

Statement by

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before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

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I am pleased to be able to participate in this Hearing. The following are my responses to the questions posed by Chairman Fauntroy which are not dealt with in our joint statement.

What has been your bank's involvement with community and scholarly activities? In this connection, I would be pleased to know what work-training programs, upward mobility programs, affirmative action policies, forms for small and minority businesses, and research activities your bank has been and is presently engaged in doing.

Perhaps the most fundamental contribution of the Bank to the region we serve is our research program on the New England economy. This program which absorbs a sizable part of our research budget, has over the years led to the Bank becoming known as a center for objective expertise on New England economic problems. Our regional research staff routinely services requests for data and analysis from New England Governors and Mayors. They were actively involved in the resolution of the financial crises of the State of Massachusetts and the City of Boston.

We have cultivated close contacts with the New England academic community. Two prominent economists, James Duesenberry of Harvard and Robert Solow of MIT, have served as Chairmen of the Board of Directors of our Bank. We solicit the views of a panel of prominent New England economists prior to each FOMC meeting and transmit them

to the FOMC members as part of our contribution to the Red Book. We sponsor one or two conferences a year on some topic of pressing interest. These conferences have served to strengthen the ties between the Bank and the academic community. In a conference to be given next month on government policies to influence the savings rate, we will have papers presented by faculty members from Harvard, MIT and Yale, as well as by economists from outside the region.

The Bank is actively involved in efforts to resolve the social, as well as the economic problems, of our region. I serve as chairman of the Tri-Lateral Council for Quality Education, a business group which seeks to improve the quality of the Boston School System. I am also Vice Chairman of the Boston Private Industry Council, a member of the Advisory Council to the Coalition of Northeast Governors and a member of the Coordinating Committee (sometimes known as "The Vault"), which is a business group concerned with the problems of the City of Boston. We encourage Bank officers to get involved in community affairs. Among other affiliations, our officers are directors of the Neighborhood Housing Services, the Massachusetts Higher Education Assistance Corporation and the New England Education Loan Marketing Corporation.

As a member of the Tri-Lateral Council for Quality Education, the Bank has entered into a partnership arrangement with South Boston High School under which we contribute to enriching the educational experience of the

students. We also seek to prepare students for entry into the world of work by counseling, teaching them how to participate in a job interview, and providing the experience of a part-time or summer job. Twenty-five students from the South Boston High School worked in the Bank this summer.

The Bank operates a Skills Development Center in which disadvantaged young people who do not meet our minimum employment standards are taught clerical skills and good work habits. Seventy-eight trainees have graduated from the program and have been placed in permanent jobs, including sixty-six placements within the Bank. One graduate of the Skills Development Center is now a computer programmer.

The Bank is a member of the New England Minority Purchasing Council and, as part of our affirmative action program, has an annual target for purchases from minority vendors.

The status of business and financial liquidity, in the economy as a whole and in your District, and the implications for monetary policy.

The lack of economic growth during the past three years, together with declining profitability and high interest rates, has depressed business liquidity to a record post-war low. For nonfinancial corporations, the debt-to-asset ratio now has reached 60%, well above the customary 50% established in the late 1960s and 70s. During the 1980s to date, about two-thirds of business borrowing has been short term. High leverage and high

interest rates have pushed the ratio of debt service charges to cash flow above 50%, well above the 30% ratio that prevailed during most of the 1970s. A drop in the rate of return on assets has been responsible for much of the erosion in business liquidity. The rate of return on total nonfinancial corporate assets is only about two-thirds of its level in the late 1960s and early 1970s.

While we have no direct estimates of regional business liquidity, there is no reason to believe that conditions in New England differ sharply from those nationally. Nonetheless, we know of no major New England corporation which is currently suffering a severe liquidity squeeze. The major decline in interest rates of recent weeks has undoubtedly helped to ease the situation of many firms and the sharp rise in common stock prices should make it feasible for some of them to strengthen their equity positions.

The commercial banks of New England are in good condition, undoubtedly reflecting the relatively strong performance of the New England economy. While it is too early in the game to form a final conclusion, my impression is that loan losses at New England commercial banks, while showing a rising trend, may not be as serious as the loan losses suffered in the 1974-75 recession.

The thrift institutions of New England are highly liquid, reflecting very conservative asset management since 1975. We have seen very few forced mergers of

thrift institutions in New England, in large part because their capital positions tend to be substantially stronger than the thrift industry nationally.

The implication for monetary policy is that the Federal Reserve must remain alert to evidence of any generalized liquidity problem and to any development which might threaten the viability of the financial markets.

Employment and business conditions in the economy, as a whole and in your District, and the implications for monetary policy.

The New England States have weathered the recession relatively well. Unemployment rates throughout most of the region have been consistently below the national average. During the first six months of 1982, the average unemployment rate in New England was 7.8 percent, which compares with the U.S. figure of 9.1 percent. Total employment has tracked closely the national trend, despite the loss of approximately 50,000 state and local government jobs in Massachusetts attributable to Proposition 2½.

