

Remarks by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

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There is a commonly held view that Hawaii is the nearest thing to paradise here on earth. I'm also conscious that central bankers have a certain reputation: like puritans, it is said, we have a haunting fear that someone, someplace may be happy. So you have left me with a dilemma -- whether to remain in character or to remain in Hawaii.

Well, I have to tell you character won out.

The opportunity to meet, however briefly, with so many American bankers, at a time of challenge is simply too good to let slip by without intruding on paradise for a few minutes to discuss our common problems.

But, at the risk of losing my reputation, I also want to assert that the hard realities I will be addressing come in the midst of enormous opportunities. For the national economy, there is an opportunity to build on the progress so visible now toward both economic growth and toward greater price stability. For banking, there is an opportunity to deal with the disarray and uncertainties -- with the hazards and the inequities -- so evident in the legal and regulatory apparatus surrounding banking, and to do so in a way consistent with our common interest in an efficient, competitive, and strong banking system. There are indeed obstacles to success -- but they are obstacles we can clear away.

Virtually every person in this audience is conscious - sometimes painfully so -- that the economic adjustments of recent

years have left an imprint on your balance sheets. Consciously or not, borrowers and lenders alike, too often had counted on continuing inflation in undertaking commitments. The recession itself drained the financial capacity of more marginal borrowers. Prolonged high interest rates have added to the strains.

To see credit problems among your business borrowers show up, even as the economy as a whole is on the mend, is not in itself unusual. In a few areas -- notably energy, where change was so abrupt -- problems are more acute than after the last recession. But many banks had fortunately been working to restore the capital strength eroded in the 1970's, and they have been able to maintain satisfactory profits in recent years. In the context of a growing economy, the problems can be contained.

In dealing with domestic credit problems, bankers have long known that potential losses can often be minimized, and the interests of their customers and their communities best served, by working closely with borrowers over a period of time, by revising loan terms to meet new circumstances, and, where fundamental prospects justify it, even by extending new credits to bridge a period to financial health.

I need not emphasize that the process can be tedious and time consuming, and it is never free from risk. But the alternative would be more costly, involving the unnecessary failure of customers and jeopardizing the future prospects and growth of the bank itself.

What is unique in our postwar experience is that the residue of domestic credit problems is today accompanied by the problems of many countries in servicing their external debt. The magnitude of the problem can be seen in a few broad statistics. Excluding OPEC countries, developing nations - where the problem has centered -- have total external indebtedness of about \$575 billion. While much of that is owed to public bodies and commercial creditors, close to half -- \$285 billion -- is owed to banks around the world, and something over \$100 billion to U.S. banks alone. Concentrations, as might be expected, are particularly high with respect to a few large developing countries that had achieved dynamic growth in the 1970's.

It's easy to sit back now and analyze the factors, beginning with the oil shocks of the early 1970's, that led to an unsustainably rapid buildup in debt. Borrowers and lenders no doubt made mistakes, generated in part by attitudes arising out of years of inflation, low -- or non-existent - real interest rates, and confidence that funding would always be available. Lending to sovereign borrowers for balance of payments needs does not have some of the natural discipline associated with project lending or lending to private enterprises.

There are lessons here for banks, for borrowing countries, and supervisors alike. That is the core of truth in the demands in our Congress and elsewhere for a review of regulatory and supervisory procedures, and, as you know, the banking agencies

have been working together to review and modify approaches toward the supervision of international lending.

As we work in those directions with an eye toward the future, we cannot escape dealing with the immediate problems in the international debt area. We all have an enormous stake in managing those problems effectively. That is obviously true for the many larger banks with substantial foreign loans. But it is an illusion to believe that any of us -- managers of large or small banks, domestic borrowers, or citizens generally -- could escape scot free in the kind of financial environment implied by a breakdown of international credit flows.

We have a strong safety net under our own banking system, as do other leading countries. But however effective those arrangements as a last resort -- and however astute the conduct of monetary and fiscal policy in the face of such a breakdown -- there would be unavoidable risks for our credit markets, for interest rates, and thus for the prospects for growth here and abroad.

In the past year, after the Mexican crisis erupted into world view, attitudes have often seemed to oscillate between fear and complacency. After the initial demonstration of strong cooperation, the sheer magnitude of the continuing effort -- involving hundreds of banks, a number of borrowing countries, and the governments and central banks of the industrialized world -- has sometimes led to a sense of weariness. Questions are occasionally raised about whether

such an effort could, or should, be maintained. My answer is simply there has not been, and is not now, a reasonable choice. We cannot afford a sense of complacency that the problem is over, or that we can leave it to others to solve. And the stakes are too high to fail.

