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Statement by

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before the

Committee on Banking, Housing and Urban Affairs

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I appreciate the opportunity to appear once again before this Committee to review monetary policy in the context of our overall economic performance and problems. In accordance with the Humphrey-Hawkins Act, the semi-annual report of the Federal Reserve Board reviewing economic developments and the decisions of the Federal Open Market Committee with respect to monetary and credit targets for 1984 and 1985 was transmitted to you this morning. As indicated there, the FOMC reaffirmed the target and monitoring ranges for the various monetary and credit aggregates for 1984 and decided to reduce the top end of the ranges for M1 and M2 for 1985. I will discuss that later in my testimony. First, I would like to summarize some key points about the economy and call your attention to particular problems that present clear risks to an otherwise positive outlook.

## The Overall Economic Performance

Measures of aggregate economic activity, employment, costs, and prices have provided an almost unbroken string of favorable news so far in 1984. The process of recovery from the deep and prolonged recession -- a recovery that began amid widespread doubts about both its potential vigor and staying power -- had proceeded strongly through 1983. There were widespread anticipations early this year that, as we moved beyond recovery into a new expansion phase, the pace of growth would slow. But in fact growth actually accelerated as we moved into this year. During the second quarter of 1984, the economy as a whole operated at a level more than four percent higher than in the closing months of last year and 7-1/2 percent higher than a year earlier.

Almost three million more people have been employed so far this year, bringing the total gains over the past 18 months close to 7 million. The unemployment rate has dropped to about 7 percent. Business investment has risen very rapidly this year, while consumer spending has remained strong. The forward momentum of the economy still appears considerable.

At the same time, inflationary pressures have to this point remained subdued, with most summary price measures rising little, if at all, faster than the sharply reduced rate of 1983. In fact, a number of sensitive commodity prices have dropped recently, following sizable cyclical increases. Highly competitive domestic and international markets, influenced by the strength of the dollar overseas and continued strong efforts to discipline costs, have been key factors contributing to greater price stability. The net result has been rising productivity and good gains in real incomes, even while nominal wage and salary increases have remained moderate.

Looking only at these overall measures, this recovery and expansion period has been atypical -- atypical in the sense that such a rapid expansion has been maintained longer after the recession trough than in any comparable cyclical period since World War II, excepting only the Korean War episode. But the period has been atypical in other ways as well -- in ways that potentially could have severely adverse implications unless dealt with by timely and effective policy actions.

Imbalances and Strains

In any period of recovery and expansion, some sectors fare relatively better or worse than others, and in that general respect this period has been no exception. Some of our heavy industries -- for instance, steel and other metals and heavy machinery -- are still at operating rates well below earlier experience. Demand for our agricultural products from abroad has not been buoyant, and many farmers -- particularly those with large debts -- are being severely squeezed by high interest rates and falling land prices.

What is different, in degree and in kind, is that some inevitable unevenness in patterns of growth in particular sectors has been aggravated by the massive and related imbalances in both our fiscal position and our international trading accounts and by some strains in financial markets. As you know, rapid growth has been reflected in some reduction in the budgetary deficit, estimated for fiscal 1984 in the neighborhood of $170-$175 billion. The Congress is in the process of enacting the so-called "downpayment" against future deficits, part of which has already been signed by the President. But the hard fact is, as I am sure the Congress is fully aware, the deficit remains huge in absolute and relative terms, and absent further action little or no further decline now seems probable for 1985 and beyond, even assuming the economy continues to move to "full employment" levels.

That circumstance has been reflected in continued large Treasury borrowings, and expectations of indefinite continuation.

Meanwhile, private credit demands, responding to and supporting growth in consumption and investment, have accelerated. Personal savings relative to income have remained in the lower range characteristic of the late 1970s, and despite growth in internally generated corporate cash flows, the sources of domestic funds have fallen far below our demands. In these circumstances, interest rates -- already historically high -- tended to move still higher during the spring. Those high interest rates, combined with favorable economic conditions generally in this country, have attracted more and more capital from abroad to help meet our domestic needs, and the dollar has appreciated despite deterioration in our trade and current accounts.

The strong dollar and the ample availability of goods from abroad at a time when growth in most other developed countries has been relatively sluggish have certainly been potent forces helping to contain inflation. The capital inflow, supplementing our net domestic savings by a quarter, has been a factor containing pressures on our own financial markets. And, the large rise in our imports has helped stimulate economic activity among some of our leading trading partners and eased somewhat the severe adjustment process underway in Latin America.