This relatively strong performance reflects the transformation of the New England economy, with competitive high technology companies gradually replacing the old-line industries. Some of our high technology companies have been adding to their employment rolls right through the recession. New England is also benefiting from the upturn in defense procurement, which is cushioning, for many companies, the decline in consumer demand for their products.

On the other hand, New England is heavily dependent on capital goods production. Many high technology products are investment goods, and the region is still active in machine tools and other more traditional capital goods industries. These companies have been living off their order backlogs. New orders are weak because of high interest rates and the strength of the dollar on the foreign exchange markets, which has made our exports less competitive in world markets. More than anything else, these companies need public policies which will reduce the cost of capital and render financially feasible investments which have been shelved because of high cost of money. Policies which expand total demand without bringing interest rates down are not going to meet the needs of New England's capital goods producers.

The relative importance of further reductions in inflation at this time compared with the state of employment and business conditions and liquidity.

We are at a delicate juncture for monetary policy. We must have a policy which provides a financial base for a sustained upturn in economic activity while, at the same time, providing assurance to the financial markets that the Federal Reserve continues determined to reduce the rate of inflation in the years ahead. To restore the economy to a healthy state, produce a substantial decline in the unemployment rate, and generate the increases in productivity necessary to produce rising

real incomes for the people of the United States, we must reduce the costs of capital for new investment. A precondition for a healthy economy is a healthy bond and stock market. To generate a healthy bond and stock market, we must convince the investor that the inflation rate is going to continue to decline in the years ahead. This is why inflation control must not take a back seat to any other policy objective.

Disinflation is a painful business. We have paid a heavy price for the gains we have made thus far, but the gains are real and critically important. The inflation rate is down substantially, we have seen a surprisingly large decline in the rate of advance in wages and salaries and there is evidence of fundamental changes which will show up in sizable productivity gains as the economy turns up. We have begun to lay the foundation for a strong economy for the balance of the 1980s.

Yet these developments are viewed with a heavy layer of skepticism by many players in the investment markets. They saw the inflation rate decline and wage rate increases decelerate in the wake of the 1974-75 recession, but it proved to be purely a cyclical phenomenon. Because we were unwilling then to continue to give high priority to inflation control coming out of the 1974-75 recession, the gains won at such heavy cost soon evaporated and we moved quickly back to stagflation--with high unemployment and double digit inflation.

After the 1974-75 recession business liquidity improved only superficially. During the late 1970s, rising inflation eroded business profitability while inevitably increasing the cost of long-term financing. As a result of this experience, I believe that a steady reduction of inflation is a precondition for sustaining growth and attaining acceptable levels of employment and business liquidity in the 1980s.

We should learn from the experience following the 1974-75 recession, but many in the financial markets are not sure that we will. When they are convinced that we will stay the anti-inflation course, long-term interest rates will come down sharply.

The appropriateness and viability of the monetary targets currently used by the Federal Reserve, specifically the M-1 aggregate, and your views on alternative targets, including the monetary base, a credit target, GNP, or targetting of real or nominal interest rates.

I have come to the conclusion that we can no longer measure the money supply of the United States with any kind of precision. By that I mean that we can no longer draw a clear line between money and other liquid assets. Innovation and the computerization of the financial system are revolutionizing the manner in which the American people handle their cash balances. This has brought us to the point where any definition of the money supply must be arbitrary and unsatisfactory; i.e.,

it must include assets that some people view as short-term investments (not transactions balances) and exclude other assets that some people consider part of their transactions balances. Cash Management, Sweep, and Money Market Accounts are making "idle" transactions balances disappear. In the future, people may have much less need for transactions balances--funds may pass from a buyer's cash management account to a seller's cash management account, existing as transactions balances only long enough to complete the trip.

All of the monetary aggregates can be distorted by shifts from one type of liquid asset to another, shifts which have no significance for monetary policy. To an increasing degree, longer-term securities and real assets have also become an abode of purchasing power because these assets may be tapped for transactions purchases on demand through modern credit arrangements. More and more purchasers look to their "lines of credit" rather than their check book balances in completing their transactions.

Thus, we have a serious measurement problem with the concept of money. We have been attempting to deal with this problem by periodically revising the definition of the money supply. This raises another issue. What we call M-1 in 1982 is not the same thing that we called M-1 in 1975. There is no necessary reason to believe, therefore, that the new M-1 (and its successors of future

years) will behave in the same manner relative to nominal GNP as the old M-1. Furthermore, M-1 velocities have risen more rapidly in recent years in response to rising interest rates. Presumably, as interest rates move down, we should expect a slowing in velocity--but when and by how much? With all the uncertainties surrounding both the measurement of M-1 and its relationship to the nominal GNP, I have concluded that the monetary aggregates, particularly M-1, are no longer suitable guidelines for monetary policy.

My suggested alternative is total liquid assets, which is both stably related to the nominal GNP and unaffected by shifts from one type of liquid asset to another.

I should add that the problems with M-1 as a target for policy are problems for the future, not the present. If we had been implementing a total liquid assets target in 1982, we should probably have chosen a range of 8 to 11 percent. The growth rate for total liquid assets thus far in 1982 has been somewhat above the upper limit of this range. Thus, a switch to total liquid assets would not have produced an appreciable difference in monetary policy in 1982.

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