PROBLEMS OF THE DOLLAR-- AT HOME AND ABROAD

REMARKS BY

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I was pleased to be included in the program of the 25th Annual National Credit Conference of the American Bankers Association, particularly since you are meeting in my new "home base." For there is certainly enough in the way of mutual interest for us to discuss. If there is one theme which seems to underlie your program, it is the variety and pace of change that is affecting the country and the banking industry.

Over the past two decades, I have come full circle from central banking to commercial banking and return. Travel is broadening, it is said, and I have observed a number of changes in the craft and practices of banking in this journey.

The innovations of bankers have enlarged the variety and scope of financial services available to the public—and have also challenged the resourcefulness of the central bank on many occasions. The interactions involved in this dynamic process have paved the way for progress in the field of banking and finance.

As we meet today, the problems of the dollar at home and abroad must rank high on the list of matters deserving our attention. Simply stated, at home we are experiencing a rapid expansion in the economy—which is laudable in many ways—but which also shows signs of strains and continued inflationary pressures. Abroad, despite the 10 percent devaluation of the dollar which had already occurred on February 13, our currency was faced with another acute crisis late last week, in a speculative assault that produced a temporary closing of official exchange markets.

Taken together, these developments are certainly enough to cause all of us to "stop, look and listen." In an earlier era, such a climate would have signalled strong deflationary policies, especially by the central bank. But we no longer live in a world where such single-minded remedies are acceptable, and solutions must be sought across a broader front.

What are the major implications of these developments for the economy, for credit markets, and for public policy? In particular, what are the implications for banking? As best I can in the time available, I would like to address these problems.

Booming Economy and Demand for Bank Credit

The real growth of the economy has been expanding for the past five quarters at an average annual rate of 7¼ percent. This much expansion is something of a mixed blessing. On the one hand, it has brought idle resources back into production and has cut by half the gap between estimated "full employment output" and actual output. At the same time, the rate of growth that we have been experiencing is nearly three percent above the long-term trend rate. Activity in the capital goods and consumer goods industries already is attaining boom proportions, and therefore some moderation in these sectors would be welcome. A continuation of current rates of expansion could generate excess capacity and unsustainable inventory accumulation, resulting in a readjustment or even recession.

The economic outlook for the year has been widely presented and discussed, both from official and private sources. According to the most widely-held view, real growth for 1973 as a whole should about match the 1972 pace of 6.4 percent.

However, the distribution of the growth throughout the year is likely to be less even, with a strong first half and a slower second half. The combination of rising employment, higher social security benefits and an extra $8 billion of Federal tax refunds from overwithholding in 1972 should result in at least a 10 percent increase in after-tax personal income. With strong demand impinging on the economy, the possibility must be recognized that the rate of inflation in 1973 could move higher than the 1972 pace of 3 percent, instead of reaching the announced goal of a lower rate.

The strong growth in total output in 1972 was accompanied by a record expansion in bank loans, with an increase of $56 billion. Within the framework of an accommodative monetary policy, there were sharp advances in all categories of bank loans —e.g., mortgage loans by over $16 billion, business loans by nearly $14 billion, and consumer loans by $10 billion.

Given the prospects for the domestic economy in 1973, several widely-known private forecasts are anticipating a demand for bank loans about as large as last year's record increase. The composition may be somewhat different, however. Given the pace of business capital spending and inventory accumulation, the increase in business loan demand may be even larger than in 1972, while consumer loan growth may continue to be as strong. On the other hand, growth in mortgage loan demand may slow down somewhat, in view of the expected decline in housing starts.

Since the first of the year, it is evident from published data, actions and policy records that a firmer monetary policy has already been adopted. The growth of key monetary aggregates has slowed down from the rate prevailing in the second half of 1972. The discount rate was increased in both January and February, to bring it into better alignment with rising short-term open market rates stemming from strong credit demands, and also in view of developments in foreign exchange markets, to further the objective of economic stabilization.

Wholly apart from further policy moves which could develop from the current problems of the dollar abroad, bankers should be asking themselves: "Where are the funds going to come from to satisfy burgeoning loan demand?"

Toward a Viable Policy on Loan Commitments

According to press reports on your meeting a year ago, the presidents of four large banks said they constantly feared that loan demand might exceed their ability to meet loan commitments, even though the industry was doing a better job of gauging the potential usage of lines of credit and firm commitments. As one panelist put it, "The airline and hotel industries know the extent to which they may be oversold. Our nightmare is that someday we may wake up and find we are over-extended."

