# A Look at the Economy and Some Banking Issues

I am pleased to have the opportunity to meet with you today. For most of the past forty years, my distinguished predecessors at the New York Fed have shared with this audience their views on the important economic and financial issues of the day. With that tradition firmly in mind, it seems fitting that this is my first public address as president of the New York Fed.

In my remarks today, I want to first turn my attention to the economic situation and then to comment on a number of issues relating to banking, including the pressing—indeed urgent—need for banking legislation. I will conclude with a few brief observations on the role of the Federal Reserve Bank of New York as I assume the Presidency of that institution.

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Judgments about the economic situation require some perspective; a sense not only of where we are, but also a sense of from where we have come and where we are going. It seems to me that such a perspective—a capacity and a willingness to take that longer and more penetrating look—is particularly important in the current setting.

Remarks of E Gerald Corrigan, President, Federal Reserve Bank of New York, before the 57th Annual Mid-Winter Meeting of the New York State Bankers Association on Thursday, January 31, 1985

It was not all that long ago that the United States' economy and the economy of much of the world was being ravaged by rapidly escalating inflation That process of mounting inflation took its slow, insidious but inevitable toll on the most basic structural elements of our economy. Even today—after three years of modest rates of advance in wages and prices and after a deep and protracted recession—the legacies of that earlier period of inflation are still with us as, for example, in the inflation premium which remains embedded in long-term interest rates.

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Fortunately, there is little evidence at hand to suggest that a resurgence of inflationary pressures is likely in the near term, even as we enter the twenty-seventh month of the current economic expansion. In fact, most indicators of overall economic activity are encouraging The pace of real economic growth here in the United States seems to have regained an appropriate degree of momentum following the pause in growth in the summer and fall; inflationary pressures, as mentioned earlier, seem well contained at the moment; and, most of our markets for financial instruments as well as for goods and services seem to be performing relatively well with few signs of the congestion or bottlenecks that can often be symptoms of trouble down the road. There are, of course, some exceptions to this encouraging picture and I will comment on them shortly.

While some of the gains in economic performance over the past few years have been importantly influenced by cyclical forces, I believe one can now assert with some conviction that these improvements also reflect structural or more permanent improvements in the underpinnings of our economy. Let me cite a few examples:

—prompted in part by foreign competition, there is widespread evidence that businesses of all sizes have become serious about the business of business. Cost containment, productivity enhancement, and improved quality are the rule, not the exception

—there is increasing evidence of a determination to strengthen balance sheets in ways that, among other things, take account of the reality of a less inflationary environment.

—inventory management and control techniques and attitudes have been strengthened.

—consumers seem far more ready to search out lower prices and higher quality

—in a wide arena of activities—from trucking to banking—we seem more prepared to let markets do more and governments do less

—restraint on wage and salary increases has out-paced even once optimistic expectations, especially in industries where structural adjustments are taking place.

—finally, there are now straws in the wind—and perhaps more—to suggest that we are ready at last to tackle the harsh realities of truly massive structural budget deficits.

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If I am correct in postulating that these forces suggest that structural improvements in our economy are taking place, they also suggest that non-inflationary growth can be extended, not just for a few more quarters but well into the future Seizing that opportunity is obviously in our interest But I am prepared to argue that, if we do not seize it, the costs could be high indeed. I say that for several reasons.

—unemployment is still high, particularly considering the phase of the current economic expansion

—several key sectors of our domestic economy have not shared in the current recovery and thus are especially vulnerable to any generalized falloff in economic activity.

—protectionist attitudes are on the rise

—credit quality problems remain very much with us, again, especially considering the fact that we are in the third year of a business expansion.

—the debt burdened less developed countries remain vitally dependent on non-inflationary growth in the United States and in the world economy more generally.

—finally, and perhaps most importantly, a falloff in economic activity would aggravate the budget deficit and erode the political will to reduce its "structural" component

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Given the premium on growth arising from these factors, and the apparently subdued inflationary pressures in the economy, some might suggest the case for a policy of aggressive monetary expansion that would somehow yield real growth well in excess of what most observers expect for 1985. While I can readily appreciate the attraction of this point of view, I believe that such a strategy is simply too risky

For one thing, let us not lose sight of the fact that we cannot fine tune the economy. Therefore there can be no assurance that—even now—aggressively expansionary monetary policies would translate into higher real economic growth rather than higher prices. Let us also not lose sight of the fact that by historical standards the current rate of inflation is by no means low. In fact even modest rises in the rate of inflation would quickly put us back in the danger zone for both inflation and inflationary expectations