Grand plans set forth by some calling for massive injections of new governmental assistance and across-the-board forgiveness of some debt and interest simply are not negotiable; looking toward the longer future and the need to restore normal flows of credit, they would be of questionable value. Each borrowing country has unique characteristics, economically and politically; each requires, however laborious it may seem, its own approach for effective solution.

There are, however, common patterns upon which to sustain a cooperative effort. Indispensable to all else, the major borrowing countries have themselves recognized the fundamental importance to their economic future of maintaining their credit standing. In most difficult circumstances, they have attached high priority to maintaining as orderly debt service as possible.

Typically, working with the International Monetary Fund, they have moved to get on top of their problems by introducing aggressive programs of internal and external "adjustment" -- to use the euphemistic jargon of economists. The immediate manifestation is often domestic austerity,

marked by cutbacks in imports and production. But, well designed, those same programs offer the promise of dealing effectively with inflation and restoring the base for domestic growth and external stability.

The criticism of some that such programs are "anti-growth" seems to me to miss the point. In the absence of strong adjustment actions, external financing could not prudently be made available. In those circumstances, the risks to world growth, and to the borrowing countries themselves, would be much greater, as widespread default led to a breakdown of international financial arrangements, with all that would imply in shutting off flows of new credit now and into the future.

Given the magnitude of the needed changes in economic policy and structure and the time required for these to work their effects, the success of these programs requires restructuring of existing debt and, typically, some amounts of new credit to bridge the period of adjustment. In some instances, governments can, and have, played a crucial role. They have provided short-term liquidity pending the availability of IMF disbursements and new bank loans, extended fresh export credit and rescheduled their own loans. But the brunt of such financing efforts, naturally and inevitably, must fall on the world commercial banking community, as the major creditor.

In concept, the approach is consistent with that relevant to domestic borrowers in difficulty. What is special, under existing circumstances, is that the success of the entire effort, as you well know, requires extraordinarily close coordination among private and public lenders and negotiating a uniform approach among so many banking institutions.

Indispensable is an overworked word, but in all of this the International Monetary Fund truly has such a role. First, it works with the borrowing country in appraising its economic measures so that it can, in effect, certify as to their adequacy to achieve the necessary results. As an essential complement to that effort, it provides some of its own funds to assist in covering temporary financial needs, and works with other creditors to assure the overall adequacy of the financing plan.

One of the ironies of our time is that, just when the capacities of the IMF are being tested and engaged more fully than ever before, questions have been raised about the continued support of its leading member -- the United States. It's not just a matter of the money involved in the quota increase pending before the Congress, important as that is. Symbolically, the failure for the first time to approve an internationally agreed increase in IMF resources -- by design or otherwise -- could only be widely interpreted as an unwillingness on the part

of the Congress to support the current effort of so many nations and institutions to manage and contain the situation. As the President made plain in his eloquent remarks at the recent IMF-World Bank meetings, failure of that effort could lead to "an economic nightmare that could plague generations to come." In the Congress, questions have been raised as to whether the banking community is really united behind this. I hope you will clarify that matter.

As I suggested a few minutes ago, the understandable concerns of the Congress about the role and responsibilities of banks, supervisors, and borrowers in the past and in the future are being addressed, as part of the legislative process and otherwise. At the same time, we must recognize the legitimate and necessary role of international credit in an expanding, market-oriented world, and resist legislating rigid measures destructive of that role. That is the approach we and others have taken in working with the Congress on the proposed legislation, in the process consulting with banks active in international lending.

At this stage, any evaluation of the current situation with respect to international debt is bound to show a mixed pattern. Our neighbor to the south -- Mexico -- is well along in implementing its economic program, the rate of inflation is declining, and its international financial position has improved markedly. But we also have to recognize that this more solid footing has been achieved in the midst of severe domestic recession, and at a depressed level of imports. The challenge remains to retain and build on the evident progress as the economy, and imports, recover.

Signs of financial stabilization in a number of Latin American countries are appearing, in some cases despite the effects of droughts and floods. In the largest country of all -- Brazil -- the comprehensive revised economic program developed by the leadership of that country over the summer is now being implemented. Some signs of progress as a result of these and earlier efforts can already be seen -- especially in a growing trade surplus.

A complementary financial program has been developed, and now must receive the early commitment of hundreds of commercial banks, as well as the governments involved.