If that was a proper concern a year ago, it is even more relevant today. I believe it is a healthy development that banks are giving increased attention to the whole problem of what constitutes a prudent upper limit on loan commitments. Bankers should become more cognizant of the risks attendant to making loan commitments which are likely to be exercised at a time when loanable funds are scarce and expensive.

In 1969, for example, commercial banks, faced with a $4 billion net outflow of deposits, tapped some $20 billion in nondeposit sources of funds with which they were able to make good their commitments and to expand credit by about $16 billion. Fulfilling commitments partly through the purchase of Eurodollars at rates of 11 to 13 percent was, however, a very costly undertaking. These rates were well above the 8.5 percent prime rate, or even the prime rate plus a stipulated spread written into loan agreements. In fact, the subsequent introduction of the floating prime rate in part represented an effort to lessen this gap by tying the lending rate more closely to current yields in the money market.

In view of these considerations, I would urge banks to continue their efforts to work toward a viable policy on loan commitments. Specifically, this should involve efforts to project or forecast loan demand under alternative conditions affecting economic activity and the demand for credit. The individual bank is not able, of course, to alter the overall economic and credit environment, but within certain limits it may tailor its balance sheet to meet anticipated changes in economic activity and the demand for credit.

I seriously doubt that there is a universal formula applicable to all banks. Rather, each bank must develop reliable information on the utilization rate of its lines of credit and firm commitments, especially during periods of tight money. In my judgment, that is the key to developing a policy for each bank on a workable upper limit to such commitments.

It is no more realistic for a bank to base its plans on 100 percent utilization of loan commitments than it is to plan on 100 percent withdrawal of its demand deposits. But unless it knows what the utilization rates have been in the past, and makes estimates of the level and timing of future peaks in utilization, it is flying in the dark. Moreover, the prudent upper limit to commitments will vary widely between banks, based on such factors as their liquidity in the form of secondary reserves, the strength of their capital position and hence their ability to incur losses from sales of non-liquid assets, and their ability to deal in "liability management"—i.e., reliance on interest-sensitive "purchased funds." In turn, the capacity of a bank to rely on purchased funds hinges on such matters as the stability of other sources of funds, especially demand and savings deposits, and its ability to increase the rate of return on loans when the cost of purchased funds is rising.

In any event, if past experience is any guide, the present and prospective climate is likely to produce an increased utilization of loan commitments already on the books. Thus, from my vantage point, it would appear that for most banks a substantial further increase in commitments at this time could invite a liquidity and profit squeeze.

International Monetary Problems—
Implications for Banking

American banking has been greatly affected in recent years by structural changes and institutional innovations in the field of international finance. As a consequence, international monetary disturbances such as we have experienced in recent weeks interact quickly with our banking system through linkages with banking systems abroad.

U.S. banks have placed special emphasis upon the rapid expansion of their foreign branch systems and Edge Act facilities in order to service the growing banking needs of their customers abroad. A similar tendency for foreign banks in the U. S. to expand has stiffened banking competition here.

In the period 1965 to 1972, assets of

agencies and branches of foreign banks in the United States increased three-fold to about $13 billion, and the assets of foreign branches of U. S. banks increased about eight-fold to about $75 billion.

One of the most significant innovations over the last decade has been the development of the Eurodollar market. This market offers a means of financing the overseas activities of U. S. banks, and in periods of tight money has been a source of funds for domestic needs of such banks. On balance, most observers would agree that the Eurodollar market has been a major constructive force in the financing of economic growth and expanded international trade.

At the same time, however, the Eurodollar market has a potential for transmitting monetary instability, as witnessed by recent developments. With the size of the market estimated at about $80 billion, the shifting of even a fraction of this amount to "strong currencies," for speculative or precautionary motives, can quickly undermine the viability of the fixed exchange rate system that has prevailed in the postwar world.