Beyond that, we must recognize that there are constraints on the capacity of the economy to grow at rates well in excess of its long-range trend rate of expansion—especially as the process of expansion matures. For the moment those constraints are not so much a matter of plant or even labor market capacity. Rather, the constraint that we must be sensitive to is the capacity of our credit markets to support rapid growth Vigorous expansion in the private economy in 1985 or beyond would, of course, have to be financed in a setting in which the flow of internally generated funds is already ebbing and will probably ebb further Unfortunately—given the budget deficit—there is precious little room to finance private expansion in the near term. Indeed, it may not be easy to finance even moderate rates of economic growth unless some actions of size and substance to reduce the deficit are forthcoming in the near term

Let me put the current credit market situation in some perspective. At the risk of an oversimplification and using well rounded numbers, our current situation is one in which savings flows amount to about nine and one-half percent of the Gross National Product Of that total, about seven percentage points is being generated domestically and about two and one-half percentage points—or more than 25 percent of the total—represent foreign savings

The demands for those savings flows start, of course, with the government itself since the government is always first in line at the credit window. Unfortunately, in the current setting, the financing requirements associated with the operations of the Federal Government are almost five percent of GNP. Thus, the Federal government is consuming about 50 percent of the available saving flows. Keeping in mind that fully 25 percent of those flows are coming from abroad, the hard, if not brutal, fact of the matter is that there simply is not much room to finance new cars, new houses and new factories.

Given the budget deficit and our dependence on foreign capital flows, the balance in our credit markets is very delicate. Any marked increase in domestic private credit demands or sudden diminution of foreign savings flows could put significant upward pressures on interest rates While superficially it would seem the Fed could "solve" this problem by pumping out more money, this so-called "solution" would be fleeting. The markets would very quickly see the inflationary implications in this, with the result being more rapid inflation and the very pressures on interest rates we sought to avoid Stated differently, the case for a basic and continuing discipline in the money and credit creation process—a discipline sprinkled with an appropriate dose of flexibility and common sense—is in no way diminished by our current situation—if anything, that case becomes more compelling.

**In considering the work yet to be done, nothing looms larger than the need to reduce the budget deficit. And, no single thing we can do holds the promise of greater rewards for both the internal and external sides of our economy.**

At the same time, the case for prompt and significant action to reduce the budget deficit becomes all the more urgent, particularly in the face of our staggering trade and current account deficits. The importance of effecting an orderly adjustment in those external deficits cannot be overstated While the need for orderly adjustment is clear and pressing, solutions do not come easily particularly since sudden and sharp adjustments—say, in the exchange rate—would not be accompanied by correspondingly sharp improvements in the trade and current account deficits in the short run

Thus, what we need is an adjustment process that gets at both the supply and demand sides of the credit market situation we face. That is, an approach that starts with reducing the budget deficit, thereby relieving—in an orderly way—pressures on interest rates and exchange rates. This, over time, will work in the direction of curbing our external trade deficit while at the same time reducing our dependency on foreign savings—an adjustment which becomes workable in a context in which government financing requirements are reduced More rapid economic growth in the other industrialized countries of the world can complement that process of adjustment Not by accident, the prospect for achieving that more rapid growth abroad will be enhanced in a setting in which there will be less need for other countries to raise their interest rates to guard against inflation and capital outflows induced by weak currencies It is, of course, easy to suggest this approach but it is not so easy to put it into action. And, there are no assurances that all the pieces will fall neatly into place. Yet, it seems clear to me that such an approach is the only reasonable alternative available to us.

In stressing the importance of reducing our budgetary deficits I know I run the considerable risk of beating the proverbial dead horse—although, in this case the horse is all too lively. Surely, it will be pointed out that need to reduce the deficit is widely, if not universally accepted And, the point can also be made that there seems to be some considerable momentum behind the deficit reduction effort at this time. I accept both of those points, but I am not yet persuaded that we fully appreciate the consequences of a failure to act and to act now.

To come full circle, we find ourselves in a situation in which our economy is doing rather well and in a situation in which many of the building blocks for sustained prosperity seem to be fitting into place Yet, with all that promise and potential we have some weak spots, some risks, and some work to be done. In considering the work yet to be done, nothing looms larger than the need to reduce the budget deficit. And, no single thing we can do holds the promise of greater rewards for both the internal and external sides of our economy In such a setting and in a context in which we maintain that basic discipline in monetary policy of which I spoke earlier, that elusive goal of a growing yet stable economy and a correspondingly strong currency will be within reach.