The success of each part of the Brazilian program -- the fundamental economic adjustments and the financing -- will, in the end, be dependent on the other. Both aspects are now in a critical phase. As in other instances, it is a combination of effective adjustment and adequate financial support, equitably shared among creditors, that would appear to provide the best means available -- it may be the only means available -- to enhance the creditworthiness of the borrower and protect the interests of the creditors.

The point has been made over and over that the ultimate success of all these efforts is dependent on sustained economic recovery in the world at large. Over time, it is demonstrable that, with actively growing export markets, the debtor countries

will be able to resume orderly economic expansion at home consistent with significantly lower debt service ratios. I cannot stress enough, in that connection, the need to resist protectionism and to encourage open markets in the industrialized world, a task made immeasurably easier in the midst of continuing growth.

It is also apparent that that process of growth and expanding export markets is necessarily a matter of years -- not months. Realistically, we must approach the debt problem with the knowledge that extraordinary cooperative efforts will be required for some time before more normal lending patterns can be restored.

But I must also point out that the process will be greatly speeded, and better assured, to the extent interest rates decline, most of all in the United States, because of the simple fact that so much of the developing country debt is denominated in dollars at floating interest rates. And I would also emphasize that the "adjustment process" is more than a matter of adjusting trade flows. Many borrowing countries have seen their problems aggravated by lack of confidence, by their own citizens as well as by potential foreign investors. As these nations demonstrate success in achieving internal financial stability, in freeing internal markets, and in maintaining a strong competitive position, they can anticipate increasing and retaining their own savings, attracting some of the capital of their own citizens back from abroad, and

seeing new equity investment from foreign businesses. Then, indeed, the return to full external financial equilibrium will be speeded.

In concentrating on the debt problems of the developing world, I would remind you that more economically advanced countries, currently as well as in the past, have by no means been free of inflationary and budgetary excesses. Happily, we in the United States have made enormous progress against inflation, are in the process of recovery, and can currently enjoy a strong dollar and a high level of capital inflows. But we must not be blind to the evident risks to the sustainability of that progress -- risks that are within our own control.

Our recovery is still unbalanced in important respects. In particular, exports continue to decline, the trade deficit has risen to historic and disturbing levels, and our "smokestack" industries are still suffering from recession, from competitive problems, and from high interest rates. Many would question the sustainability and balance of the recovery over a long period should interest rates remain at such high or higher levels.

The progress against inflation -- and expectations that it can be sustained -- should itself over time provide a strong base for lower interest rates. But we have -- as you well know -- a strong market factor weighing in the other direction. I am referring, of course, to the massive continuing and prospective deficit in the Federal budget -- a deficit not very much less than our capacity to generate net domestic savings and equivalent

to about 40 percent of all the funds available in domestic credit markets. One implication is that, at a time when the whole world needs capital and debt problems are aggravated by continuing high interest rates, the United States is absorbing tens of billions of dollars of capital from the rest of the world as our international trading position erodes -- that situation cannot persist indefinitely.

I won't linger over the fiscal problem longer because it has become so familiar. Let me simply say that failure to address our continuing structural budget deficits would pose, in all its implications, the greatest single threat to balanced and sustained recovery partly because it aggravates the problems of other debtors at home and abroad. The frustration is that the wide consensus on the nature of the problem has not been matched by effective action. We cannot, in my judgment, be content to delay action until a crisis is upon us.

I am conscious that I have left little time to discuss the developments and prospects for institutional change in banking -- a matter that justifiably has been the source of a great deal of uneasiness and uncertainty among you. My own concerns have been elaborated in considerable detail elsewhere. The pervading atmosphere of unfairness and competitive distortions, the constant stretching and testing the limits of law and regulation and clear circumvention of their intent, as well as the sense of regulatory disarray, are inherently troublesome and

unhealthy. In the end, the process could weaken the banking system and impair continuing basic objectives of public policy.

As you know, we in the Federal Reserve worked with the Treasury as it developed a comprehensive approach toward defining and expanding the powers of bank holding companies. We have and do support the general approach of the Administration's proposed legislation, and have suggested some areas where modifications appear desirable. That legislation would, entirely apart from the new powers specifically called for, provide for a sweeping simplification of the entire process of regulating bank holding companies, an important objective we share with you.

We approach these matters, as you know, with the conviction that the banks of the country -- and the payments system they largely administer -- play a crucial role in our economic life. In reflection of their special role, banks have long been supported by a broad public safety net, and are subject to certain regulations and supervision designed to protect their safety and soundness.