As we know, last Thursday foreign central banks were forced to absorb well over $3 billion of U.S. dollars in support operations designed to maintain the new currency parities agreed upon in the currency realignment of February 13. The bulk of the support operation was undertaken by West Germany. This new crisis for the dollar resulted in closing the official foreign exchange markets of leading countries, and according to announcements from the finance ministers of the European

Common market, official exchanges will remain closed all of this week, pending an agreement on new measures to restore monetary stability. Meanwhile, the major European currencies will all float unofficially against the U.S. dollar. President Nixon has made it clear that there will be no further devaluation of the dollar in terms of gold. The present crisis is not justified by existing exchange rate relationships, but rather has speculative origins.

The question thus arises as to whether the volume of Eurodollars, especially as fed by chronic deficits in the U.S. balance of payments, has become unduly large in view of the lack of any international control over it. It would be unfortunate if the constructive aspects of the Eurodollar market had to be sacrificed because of the role which Eurodollars may play in exchange-rate instability. Thus, participants in the market have a vital stake in measures to restore a workable international monetary system, which among other things, requires urgent attention to the U.S. position in international payments.

The currency adjustments associated with the February 13 devaluation of the dollar were important first steps toward reestablishing competitive prices for U.S. goods abroad and restoring the U.S. balance of payments to reasonable equilibrium. They were only steps toward these goals, however, and in the light of events last week, it is clear that much more needs to be done and be done quickly.

The basic causes of international disequilibrium remain. Many of these causes concern the restrictive conditions under which international trade is conducted. Some of these, such as discriminatory tariffs and quota restrictions abroad and the desire of some foreign countries to maintain persistent balance of payments surpluses, are in the hands of other sovereign states and thus lie beyond our control. Others concern the structure of the world payments system, which clearly needs to be overhauled. The responsibility for devising a stable world payments system and maintaining the stability of that system once established, must be shared by both surplus and deficit countries. In particular, those nations with persistent balance of payments surpluses should take appropriate steps to adjust their position, so as to aim for equilibrium.

But much of the responsibility for the international financial disequilibrium of the last few years lies at our own doorstep. We have had an almost uninterrupted string of balance of payments deficits since 1950. In the early 50's these deficits, which ranged generally from $1 billion to $4 billion per year, were welcomed abroad. They were part of our effort to rebuild the war-depleted reserves of other countries and thus hasten the restoration of currency convertibility in the Free World. In the early 60's, our deficits also generated the dollars needed by the private sector abroad to meet the growing requirements of a burgeoning world economy.

Our continued deficits, however, generated more dollars than the world wished to hold. As this became apparent, we adopted various measures to reduce if not eliminate the deficits—including the Interest Equalization Tax, the

Voluntary Foreign Credit Restraint Program, and controls over direct foreign investment by business.

Still the deficits persisted. The U.S. trade surplus, long a mainstay of our balance of payments, began to deteriorate after reaching a high level of nearly $7 billion in 1964. By 1968 and 1969 it was little more than $600 million. The following year (1970) the surplus rose to $2.2 billion, only to drop sharply into a $2.7 billion deficit the following year, the first annual trade deficit experienced by the U.S. this century. This was followed by a $6.8 billion trade deficit last year. Even though exports rose by $6.1 billion in 1972, the deficit grew because imports increased by $10.2 billion. In part this reflected a more rapid increase in business activity in the U.S. than in most countries constituting our major export markets. Also contributing to the U.S. trade deficit last year was the rise in import prices relative to the rise in export prices due in part to stronger inflationary pressures abroad than here, and to the initial perverse effects of the Smithsonian currency adjustments on our trade position.

In recent years our overall payments deficits have been on such a scale as to swamp the monetary systems of other countries. In 1971 the deficit on a gross liquidity basis was nearly $24 billion, and was even larger (almost $30 billion) on the official reserve transactions basis.

Last year, even though there was some improvement, the U.S. balance of payments deficit was still extremely large by historical standards—$15.6 billion on a gross liquidity basis and $10.1 billion on the official reserve transactions basis.

It is obvious from the recent turmoil in the exchange markets that deficits of this magnitude are wholly incompatible with world financial stability today. Recognizing this, Federal Reserve Chairman Arthur F. Burns, in a recent statement before the Senate Banking Committee, called for a program to end the deficits within a period of two to three years. This will not be easy—but it is essential that it be done. In a multi-national world economy, there is no simple solution to international financial problems which require multilateral action. Each nation must make its full contribution to world economic order. Discriminatory trade restraints must be removed by the countries imposing them. The U.S. export growth needed to improve our overall balance cannot be expected to overcome such obstructions. It is therefore of the greatest importance that the work of removing trade restraints (particularly quota systems and other non-tariff barriers) go forward without further delay.

