam netting of nonqualifying derivatives, had the effect of increasing reported assets. Adjusting for that accounting change, the return on assets performance of the top 50 was the same for both years.

While net interest margins narrowed as the result of higher interest rates and trading profits contracted, reduced overhead costs and lower provisions for loan losses more than offset those negative trends.

Assets and loans both grew at a healthy pace on a year-to-year basis, with assets up 8.6 percent and loans up 6.0 percent. Very difficult market conditions, rising interest rates, and market volatility reduced trading revenues and resulted in many banks substantially decreasing their risk positions, particularly in derivatives trading. Better expense control also contributed heavily to improved earnings. Overhead expenses relative to revenue peaked in 1990 at 70 percent. At present, the ratio is 64 percent and bank managers continue to put heavy emphasis on further improvement in the future. Loan loss reserves are at about $38 billion for the top 50. That works out to 177 percent of nonperforming loans. The ratio has improved dramatically from 1991 when it stood at only 73 percent of nonperformers.

Capital ratios have also improved. The capital markets have provided significant amounts of both new equity and debt capital. These factors, along with strong earnings, have raised the total risk-based capital of the top 50 to more than 13 percent and the equity ratio to 7.2 percent.

The return on equity for the first half was 15.5 percent, down a bit from a year earlier. As a matter of fact, a number of banks, believing they have too much capital to generate a return satisfactory to the markets, have started or announced programs to repurchase some of their shares. But, they will remain after the repurchase well capitalized and have high overall ratings for safety and soundness.

Again, using the top 50 bank holding companies as a proxy, one can conclude that the industry is in excellent shape financially and current survey information and anecdotal intelligence indicate aggressive competition among banks to obtain loans. That obviously bodes well for continued economic growth.

There have been two legislative initiatives over the last year or so which have potential importance to banking in the

United States, both for U.S. banks and foreign banks operating in the United States. The first is a broad act to provide financial assistance to organizations engaged in direct financing of community development projects. Since the purpose of the legislation was certain to attract wide political support in both parties, additional features were added which might not fair so well on their own. Among those were several modest attempts to relieve some of the regulatory burden on the banks, including a mandate to the regulatory agencies to review rules and regulations and eliminate obsolete or unnecessary ones. Taken individually, none of the relief measures are revolutionary. But taken in the aggregate, they constitute a significant reduction of burden. The bill passed both houses of Congress and may have already been signed by the President as we speak.

The second initiative, of even more importance to foreign banks, is a bill to permit interstate branching by banks. This will be the final step in breaking down the artificial barriers to geographic expansion. Included in the bill is authorization for foreign banks to branch interstate as well. In that case, the House conferees prevailed over the Senate conferees who had favored requiring foreign banks who wished to branch interstate to do so through a U.S. subsidiary bank rather than directly. That would have placed foreign banks at a distinct competitive disadvantage and would have been contrary to our established policy of national treatment. The bill also proposes a three-year moratorium on assessing examination fees to foreign banks. By that time the fee issue for all banks will have been examined more thoroughly.

It is expected that this revised legislation will pass after Congress reconvenes this week. In the unlikely event that it does not or that the President fails to approve it, the Federal Reserve will be obligated to begin to collect examination fees from foreign banks in the near future.

Finally, let me say a few words about derivatives. The explosive expansion of the use of derivative products, both for hedging and speculating, has created rising concern in the United States.

The topic is being discussed currently in an overheated environment created by recent market volatility, a few sizable accidents and a media reaction which has created an aura of mystery and danger. Those factors have stimulated the habitual reaction of Congress which is to regulate everything that moves.

Some would like us to believe that derivatives are a new phenomenon -- in fact, so new, so complicated and so dangerous that no one presently living can possibly understand them, let alone know how to manage them. Not so! Derivatives have been around for a long time and have been used primarily to contain risk by providing a way to hedge against price volatility, primarily in commodities but also in financial instruments. Futures and options contracts are veterans of tens of generations of use in the commodities markets; and forwards, short positions, puts and calls have been factors in financial markets as well.