**There is a need for a greater element of prior restraint in the credit decision-making process.**

Few in the private sector have as large a role or as much at stake in achieving that happy vision as do our bankers. On the one hand, the credit decisions you make and the discipline you bring to the credit decision-making process have an important bearing on the way in which the economic and financial system functions and on the psychology of the marketplace. And, on the other hand, if weakness and instability do develop in the economy, those weaknesses will ultimately wash up on your doorstep in the form of performance problems in your own institutions.

**Because of this, the case for higher standards of prudence and caution is inescapable.**

The tasks you face in balancing the essential goals of growth and profitability with the dictates of prudence and caution were never easy But, in the intensely-competitive and progressively less regulated marketplace of 1985 and beyond, that task becomes all the more difficult. For this reason there is a need for a greater element of prior restraint in the credit decision-making process. By "prior restraint" I mean a renewed willingness to forego that extra percentage point of growth or to forego reaching out for that one last loan, only to have that loan show up in the nonperforming list several quarters later. The market—working through the price or interest rate mechanism—can ultimately provide that discipline. The danger, however, is that absent an appropriate degree of prior restraint, the discipline growing out of higher debt servicing costs will reflect itself in distressed borrowers, past-due loans or even charge-offs.

A strong economy and a renewed measure of prior restraint in the credit-making process are important in their own right. But they also complement the need for a continuation of the already substantial progress that has been made in strengthening bank balance sheets; perhaps I should extend that comment to cover "off-balance" sheets since that's where so much of the activity is these days

Amidst all the problems in the financial system and all the headlines of the past year or two, I often have the sense that the story which goes untold or unheard is the progress that has been made in strengthening bank balance sheets. That strengthening is well reflected, for example, in higher capital positions and in more conservative attitudes toward loan loss provisions, reserves and charge-offs

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If that is a fair assessment, I think it also is fair to suggest that there is a lingering question of whether that process has gone far enough and whether it will stick. One thing, however, is clear. The nature of banking has changed. when a loan, in effect, includes proceeds to pay the interest on a project for several years after the project is finished or when funding and trading practices entail around-the-clock operation in numerous instruments and numerous markets, the potential for surprises is greater. Because of this, the case for higher standards of prudence and caution is inescapable. The supervisory authorities have a role to play in fostering those higher standards as, for example, in calling for higher levels of capital and in calling for more emphasis on assessing and controlling risk in new lending, financing and funding instruments.

Yet, there is a point beyond which the supervisor cannot and should not go. For example, no good purpose would be served by supervisory policies which might have the effect of grinding the credit-making machinery to a halt. Similarly, no good purpose would be served by a supervisory process that becomes so enmeshed in the details of bank management that it undermines the incentives of individual institutions or the marketplace more generally. For these reasons I want to stress that responsibility for ensuring that the balance sheet rebuilding process goes far enough and does, in fact, stick is first and foremost the task of bank managers and not bank supervisors, although we both have a role in that process.

**As things now stand, the understandable compulsion of institutions to seize every loophole in law and regulation to achieve some strategic business purpose threatens to reach a point of *de facto* restructuring of the financial marketplace such that even the most basic of doctrines—such as the separation of banking and commerce—may be irreversibly breached.**

Bank supervisors are also confronting a very difficult balancing act· namely, how to strengthen the bank supervisory process while at the same time making it more flexible. Achieving those dual goals of a stronger yet more flexible, supervisory apparatus will not be easy, especially in the current environment I would like to be able to offer to you a blueprint as to how we can best achieve those objectives but I'm afraid I don't as yet have one. As we go about the process of trying to create that blueprint, however, several things strike me as being very important, including the following.

—bank supervisors cannot be expected to pinpoint all future problems;
—the emphasis should be on supervision, not regulation;
—we cannot allow the legitimate demand for disclosure and market discipline to overwhelm the integrity of the process whereby banks and their supervisors can freely go about the business of solving problems,
—more attention needs to be focused on the goals of the supervisory process rather than on the legitimate and alluring organizational questions relating to the structure of banking and financial regulation.

These are important issues to you, to us, and to the public at large. It is precisely because they are so important that efforts aimed at reform be well conceived and well executed. Here, too, bankers and bank supervisors have a strong common interest

**There are activities—some high on the "wish list" of individual institutions—which raise difficult questions concerning possible conflicts of interest, risk and ultimately ownership and control of banks.**

Bankers and bank supervisors also have a common interest in the pressing—indeed urgent—need for the Congress to enact broad based new banking legislation The case for legislative reform is powerful, resting as it does on the grounds of efficiency and competitive equity But it is also compelling because of other, even broader aspects, of sound public policy As things now stand, the understandable compulsion of institutions to seize every loophole in law and regulation to achieve some strategic business purpose threatens to reach a point of *de facto* restructuring of the financial marketplace such that even the most basic of doctrines—such as the separation of banking and commerce—may be irreversibly breached.

