

The Changing World
of
Central Banking

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Four major developments of the past 20 years have greatly influenced the making of monetary policy in the United States. They are: the rapid integration of world trade and finance, the deregulation of the banking system, the move to floating exchange rates and the financial aftermath of disinflation. To varying degrees all central banks have been touched by these changes, but the Federal Reserve has, perhaps, been more affected than most.

I suspect that the delegates to the Bretton Woods Conference would be dazzled by the growth of world trade since 1945 and even more surprised at the current magnitude of international capital movements. The pace of change in international trade and finance, particularly since 1970, has been so rapid that policy-makers have been hard pressed to cope with its consequences.

Integration of World Trade and Finance

In the United States, the total of exports plus imports of goods and services amounted to 12-1/2 percent of the GNP in 1929. By 1940, this share had declined to 9 percent, reflecting the general shrinkage in world trade. It took 25 years after the end of World War II for this figure to return back to the 1929 level. Then, in the short span of 10 years, 1970 to 1980, it doubled to about 25 percent. Since 1980, it has remained above 20 percent.

If we can say that the U.S. economy is now twice as integrated into the world economy in terms of trade as it was in 1970, the multiple for the integration of the financial sector must be substantially higher. This is more difficult to quantify. One measure might be U.S. bank claims on foreigners. In 1950, they amounted to only about \$1 billion. In the following 15 years, to 1965, they grew to \$12 billion. In the next 15 years these claims ballooned to \$204 billion, and in three years, 1980-83, they more than doubled to \$430 billion. Foreign claims on the United States grew in a similar pattern.

The Federal Reserve Bank of New York estimates that foreign exchange trading in the United States rose from an average daily volume of less than \$1 billion in 1969 to more than \$23 billion in 1980 and to almost \$34 billion in 1983. The Group of Thirty recently estimated that average daily foreign exchange transactions worldwide doubled between 1979 and 1984, rising from \$75 billion to \$150 billion, a number whose magnitude goes far beyond the needs for financing trade.

Until the late 1970s, the econometric models used by the Federal Reserve in forecasting the U.S. economy were essentially closed economy models. Year-to-year changes in our net export position were so small that they could easily be ignored in forecasting the GNP. Not so today. In 1986 and 1987 changes in the U.S. exchange rate and our net export position are likely to be a dominant (if not the dominant) factor in determining the growth of output and employment in the United States.

In setting monetary policy 20 years ago, the Federal Reserve generally needed to ponder only the impact of interest rates on domestic economic activity and the longer-run consequences of changes in the money stock on our inflation rate. Under Bretton Woods there was no short-term linkage of interest rates to the exchange rate for the United States. Capital movements were infinitely smaller in those days, national money markets were much more independent, international debt levels were quite small and there was no such thing as floating-rate debt.

The integration of world trade and finance has considerably complicated monetary policy-making. Changes in U.S. interest rates have a much more direct and immediate impact on other countries than they did 20 years ago--through three channels.

First, with the internationalization of the dollar and the vast increase in capital mobility, the independence of national money markets has been greatly reduced. Changes in U.S. interest rates rather quickly influence interest rates around the world.

Second, changes in U.S. interest rates are likely to affect the exchange rate between the dollar and other currencies, with consequent changes in trade flows, employment and inflation rates.

Third, with about 80 percent of international debt denominated in U.S. dollars, and most of that on a floating-rate basis, even small changes in U.S. interest rates can cause serious changes in the real debt service burden of debtor countries.

The financial world is a much smaller place than it was in the 1960s. The Federal Reserve, as a consequence, must give

considerable attention to the effect of its policies on the world trading and financial system. In the long-run, there is no conflict between the optimum monetary policy needed to meet the domestic objectives of the United States and the optimum policy from the standpoint of the world economy. In both cases welfare will be maximized long-run if the U.S. economy can be sustained on a moderate growth path, avoiding the boom-bust cycles and the large swings in interest rates of the past. However, there will be occasional short-run conflicts. In both 1983 and 1984, U.S. monetary policy firmed in response to an economy growing at an unsustainably rapid rate. The short-run effect may have been to retard briefly the growth rate of the world economy and to increase the debt service burden of some developing countries, but it is highly likely that in the absence of those policy moves in '83 and '84 the current level of U.S. interest rates would be significantly higher than it is.

Deregulation of the Banking System

The deregulation of the interest rates that depository institutions may pay has had several positive consequences. It has increased competition for the funds of the small saver, opening up an array of new financial instruments that offer a market rate of return together with a variety of services. By eliminating the de facto subsidization of home mortgage rates, deregulation will produce a more economic allocation of resources between residential investment and business investment. Unfortunately, deregulation also has had two adverse consequences for the conduct of U.S. monetary policy.

First, in the deregulated system larger interest rate changes will be required to produce a given domestic economic impact than was the case in the regulated system. In the 1960s the Federal Reserve was able to influence the economy with relatively modest interest rate changes. Whenever market interest rates rose above the regulated ceiling rate, funds would flow out of depository institutions and widespread nonprice rationing of credit would take place. Borrowers who did not have access to the money markets were not able to obtain credit, even if they were willing to pay higher rates. The housing industry, in particular, responded promptly to any movement of market rates above or below the regulated ceiling rate.

In the deregulated environment, nonprice rationing of credit is largely eliminated. Mortgage money will always be available at a price. Almost the entire burden of adjustment is thrown on price-rationing of credit. Inevitably, larger interest rate swings will be required than in the regulated system.