But what is in question is the sustainability of that process, as the United States becomes more and more dependent on foreign capital, as our export and importing-competeting industries are damaged and seek protectionist relief, and as interest rate pressures remain strong. The only real question is whether the needed and inevitable adjustments will be facilitated and encouraged by constructive public policies, consistent with long-term growth and stability, or whether we are content, despite all the strains and dangers, to let events simply take their course. Short-sighted relapses into lack of financial discipline, widespread protectionism, and wage and pricing excesses could only aggravate the situation.

It is, in the end, the choice between building on the enormous progress of the past to achieve <u>sustained</u> growth in a framework of greater stability or a relapse into inflationary economic malaise. With that choice clear, I am confident that the needed policies are well within our collective grasp.

The continuing difficulties of some heavily indebted developing countries in Latin America, and in some other places as well, has been one point of uncertainty. A sense of greater concern has, ironically, come at a time when several of the largest borrowers have more clearly made substantial progress toward reducing external financing requirements and toward carrying out the more fundamental adjustments that should provide a firm base for their renewed growth. But other borrowing nations have made less progress, and the uncertainties have been fed by signs of growing protectionism in industrialized countries and by the increases in interest rates in the United States which impact directly on debt service costs of countries with large external dollar-denominated debt.

Within the United States, the relatively high level of interest rates has aggravated financial pressures in the farm sector. Many thrift institutions face the prospect of weak earnings at a time when capital positions have been eroded by losses earlier in the decade. And, despite the rapid growth of the economy and strong increases in business profitability overall, more stable prices have exposed some weaknesses in credit practices in the energy and other areas encouraged by earlier inflationary expectations.

Monetary Policy

These developments have provided the setting for the implementation of monetary policy thus far in 1984 and for the review of monetary and credit objectives by the Federal Open Market Committee for this year and next.

In reaching its policy judgments, the Committee members shared the widespread view that the overall rate of economic growth would moderate soon as resources become more fully employed and would continue through 1985 at a sustainable pace. While the rate of price increase has been somewhat slower than expected over the first half of 1984, that rate is generally expected to rise by a percentage point or so next year, assuming that the dollar remains in the same general range as over the past year. In making those projections, which are detailed in Table I attached, Committee members also noted that continued high budget deficits and other factors, unless dealt with effectively, would pose substantial risks of less satisfactory results with respect to economic activity or prices or both.

The economic projections, of course, took account of the decisions made on monetary policy. Broadly, monetary policy will remain directed toward providing enough money to support sustainable growth while continuing to encourage greater price stability over time. As detailed in the full report, Committee members felt that broad objective was consistent with the growth ranges for money and credit specified in February for this year, and no changes were made. For 1985, the tentative decision was reached to reduce the ranges slightly for both M1 and M2, specifically by lowering the top end of the ranges specified for this year by 1% and 1/2%, respectively. The target range for M3 and the monitoring range for domestic credit were left unchanged. These tentative decisions for 1985, reflected in Table II attached, will be carefully reviewed at the start of next year.

In assessing the appropriate ranges, and the relative weight to be placed upon the various aggregates, the Committee reviewed the evidence of more typical cyclical behavior of M1 in recent quarters relative to GNP, following the unusual behavior of velocity in 1982 and early 1983. In the light of that examination, it felt that roughly equal weight should be given each of the monetary aggregates in implementing policy. However, appraisals of their movements, and relationships among them, will continue to be judged in the light of developments in economic activity, inflationary pressures, financial market conditions, and the rate of credit growth.

While both M1 and M2 have grown within their targeted ranges of this year, 4 to 8 percent and 6 to 9 percent respectively, M3 and particularly domestic credit, have expanded faster than anticipated. Credit growth has, in fact, continued to outpace that of nominal GNP, as was the case last year but contrary to longer-term trends. Viewed in a medium-term or longer perspective, those growth rates for M3 and domestic credit are higher than consistent with sustainable rates of growth in the economy and progress toward price stability. For that reason, the Committee decided not to raise the target ranges for this year, feeling that would provide an inappropriate benchmark for measuring desired long-run growth, even though Committee members recognized that, as a practical matter, growth in these aggregates, at least for domestic credit, would likely exceed the specified ranges.