That supervisory responsibility has long been divided between the state and federal governments, and among several government agencies, including the Federal Reserve. A review of those arrangements has taken place from time to time by the Congress and others, and now has been initiated again by a Task Group headed by Vice President Bush, of which I am a member.

I believe it would be a mistake, in terms of practical legislative and timing considerations, to attempt to deal with this historically controversial issue in the Congress before or during the debate

on the range of substantive issues encompassed by pending legislation. But there also can be little doubt that questions concerning the supervisory apparatus can usefully be raised and reviewed in the light of today's markets and legislation emerging out of the present debate on powers and geography.

In considering the appropriate locus for regulatory oversight, it may be useful for me to make one fundamental point. The charter of any central bank, implicitly or explicitly, encompasses a responsibility for protecting and promoting the stability and orderly functioning of the banking and financial system; indeed, it was those concerns that led to the establishment of the Federal Reserve. The idea that something called monetary policy -- defined as concern about some abstractions labelled monetary aggregates -- can be separated from concerns about the strength and nature of the institutions that actually supply and manage the money supply strikes me on its face as illogical.

Day after day, I am struck by an irony. Bankers understandably emphasize to me again and again the need, in our supervisory or regulatory policies, to take account of the broader implications for, say, the continuity of foreign lending, stability of the international banking system as a whole, and other concerns of monetary policy. Conversely, they often and rightly emphasize the impact of certain monetary policy decisions on their institutional strength and behavior.

Let, at the same time, I learn of banking lobbyists scurrying around Washington promoting the notion that somehow these concerns -- monetary and regulatory policy -- should be in separate compartments, administratively completely divided. That naive and narrow notion, I fear, has even seeped into a recent pronouncement by the ABA itself. I hope I have misinterpreted it.

In any event, let's consider the issue on its merits, not by disingenuous pronouncement. There are obviously areas of supervision and regulation peripheral to the basic concerns of a central bank, and some have long been under the surveillance of others. But you should also understand that any so-called "reform" that had the effect of crippling the ability of the Federal Reserve to carry out its basic central banking responsibilities would be unacceptable to me. Those essential responsibilities encompass effective influence on, and an active presence in, those supervisory, regulatory, and operational areas critical to the stability of the banking and payments system. Lest there be any doubt in your minds, those concerns cannot, in my judgment, be met simply by receipt of information from other agencies.

In this area, I know we share with you a natural and abiding interest in the financial strength of our banking institutions and their ability to innovate and compete. That fundamental common concern, in my judgment, does not require that the role of a supervisor, in banking or any other regulated industry, be confused with that of chief industry cheerleader,

expected to urge on every proposal made by industry groups. Rather, there is a clear responsibility to evaluate those proposals -- and to take initiatives of its own -- against the background of both continuing public policy objectives and particular industry concerns.

Finally, let me say explicitly what I take for granted. The range of problems that I have touched upon today -- problems of international and domestic credits, deficits in the budget, competitive pressures among financial institutions -- need to be resolved within a framework of continued progress toward price stability. No doubt, the transition to greater stability -- against the skepticism and expectations of so many -- has upset easy assumptions that inflation would "bail out" marginal borrowing and lending practices. Points of vulnerability in the financial system have been exposed.

In this situation, some might be tempted to call for relief the "easy way" -- to reinflate, to go back to the familiar days when rising prices seemed, at least in the short run, to cover a lot of mistakes and ease frictions.

But, as one country after another has found, accelerating inflation -- no matter how much indexing in an economy, no matter how much external disciplines are for a time ignored -- is simply not consistent with lasting growth and prosperity. And the longer you take to deal with inflation, the harder it becomes.

After all the strain and pain in restoring greater stability, we cannot turn back. That consideration remains at the forefront of our attention in formulating monetary policy. It necessarily limits our flexibility in meeting the demands for credit -- public and private -- and in managing the money supply. We all want to see recovery extended for years ahead while containing inflation. Monetary policy is working toward that goal. But success will be dependent on action in other directions as well -- on the budget, on keeping our financial system strong and our markets open and competitive, on encouraging productivity, and on discipline in pricing and wage bargaining in the decisions we all make day by day.

I close as I started. After years of turbulence, we have an enormous opportunity to achieve growth and stability over a long period ahead. We could, of course, lose that opportunity if, from fear or complacency, we fail to measure up to the obvious challenges. But then we would have no excuse -- for those challenges are so plain for all to see. And it is precisely because they are so evident that there can be no doubt that we can find the way to deal with them together.

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