To be sure, these instruments have not always been used solely on defense or to minimize risk. By their very nature, they can also be used for speculative purposes. But, then, what financial instruments <u>cannot</u> be used for speculation? In the most simplistic illustration, it can be argued that a person buying a share of stock, expecting the price of that share to go up while it is held, is speculating. If the price goes up, there is a profit; if it goes down, there is a loss. And, if the company invested in fails, the investors loses everything. The size of the bet only makes it more dramatic, but it doesn't change the fundamental elements of the transaction.

The complexity of certain of the newer, more exotic derivative instruments may make their operations more difficult to understand, particularly under varying degrees of volatility in the markets. To try to understand these new instruments, very sophisticated mathematical models have been designed to simulate the behavior of markets and of market instruments like these sophisticated derivatives during episodes of volatility which may be triggered by wide swings in interest rates.

During the recent episodes, some of the models failed to provide the guide to safe harbor because they assumed narrower swings in interest rates than actually took place.

Those who invest in hedge funds are generally well-heeled speculators, willing to take very significant risks in pursuit of higher than usual profits. Where the minimum investment is $250 thousand or even as much as $1 million, are we really concerned that some of the rich high-rollers lose a bundle in the course of a market adjustment? Well, I, for one, have not shed any tears over them. There is no evidence that uninformed widows and orphans are playing the derivatives market, unless, of course, they are very rich widows and orphans who should know what they are doing. And, if that's the case, who cares.

Much of the current rhetoric urging legislation to regulative derivatives and their use focuses on threats to the safety and soundness of banks. Some argue that proprietary trading in derivative instruments is extraordinarily risky and, therefore, inappropriate for United States banks with insured deposits. But, making term loans to businesses is probably the riskiest business of banks and we don't give that a second thought.

A simple but useful definition of banking is that the banker essentially manages financial risks for his depositors. His job is to <u>manage</u> risk not <u>avoid</u> it. It is certainly reasonable to assume that exotic, or at least exotically <u>named</u> derivatives are riskier than single-family mortgage loans. But does it follow that they are, therefore <u>un</u>manageable and should be prohibited to banks?

Let's be realistic. Derivatives are not new. They are not mysterious. And, if managed properly, like any risk, they are not particularly dangerous. A race car is not in and of itself a dangerous vehicle. It is only dangerous and life threatening in the hands of an ordinary driver. And, in that analogy lies the answer to the question of what to do about derivatives.

I am convinced that with full disclosure by banks of their derivatives activities and exposure, trained auditors and examiners will be able to assess the risk inherent in the activity and then make an informed judgment whether the risk management process in the bank is adequate to protect against disastrous loss that would threaten depositors and shareholders. A good risk management system must include:

-- A position monitoring and reporting system capable of keeping management absolutely current with market developments and the bank's position.

-- Stop-loss disciplines should be in place to automatically trigger the close-out of deteriorating positions.

-- Exposure limits should be in place for each category of risk undertaken and these should be specifically known to and approved by the board of directors.

-- Credit policies and procedures should provide for adequate assessment of counter-party credit risk.

-- Authority to make exceptions to position limits and stop-loss procedures should be vested in senior management officials who are not responsible for the profitability of the trading operations.

-- Market models used for designing investment and trading strategies should enable management to "stress test" the bank's position to identify emerging problems in a changing market.

-- And, finally, management, both top management and trading management, should have a thorough understanding of the instruments and how they are being used; and trading management should be experienced in trading in volatile as well as stable markets.

If examiners have enough information disclosed to them to make an accurate assessment of the degree of risk undertaken by a bank, they should then be able to judge the ability of a given institution to handle that risk and take whatever steps needed to adjust individual institutions to their individual risk tolerance.

Legislation would inevitably try to set standards or parameters for the industry which ignore individual differences among institutions. On the other hand, with disclosure and trained examiners, the supervisors will be able to recognize individual capacities and permit broader range for those who are qualified and restrict participation for the amateurs.

I am sure you sense my aversion to legislated regulation when good supervision can do a better job.

In summary, the U.S. economy and its banking system are in good shape and the central bank is pursuing a monetary policy aimed at sustaining growth without further inflation.

Thank you for your attention. I would be delighted to try to answer any questions you may have.

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