In reaching those judgments, the Committee recognized that the rate of business credit growth had been amplified by an unusual spate of merger activity and corporate financial reorganizations -- so-called "leveraged buy-outs" -- that had the effect of substituting debt for equity. The implications of those financings, while potentially adverse from the standpoint of the overall financial strength of particular businesses, are relatively neutral from the standpoint of demands on real resources and overall credit market conditions. Estimated adjustments for that activity on the rate of overall credit growth would reduce the indicated expansion over the first half of the year from a rate of about 13 percent to 12 percent, closer to, but still above, the monitoring range. That growth, together with the extraordinary rise in consumer and Federal Government debt, is shown in Table III.

Typically, Federal deficits shrink substantially as the economy moves into the second and third years of expansion -- there was a day when balance or surplus was the reasonable objective. That is not happening this time. And in contrast to 1982 and most of 1983, Treasury must compete strongly with accelerated demands for consumer and business credit and a continued high level of mortgage borrowing.

With long-term markets unreceptive, much of the increase in business and consumer borrowing is being done at banks. Thrift institutions remain highly active in the mortgage markets. These institutions, in turn, rely increasingly on certificates of deposit and other forms of market finance included in the M3 aggregate, accounting for its relative strength.

In implementing the policies reflected in the various targets, steps were taken during the late winter and early spring to increase somewhat pressures on bank reserve positions, and the discount rate was raised once, from 8-1/2 to 9%. Reserve pressures have not changed appreciably since that time, as reflected in relatively unchanged borrowings at the discount window (apart from those by the troubled Continental Illinois Bank). With both M1 and M2 remaining within their target ranges, and against the background of the economic, price, and financial market developments reviewed earlier, stronger restraining actions on money and credit growth generally have not appeared appropriate. At the same time, the relatively rapid rates of growth in M3 and domestic credit are flashing cautionary signals.

While pressures on bank reserves did not increase further, both long- and short-term interest rates rose over the spring. The continued heavy credit demands, expectations that those demands would persist against the background of the huge federal deficit and strong economic expansion, and fears of a resurgence of inflationary pressures as both labor and capital are more fully employed all played a part. In more recent weeks, rates have tended to stabilize at high levels, perhaps partly because current price trends have, at least so far, not borne out more extreme inflationary concerns expressed earlier. Nonetheless, markets remain volatile and apprehensive.

International and Domestic Banking Markets

The atmosphere surrounding credit and banking markets at times during recent months has been appreciably influenced by the apparent difficulties of one of the nation's largest banks and by continuing concerns over the ability of some developing countries to service debts held mainly by large commercial banks around the world.

As I have reported to the Committee before, orderly and full resolution of the latter problem will require a strong cooperative effort by borrowers and lenders alike over a considerable period of time. A few minutes ago, I noted there are, in fact, encouraging signs that the difficult process of internal and external adjustment is beginning to bear fruit in important countries in Latin America, including Mexico, Venezuela and Brazil. Negotiations are currently underway by the first two of those countries with banks looking toward a long-term restructuring of their external debt at terms reflecting the evidence of prudent policies and improving credit-worthiness. Provided that growth is maintained in the industrialized countries and markets for their products are not closed, prospects for economic recovery and growth on a sustainable basis in those Latin American countries appear more favorable, helped to a substantial extent by the growth in our own markets. In other countries the adjustment process is less advanced, but the progress of some, both in adjustment and financing, can point the way for others. While the challenge for all remains substantial, we need to view it realistically, as a situation that justifies neither neglect nor despair. Rather, appropriate approaches tailored to the needs of each country can bring results. But with that effort on all sides, the problem is manageable.

The problems of Continental Bank essentially reflected serious weaknesses in the domestic loan portfolio of a bank that had engaged in aggressive growth and lending practices for some time, including heavy involvement in participations in energy loans of the Penn Square Bank that failed two years ago. As other credit losses surfaced and earnings pressures continued, market sources of funding were reduced and the bank became heavily dependent on discount window borrowings during the spring. As the atmosphere surrounding the bank deteriorated and threatened to disturb markets more generally, the supervisory authorities, together with a group of other major banks, provided a massive financial assistance program pending a more permanent solution. I believe those more lasting arrangements will be announced shortly, and will provide a firm base for a healthy, but considerably smaller bank.