While the case for closing loopholes is clear, the case for a progressive easing of restrictions on bank product and geographic diversification is equally important. I, as an individual, and the Federal Reserve more generally, have repeatedly spoken out—in Congressional testimony and elsewhere—in favor of authorizing banks to enter into a range of new activities in ways that are consistent both with safety and soundness needs and with preserving the impartiality of the credit decision-making process. For example, bank participation in the underwriting and distribution of revenue bonds, mortgage-backed securities, the distribution of mutual funds, as well as broker or agency activities in insurance and real estate can be readily accommodated in ways that pose no major problems from a public policy perspective. However, there are other activities—some high on the "wish list" of individual institutions—which raise more difficult questions concerning possible conflicts of interest, risk and ultimately ownership and control of banks. The characteristics of these activities—which would include the underwriting and dealing in corporate securities, some forms of insurance underwriting and real estate investment—would seem to me, at the very least, to call for a "go slow" approach That is, an approach which is based on a very careful analysis of the issues and one which provides not only safeguards to protect against risk and conflict of interest concerns, but also one which places tight initial limits on the size and scope of these activities, at least until we are all more comfortable with our abilities to contain the potential problems they pose.

Yet, even that approach—with its limits and safeguards—raises important policy questions, not the least of which relates to how to best dovetail the legitimate Federal concerns arising, for example, out of Federal deposit insurance and lender-of-last-resort functions, with the time-honored traditions of the dual banking system. Some form of Federal pre-eminence arising from safety and soundness considerations seems necessary but we must be careful to insure that such override does not frustrate the valuable and constructive innovations that we have witnessed at the state level

Another area of contention relates to geographic expansion or interstate banking With appropriate limitations and safeguards, I am an advocate of interstate banking. And, as you know better than I, interstate banking is, in many respects, a reality Yet, in many areas of this country few issues can make the blood boil faster than can the prospect of some large New York, Chicago, or California bank acquiring control of local banking organizations. The concerns that underlie those attitudes go back to the very origins of this country. Because they are so deeply rooted, those concerns will not fade easily. For that reason, it seems to me that a building block approach may be the answer to interstate banking There are several vehicles which could be used to achieve that purpose However, from my vantage point, the specific vehicle chosen is not as important as the end result, which should be some specific date when all Federal geographic restrictions on interstate banking except for those based on safety and soundness or the need to avoid excessive concentration, should be lifted. From my vantage point, the sooner that "specific date" the better but, here too, we must all keep in mind what is realistic.

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To summarize, our Federal banking laws are in desperate need of reform and we need to get on with that task promptly. New legislation must incorporate contemporary definitions of banks and thrifts It should also include a progressive extension of bank products into some or all of those areas I mentioned earlier, as well as a measured Federal response to intense pressures for regional and ultimately nationwide banking. Within that framework there are also opportunities to clarify legislative issues relating to the role of the states and to bring about some important simplifications in the supervisory process, particularly as it applies to bank holding company applications.

Hopefully, a legislative remedy along these lines is within reach, even if the process of legislative compromise produces a bill which does not entail all the items on everybody's wish list. For my part, I believe failure to act this year could render the prospects, for orderly and progressive change moot, with results that would make none of us very happy. So, I would urge all market participants—banks and non-banks alike—to resist what I would consider short-sighted temptations to expend energies exploiting the present glaring loopholes in our banking laws rather than pressing for forward looking legislation.

Let me now conclude with a few words about the Federal Reserve Bank of New York. The Bank is perhaps a bit mysterious and certainly is imposing even in its physical characteristics. Yet, there cannot be—either to us or to you—an imaginary fence around that grand Florentine structure on Liberty Street. The ultimate strength of the bank rests in its roots being planted firmly in the community That means a free flow of dialogue on the pressing issues of the day must be high on our agenda. Consistent with that, the New York Fed is commencing a number of efforts which reflect our natural interest in the marketplace that surrounds us. These initiatives include a major study of factors driving bank profitability and equity performance in banking. They also include a comprehensive review of new financial instruments and markets with emphasis on the implications of these developments for risk to individual institutions and to markets generally Efforts such as these will require a considerable amount of dialogue between us and with other market participants.

Dialogue does not guarantee consensus, but it does help to ensure that as we go about discharging our public responsibilities with the sense of purpose and integrity which should be expected of the central bank, we will have the most informed judgments possible. We approach our tasks with an open door and an open mind, and at the same time with a steady eye on the public interest, as we are given the wisdom to see it.