

ODE Dinner
John Carroll University
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Concerns Facing the Federal Reserve

I. Introduction

- A. Joke -- Job of a central banker is to have nightmares. OR The definition of a central banker is a person who is afraid that someone, somewhere might be happy.
- B. Because I am now a central banker I will focus on the concerns I see facing the Federal Reserve over the next year or so.
 - 1. Inflationary Risks
 - 2. Risks facing the financial industry
 - 3. Difficulties with developing country debt

II. Inflationary Risks

- A. An inflation-free environment should be the Federal Reserve's primary objective because it is the only way we have to achieve maximum sustainable growth and other important goals.
- B. Today we see some inflationary risks.
 - 1. Import prices have risen.
 - 2. Demands on productive capacity can be strained.
 - 3. Economy remains strong.
- C. Federal Reserve should specify a path for reducing inflation, starting at about four percent for 1988 and going to zero in some reasonable time period -- three to five years.

III. Financial reform at a crossroad.

- A. In debating and deciding on the steps to deregulate the financial industry, the fundamental goal should be to reinvigorate market incentives and tests of performance in banking and other financial markets.

- B. The intent of bank regulations may have been to insure safety. Some regulations undoubtedly have worked in that direction, but there have been other consequences as well -- some have worked in the opposite direction.
 - 1. Have encouraged the entry of non-regulated suppliers of financial services and driven business outside of long-established channels.
 - 2. In some cases, risk-taking has been encouraged in banking itself.
 - a. Overnight financing by large banks in the federal funds and the repo markets has mushroomed, adding fragility to banking and money markets
 - b. Banks, seeking to compete with new entrants, have taken business off balance sheets with devices such as standby commitments and guarantees adding new elements of risk.
 - c. Deposit insurance has also encouraged risk-taking.
- C. Deposit insurance reform is necessary.
 - 1. Adopt risk-based deposit insurance system.
 - 2. Place more stringent limits on insurance such as \$100,000 per person.
 - 3. Enforce current limits.
- D. As we restructure the financial service industry, basic principles of capitalism should be our guide.
 - 1. Market forces should determine the outcome including the blend of financial and nonfinancial products offered by a firm, as well as the risk profile of firms.
 - 2. Market incentives and risk evaluation must include possibilities for gain and the risk of loss and ultimately failure.

IV. Difficulties with developing country debt.

- A. Since the onset of the developing country debt problem in late 1982, the heavily indebted countries have undertaken a series of painful economic adjustments that many had hoped would enable debtors to fully service their international debts.
 - 1. Despite these adjustments, the burden of debt for many developing countries has continued to grow in absolute terms and relative to the debtors' capacity to service the debt.

2. The ability and willingness of many debtor countries to undertake further economic adjustments has begun to erode.
- B. The Debt Buildup -- the 1970s witnessed a rapid growth in the external indebtedness of developing countries.
1. Oil price shocks
 2. Financing growth -- increasing proportion of the inflow of capital in the 1970s represented debt, rather than equity capital and growing share was in the form of commercial bank loans, rather than official loans or bond issues.
 3. Changing world economy -- rising real interest rates and a world-wide recession.
 4. Internal policies -- large budget deficits reduced domestic savings available for domestic investment.
- C. Belief in Full Repayment
1. The initial step following the unfolding of the developing-country debt problem in 1982 was to reschedule loan repayments and to maintain debt service through both official channels and commercial banks.
 2. The second step was to institute economic adjustment programs in the debtor country, usually under the auspices of the IMF.
 3. The Baker Plan, initially offered in the late 1985, essentially took this approach.
 4. Creditors seemed to view the debt situation as a liquidity crisis, which would be solved by time, economic growth in creditor countries, and resource adjustment in debtor countries.
- D. Debt Repayment Problems -- Debt repayment problems occur when external or internal events push debtor countries off their expected growth paths, leaving debtors with obligations to service debts that exceed their ability to make the necessary real resource transfers.
- E. Outlook for Resolution
1. Worldwide economic conditions will be important -- a number of projections suggest that growth by the major industrial countries of approximately 2.5 to 3.0 percent annually would be necessary to absorb debtor country exports.

2. Economic conditions have worsened in many debtor countries and has resulted in increased financial market tensions surrounding the international debt situation.
 - a. Despite economic austerity programs, rescheduling, and additional funding, the total external debt of heavily indebted countries rose to an estimated \$485 billion in 1987 from \$350 billion in 1981.
 - b. Debt burdens remain well above the capacity of heavily indebted countries ability to service them completely.
 - c. The ratio of outstanding public and publicly guaranteed debt to exports rose from \$101.5 percent in 1981 to 267.9 percent in 1986.
- F. The secondary market reflects concerns -- outstanding debt traded at 77 percent of book value in January 1986, the index has fallen to 47 percent.
- G. Major U.S. creditors began to take actions in 1987 that reflected lack of progress in debtors countries' resource adjustments.
 1. The U.S. banking system has reduced its exposure -- by June 1987, the exposure of U.S. banks to the 15 heavily indebted countries had fallen to \$84.4 billion from \$90.2 billion in 1982.
 2. Banks have made large additions to capital -- exposure as a percent of capital declined from 136 to 68 percent.
 3. In December many large regional banks made further substantial additions to reserves -- in many cases raising reserves beyond 50 percent of exposure.
 4. Markets have rewarded banks that have taken steps to reduce their exposure.
- H. As recent developments suggest, a more market-oriented approach now seems to offer us greater hope of attaining that goal.
- I. Solutions are unlikely to come from bold new government financing programs.
 1. Resource adjustments must involve both creditors and debtors.
 2. Creditors must provide debtor countries with increased access to their goods markets.
 3. Debtors must continue to pursue regulatory and structural changes in their economies that will attract foreign investments and that will encourage export-oriented growth.