That situation is unique for a large bank, but the episode may be an object lesson about the importance of looking ahead to anticipate problems.

In a period of rapid economic and credit expansion, there can be temptations to relax prudent credit standards in an effort to maximize growth. With deposit markets deregulated, there may be a perception by individual banks that added funds can be raised as needed in domestic or foreign markets by bidding rates higher to fund larger and larger loan portfolios -- and that loan rates can be raised as fast as deposit rates. But the aggregate supply of funds is ultimately not really inexhaustible; confidence must be maintained, and high and volatile interest rates can undermine the credit-worthiness of weaker borrowers.

When external economic developments and high interest rates impair the ability of otherwise credit-worthy borrowers fully to maintain scheduled debt service on loans made earlier in a different economic environment, prudent banking may indeed suggest forebearance and renegotiation of outstanding loans. We, for instance, have introduced supervisory procedures to assure that examiners refrain from criticizing banks for exercising forebearance on agricultural credits when consistent with safety and soundness. I also believe that, when heavily indebted countries are moving aggressively to improve their credit-worthiness, restructuring of foreign credits over a substantial period, and the provision of new money as part of an appropriate adjustment program under IMF auspices, may be indispensable parts of a favorable resolution of the international debt problem over time.

But clearly the need remains to anticipate new problems, as well as to deal with old ones. Recent credit-financed mergers have attracted a great deal of attention, and some of those have involved very large and strong companies. But there is a disturbing element in some mergers and in leveraged buy-out activity viewed more generally; it reduces appreciably the equity cushions of the resulting company.

For the economy as a whole, equity in U.S. corporations (apart from retained earnings) was retired at an annual rate of some $75 billion over the first half of 1984. That seems anomalous at a time of rising business activity and profits, and when stronger corporate balance sheet ratios would be welcome. In evaluating prospective loans to support mergers or leveraged buy-outs, bank managers need to appraise the risks prudently, taking full account of the possibility of a more adverse economic and interest rate environment. That, of course, is and should be customary policy of banks, and I sense some have reviewed practices in that respect to make sure they are appropriate in today's circumstances.

Asset growth in any event needs to be supported by adequate risk capital, and I am glad to report that capital positions of the largest banks and their holding companies have generally improved over the past few years from the relatively low levels reached during the 1970s. The supervisory agencies are in the process of developing guidelines for further improvement for those banks and holding companies, and specific proposals are now being tested against public comment. The approaches we are adopting are, I believe, fully consistent with the intent of the International Lending Supervision Act sponsored by this Committee last year and, so far as holding companies are concerned, with the spirit of the provisions touching upon capital in S. 2851.

In that connection, I would also emphasize that capital adequacy and asset strength are only two of several important tests of the strength of a banking organization. Maintaining an adequate liquidity cushion and opportunities for maintaining and improving earnings without undue risk are also of critical importance.

## Conclusion

Indicators of overall economic performance have been exceptionally favorable for more than a year. So far, a strong economic expansion has been consistent with better price performance than we have enjoyed for many years.

At the same time, there are obvious strains, imbalances, and risks that, unless dealt with forcefully, could undercut much of what has been achieved. High interest rates are plainly a symptom of the excessive demands on our savings as well as lingering (and related) concerns about inflation. Certainly, there is no evidence, in the midst of rapid economic expansion, high rates of growth in debt, and the monetary trends I have described, that the economy has been starved for money and credit. Indeed, the challenge over time will remain to work toward growth of money and credit consistent with lasting price stability. And we need to do that in ways that relieve heavy pressures on vulnerable sectors of the economy, make us less dependent on foreign capital, and reduce strains on the international financial system.

None of these problems will be cured by attempts to drive interest rates down artificially by excessive money creation; the inflationary repercussions could only aggravate the situation. Nor can distortions arising from other sources be dealt with effectively by any general monetary measures.

But we are, as a country, by no means helpless in dealing with the strains and risks.

With respect to the budget deficits, as things now stand, deficits next year will remain in the same area as currently, and unacceptably large thereafter. The implications for financial markets and the economy become more adverse precisely as growth in the private sector generates more need for credit and capital. That outlook must be changed in the only way it constructively can be -- moving beyond the welcome "down payment" to further substantive action on the budget as soon as feasible.