In an era of widespread financial fragility, when changes in U.S. interest rates have more international ramifications than ever before, this might be viewed as an unfortunate structural change. An additional burden is placed on American policymakers to avoid economic conditions which might lead to wide interest rate swings.

The second adverse consequence of deregulation is that it has blurred the line between money and other liquid assets. In the 1960s the line was very clear. Payments could be made only by demand deposits and currency. In addition since no interest could be paid on demand deposits, there was a strong incentive to restrict

assets held in this form to the amount needed for transactions purposes. Neither of these conditions exists today in the United States. Payments are being made from a variety of accounts paying a market rate of interest. The line between money and other liquid assets is irrevocably lost in the United States. It is one of the ironies of economic history that monetarist doctrine found its most widespread support at the very time that it became impossible to measure the money stock.

My response to this situation has been to recommend that we move from targetting "money" to targetting liquid assets, a proposal which has, thus far, received a total lack of support from my colleagues in the Federal Reserve System. It seems likely that the Federal Reserve and other central banks will be groping in the years to come for some financial variable which can be used in place of "money" as a guideline for monetary policy.

Floating Exchange Rates

The move to floating exchange rates combined with the great increase in the international sector of the U.S. economy have made the exchange rate a much more important factor in U.S. monetary policy formation than it was in earlier years. For most central banks, the exchange rate has always been a critical policy determinant; since the international sectors of their economies have been large enough that changes in exchange rates could have major domestic impacts on employment, output and the inflation rate. For the United States, however, this is a relatively recent phenomenon.

Under the Bretton Woods system, the exchange rate of the United States was determined by the actions of other nations in devaluing or revaluing their currencies against the dollar. Because of the asymmetry in the Bretton Woods arrangements, which put great pressure on deficit nations to devalue but little pressure on surplus nations to revalue, the effective exchange rate of the United States steadily appreciated. Even as late as 1968 and 1969, when it was widely believed that the dollar was overvalued, the dollar exchange rate was still rising on a trade-weighted basis. The short-term linkage between U.S. monetary policy and our exchange rate which we see in the marketplace today did not exist under the Bretton Woods arrangements.

The structure of the international accounts of the United States in 1969 was the direct opposite of the current situation. In 1969, we had a current account surplus. The problem was that it was much too small to finance the very large investments that U.S. corporations were making abroad. As a consequence, dollar holdings were accumulating abroad in both official and private hands. U.S. investments abroad, while they turned out to be very profitable, were undermining the essential premise of Bretton Woods, which was that the dollar should perpetually be in short supply.

Perhaps the turning point in the influence of the exchange rate on U.S. monetary policy was the Saturday meeting of the Federal Open Market Committee in October, '79. Paul Volcker returned hurriedly from the International Monetary Fund meetings in Yugoslavia convinced that, unless the Federal Reserve could persuade the world financial markets that a dramatic change had been made in

U.S. monetary policy, the dollar would decline sharply further, exacerbating an inflation rate that was already running at 10 percent. Since that meeting, the exchange rate has had increasing weight in the formulation of U.S. monetary policy.

Financial Aftermath of Disinflation

Until the 1970s, periods of rapid inflation, such as the one at the outset of the Korean War, were very brief. They did not cause a change in the long-term expectations of borrowers and lenders. The inflationary tide of the 1970s, however, lasted long enough to produce such a change. Increasingly, loans were made on the assumption that a rapid rate of inflation would persist in the future, and lenders demanded large inflation premiums in interest rates.

The sharp and sustained decline in the inflation rate in the 1980s has left in its wake a weakened financial system. Most of the problem loans in the banking system, whether they be agricultural loans, oil loans or loans to the developing countries have one common characteristic--they are the product of the decline in inflation generally and the collapse in basic commodity prices in particular. These debt problems have been further complicated by the fact that interest rates have come down much more slowly than commodity prices. In the future, when we reckon the costs of inflation, we should include in the total the costs of dealing with the financial residue of disinflation.

This is the first major disinflation that we have seen since the early 1930s. In past periods of disinflation the resulting financial problems were resolved by financial panic, severe

recession, wholesale bankruptcies and widespread debt liquidation. We are attempting to improve on this classical model, but it is a messy business.

In some cases, we may be able to grow our way out of the problem. The real burden of the Latin American debt would shrink considerably if the growth of world trade should accelerate, if basic commodity prices were to rise and if U.S. interest rates were to decline. A further decline in interest rates would also do much to resolve the problems of the thrift industry. In other cases, where we cannot buy enough time to resolve the problem, our objective must be to localize it so that failures in one sector do not spread to others. In the process, Federal Reserve officials are getting a lot of on-the-job training in crisis management.

Conclusion

Monetary policy decision-making is a much more complex process in the 1980s than it was in the 1960s. We can no longer view the United States as a closed economy. We must weigh the impact of any change in policy on the exchange rate for the dollar, the resulting feedback on employment and inflation in the United States and the impact that changes of U.S. interest rates will have on the rest of the world.

In setting policy objectives, we must understand that in the deregulated environment, with non-price rationing of credit largely eliminated, restraining an overheated economy will require much larger swings of interest rates than we saw in the 1960s. Furthermore, with the blurring of the line between money and other liquid assets, money is not likely to remain a reliable guide for monetary policy.

In this new environment, it is my judgment that the optimum monetary policy is one that will keep the U.S. economy on a moderate growth path, avoiding the boom-bust cycles of the past and the associated large swings in interest rates. The fragility of the financial system suggests that the cost of failing to keep the economy on a moderate growth path may be much higher in the future than it was in the past.