Money and Banking in a New Environment*

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My associates and I are very glad to have this opportunity once again to meet with our good friends of the New York State Bankers Association and to exchange views on problems of mutual interest. The past year has certainly been a momentous one, with both pluses and minuses among the year's economic developments. While 1972 will undoubtedly bring new problems, I think we can reasonably look forward to the coming twelve months with greater confidence in the economy than was the case when I last met with you.

In an area of major interest to bankers, we have now seen the completion of the long-awaited report of the President's Commission on Financial Structure and Regulation. I should like to make a few observations with respect to this report, after which I shall comment on some of the major domestic and international problems confronting the Federal Reserve System.

The Hunt Commission Report, as it has come to be known, addresses a number of complex and difficult issues. The Commission's thoughtful and comprehensive approach is commendable. The report merits serious consideration and analysis by the Congress, the financial community, and the regulatory agencies.

In a sense, the assignment given the Hunt Commission was an outgrowth of and response to the significant changes that have been taking place in our financial institutions and in the markets they serve. Many of these changes reflect the response of institutions to the broad economic, demographic, and social changes that have been occurring in the nation. At the same time, technological developments, particularly in the computer field, have enhanced the ability of financial institutions to provide new and improved services.

The events of recent years have made it increasingly apparent that there are basic deficiencies in our existing financial and regulatory structure and that modifications are needed. Financial institutions, however, have been limited in their ability to adapt to changing economic circumstances. They have been unnecessarily constrained by laws and regulations, many of which reflect regulatory objectives based on the experience of the 1930's. Indeed, the changes that have occurred in recent years in the financial system represent, to a large degree, an attempt by institutions to break out of the existing legal and regulatory environment. The Hunt Commission was thus charged with reviewing our existing financial and regulatory structure and providing recommendations to improve the future performance of the nation's system of financial institutions. Its task was clearly a formidable one.

The Commission urges that greater reliance be placed on competition as the vehicle for assuring that the nation's system of financial institutions will be responsive to the economic and social needs of the decades ahead. Basically, it proposes to grant broader powers and greater operational flexibility to financial institutions and to remove regulatory restraints that interfere unnecessarily with the market process. The Commission was also guided by the principle that institutions engaged in the same activities should compete on an equal basis.

The Commission's recommendations—some eighty-nine in total—are far too many to discuss here. Let me mention a few, however, that are of direct interest to me from a central banking point of view.

The Commission proposes the gradual phasing-out of Regulation Q ceilings on time and savings deposits, an action which I have endorsed on previous occasions. In

* An address before the forty-fourth annual midwinter meeting of the New York State Bankers Association in New York City on January 24, 1972.

order to help achieve a better competitive balance among depository institutions that would be needed if these rate controls were eliminated, the Commission would permit savings banks and savings and loan associations to become "full-service" consumer institutions, offering such services as checking accounts and consumer loans. At the same time, the Commission would require that all institutions offering checking accounts become members of the Federal Reserve System and be subject to uniform reserve requirements and uniform taxation. The Commission proposes to permit depository institutions to operate over wider geographical areas. It urges the states to eliminate all geographical restrictions on intrastate branching for depository institutions, including branch and home office protection provisions. Since all of these proposals are intended to foster greater competition in the financial markets, I find them generally appealing.

In the area of Federal regulation of depository institutions the Commission proposes the creation of still another Federal agency. This new agency would have jurisdiction over all state-chartered commercial banks, savings banks, and those savings and loan associations with a substantial demand deposit business. The Comptroller of the Currency would continue to have responsibility for the same group of institutions that are Federally chartered. The Federal Reserve System, in addition to its monetary policy responsibilities, would continue to administer the Bank Holding Company Act.

I would question the desirability of creating an additional Federal regulatory agency which would further fragment the division of regulatory powers. I also have doubts about the desirability of discontinuing the bank examination activities of the Federal Reserve System. The personal contacts and exchanges of opinion obtained in the examinations process provide the System with insights and intimate knowledge of individual bank operations helpful in the formulation of monetary policy. I also am not convinced that it would be wise to abolish reserve requirements on time and savings deposits, as the Commission proposes.

While our study of the report is in its early stages, I am generally sympathetic with the broad direction of the Commission's efforts. By considering all financial institutions in a unified study, the Commission has correctly recognized that individual institutions do not operate in isolation from each other. I would therefore hope that, in implementing individual recommendations, careful thought might be given to the effect of any one particular proposal on the entire system of financial institutions.

Although not covered by the Commission, significant changes have also been occurring in the nation's payments system. The number of checks in the United States has been growing rapidly and, if present trends continue, by 1975 the banking system will be required to process approximately 35 billion checks, a truly staggering amount of paper. Last June the Board of Governors of the Federal Reserve System in a policy statement placed high priority upon efforts by the System to improve the means of making payments.