With respect to our exceedingly large trade deficit, protectionist pressures are understandable, but it is no less important to avoid measures -- all too likely to be emulated abroad --

that would drive up costs, undermine the fabric of trade, and place new barriers in the place of heavily burdened debtors already struggling to make necessary adjustments. And industry and labor must continue to be sensitive to the need to remain competitive in their own wage and price decisions.

With respect to our financial fabric, public policy needs, at one and the same time, to respond strongly to threats as they emerge, while undertaking supervisory approaches, such as encouraging banks to increase capital, to strengthen that fabric over time.

And, of course, the challenge remains to reach appropriate judgments on growth in money and credit, with the objective of encouraging sustainable growth at more stable prices. I have spoken of our plans, and I am prepared to address your questions on that matter today.

But I first want to emphasize the success of all those approaches -- and they plainly are within our capacity as a nation -- are dependent on each other. No monetary policy can work without strains in the face of deficits that preempt so much of our savings as the economy is more fully employed -- and, of course, efforts in fiscal and trade policy must presume a prudent monetary policy consistent with stability and growth.

In the areas of our responsibility -- both monetary and supervisory policy -- we are working toward that end. We count on progress in other directions as well. The facts with respect to growth and inflation for more than a year demonstrate that we all have much upon which to build. But there are also clear signals that -- far from basking in the warmth of past and present progress -- the strongest kind of effort will be necessary to convert potential success into sustained growth and stability.

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Table I

Economic Projections for 1984 and 1985*

| | FOMC Members and other FRB Presidents | |
|---|---|---|
| | Range | Central Tendency |
| **1984** | | |
| Percent change, fourth quarter to fourth quarter: | | |
| Nominal GNP | 9-1/2 to 11-1/2 | 10-1/2 to 11 |
| Real GNP | 6 to 7 | 6-1/4 to 6-3/4 |
| Implicit deflator for GNP | 3-1/4 to 4-1/2 | 4 to 4-1/2 |
| Average level in the fourth quarter, percent: | | |
| Unemployment rate | 6-1/2 to 7-1/4 | 6-3/4 to 7 |
| **1985** | | |
| Percent change, fourth quarter to fourth quarter: | | |
| Nominal GNP | 6-3/4 to 9-1/2 | 8 to 9 |
| Real GNP | 2 to 4 | 3 to 3-1/4 |
| Implicit deflator for GNP | 3-1/2 to 6-1/2 | 5-1/4 to 5-1/2 |
| Average level in the fourth quarter, percent: | | |
| Unemployment rate | 6-1/4 to 7-1/4 | 6-1/2 to 7 |

*The Administration has yet to publish its Mid-session Budget Review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals is not included in this report.

Table II

Growth Ranges Reconfirmed for 1984 for Money and Debt
Compared with Actual Growth through June '84

| | Ranges | Actual Growth QIV '83 to June '84 |
|---|---|---|
| M1 | 4 to 8 | 7.5 |
| M2 | 6 to 9 | 7.0 |
| M3 | 6 to 9 | 9.7 |
| Debt 1/ | 8 to 11 | 13.1 e/ |

Note: Growth ranges pertain to period from QIV '83 to QIV '84.

e/ Estimated.

Tentative Growth Ranges Adopted for 1985

| | |
|---|---|
| M1 | 4 to 7 |
| M2 | 6 to 8-1/2 |
| M3 | 6 to 9 |
| Debt 1/ | 8 to 11 |

Note: Growth ranges pertain to period from QIV '84 to QIV '85.

1/ Domestic nonfinancial sector debt.

Table III

GROWTH IN DOMESTIC NONFINANCIAL DEBT
(Seasonally adjusted annual rates, percent)

| | QIV: 1983 to QII: 1984 1/ |
|---|---|
| Total | 13.1 2/ |
| Federal | 14.6 |
| Other | 12.6 |
| Selected Categories | |
| Home Mortgages | 11.7 |
| Consumer Credit | 18.4 |
| Short-term Business Borrowing | 15.6 |

1/ Based on quarterly average flow of funds data. QII: 1984 partly estimated.

2/ Adjusted for the credit used in corporate mergers and buyouts, it is estimated that growth in domestic non-financial debt would be about 12 percent (SAAR) over the first half of 1984.