It is also essential and urgent that a viable international monetary system be devised and put in place.

We could threaten to impose import restraints of our own, or more stringent controls over capital flows, but these measures would carry with them the seeds of self-defeat through the stifling of trade, and widespread economic dislocation. One important contribution to world economic order would be to end inflation in the U.S. An effective program, not only in monetary policy, but particularly with respect to fiscal policy, could be expected to help calm the inflationary expectations now undermining the dollar abroad.

It will not be enough to completely overhaul the machinery of international trade and finance. Such an overhaul will not do the job if we are not capable of using the machinery properly. If inflation in the U.S. is not subdued and domestic stability restored and maintained as a continuing national policy, no trade programs and no programs of monetary reform will restore international stability. The U.S. is too large a part of the world and the dollar too important a currency to permit indifference in the conduct of our domestic affairs. One key to international stability is confidence in the dollar abroad, and the key to that confidence is economic stability at home.

To achieve this, we must use every means at our disposal. Monetary policy is a powerful tool, but one that works best in making adjustments before stresses reach dangerous proportions. But it is no substitute for the power of fiscal policy, and monetary policy cannot contend against perverse fiscal policy. Solutions to our problems on the international front require us to respect and observe the classic policy prescription of "putting our house in order"— advice we have freely given other nations for a great many years. What role can we expect of fiscal policy?

Fiscal Restraint Urgent

The restraint on expenditures reflected in the Administration's current budget plan should merit particular attention from the banking community, especially in view of the support of a restrictive Federal budget announced by the American Bankers Association last fall. All too frequently in the past, public policies of restraint have leaned most heavily upon monetary policy while fiscal policy was at best neutral, and at worst expansive. As a result, monetary policy became more restrictive and interest rates soared.

A failure to achieve a reduction in the rate of growth in Federal spending commensurate with Federal revenues in 1973 and 1974 could result in a continuation of deficits even at full employment. In the 1974 budget fully three-fourths of all Federal outlays are categorized as "relatively uncontrollable." These expenditures include social programs financed out of trust funds, interest on the public debt, and obligations and contracts from prior years, to name but a few of the items. The proportion of "uncontrollable" items in the budget has grown 10 percent from 1971, and this rising proportion severely limits the ability to impose restraints upon spending.

The emphasis upon restraining growth in nondefense spending in the President's fiscal 1974 budget, arises from the fact that nondefense spending now constitutes the largest part of the budget. In 1968, when the Viet Nam build-up was approaching its peak, nondefense spending made up less than half of the total budget. In 1974, it will account for well over two-thirds of the total budget. The plain fact is that nondefense spending has grown relatively and absolutely at a faster rate than Federal revenues. In order to restrain growth in Federal expenditures, priorities must be assigned to programs, and the ones which have outlived their usefulness or which do not generate benefits proportionate to their costs must be reduced or eliminated.

A fiscal policy which engenders a succession

of Treasury deficits restricts the options of the central bank and commercial banks as well. It is a responsibility of the Federal Reserve to facilitate Treasury financing operations, and the more frequent the trips to credit markets, the smaller the latitude for implementing a consistent monetary policy. The end result is that credit for the private sector is less available and more costly than would have been the case if fiscal restraint had been exercised. To this end it is imperative that we achieve a better mix of monetary and fiscal policy.
As a bare minimum, the growth of Federal expenditures should be held to the growth in revenues in periods of near-full employment when deficits would be inflationary. At present, it would be even better if the "full-employment" budget showed a surplus, and some observers are recommending a tax increase, if necessary, to achieve this objective.

In Conclusion
The problems of the dollar at home and abroad are formidable—in view of domestic inflationary pressures and a speculative attack on our currency in the foreign exchange markets. But these problems can be dealt with successfully, given the cooperation of all major groups in society, including the banking industry.

In some ways, we are engaged in a bold new effort to solve these problems through a coordinated use of monetary policy, incomes policy (Phase III), and fiscal restraint. It is only in this manner that the Federal Reserve System can achieve its goal of helping to restore non-inflationary growth without a credit crunch. If fiscal policy and price-wage restraint fail to carry their share of the burden, the whole country—including banks and their customers—will be the loser.