Speaking for our Bank, we are proceeding as expeditiously as possible along several avenues toward achieving the System's desired objective. Many years before the recent interest in establishing regional clearing facilities in which settlements are made in immediately available funds, our Bank participated with the local banking associations in forming two check-clearing bureaus within the Second District (one in Long Island and the other in Bergen County, New Jersey). We are now in the process of planning to assume the cost of operating these bureaus as Reserve facilities. Studies are also under way to determine other areas for establishing such facilities within the Second District. Along with the other Reserve Banks, we have undertaken actions aimed at reducing dependence upon checks by encouraging banks and their customers to make greater use of the System's expanded capabilities for the electronic transfer of funds.

We believe that significant savings in manpower and unnecessary handling of checks can be achieved. By increasing the speed and efficiency of check handling, we can also reduce check frauds, "no funds" checks, and check "kiting" losses to banks and the public. Overall, we are confident that our efforts will enable the banking community to provide faster, more convenient, and more economical banking services to the public.

I would like to turn to a review of the current setting for monetary policy. With respect to the prospects for the domestic economy, I am looking forward, like most others, to further economic recovery in 1972. But the events of the past few months, including the search for a viable incomes policy, passage of important new fiscal measures, and most recently the far-reaching changes on the international monetary scene have certainly added substantially to the usual hazards of economic forecasting. I will, therefore, only offer a few general observations about the longer run prospects for economic stability as they are influenced by trends in national economic policies.

First, as some of you may know, I have long supported the use of an incomes policy to combat the massive problem of inflation in this country. The failure of inflation to yield in the mini-recession of 1967, in the period following the imposition of the temporary surtax in mid-1968, and in the recession of 1970 had made it increasingly apparent

that this inflation was extraordinarily deep-seated and virulent. A cure through conventional policy measures—short of creating a major economic downturn—had become unlikely, particularly in light of the high level of unemployment. I believe that there is in this country a reservoir of concern for the national interest sufficient to make an equitable incomes policy work, provided that it is supported by appropriate control over aggregate demand through conventional stabilization policies.

This proviso regarding the need for supportive fiscal and monetary policies to aid the success of Phase Two is crucial, and is something about which I feel considerable unease. The very slowness of the recovery from the 1970 recession has created a risk that excessive fiscal and monetary stimulus might be resorted to in order to get quicker results. The Federal budget deficit has been progressively increased by the legislating of expensive new domestic spending programs, coupled with liberal tax reductions for both businesses and individuals. These actions can be justified as needed for short-run stimulation of economic growth to improve employment opportunities. At the same time, it is well not to lose sight of the longer run implications. Clearly, if the Federal spending trend is to continue upward at a rapid pace—and I know of no convincing reasons to expect otherwise—then at some point the tax-cutting trend of the recent past will have to be reversed. And, as anyone will agree who recalls the long and frustrating battle to bring restrictive Federal tax action to bear on the problems of the economy in the early years of the Vietnam escalation, it is far more difficult to secure tax increases—no matter how compelling the need—than tax reductions.

Monetary policy is also not immune from the risk of going too far in stimulating the economy's recovery. This can be especially true in periods of massive Federal deficits when, in order to avoid soaring interest rates and disruptive conditions in financial markets, rapid expansion of bank credit may be required to help finance a part of the Treasury's borrowing needs. Moreover, the Federal Reserve, like other policy makers, is rightly concerned about alleviating the social and economic costs of high unemployment. In so doing it can overshoot the mark. The easing of monetary policy in mid-1968, amid fears of economic overkill following passage of the tax surcharge, is a good example of System overreaction. In the present setting, excessive preoccupation with short-run movements in the money stock might lead us astray. I am, however, hopeful that the System has learned from its past experience, and that it will remain steadfast in its efforts to lay the groundwork for sustained growth based on reasonable price stability without the need for long-lasting wage and price controls.

Achieving and maintaining a high level of employment is, of course, a prime responsibility of the Federal Reserve System. However, the experience of the past few years raises a serious question as to just how low a level of unemployment may be consistent with the maintenance of reasonable price stability and international payments equilibrium, which are also major national policy goals. This question clearly deserves further study. At the least, the setting of an employment goal ought to recognize that the benefits of higher employment may involve costs—sometimes very high costs—through the ravages of domestic inflation and international trade and monetary strains. I certainly do not know how to quantify these conflicting considerations, but it does seem to me that we have now paid a very dear price for the overly full employment that prevailed from 1966 through 1969.

But, while I think that forced draft expansion of the economy is an excessively costly way of achieving high employment, and one that is ultimately destructive of its own ends, I do not believe that we need to accept relatively high unemployment as a permanent price of economic stability. There is much that can and should be done to make relatively low unemployment a viable policy goal. Among other things, we still need to do more to develop adequate and realistic programs for job training and retraining, to provide equal educational and employment opportunities for all, and to break down artificial barriers against entry into certain occupations. Equally important, a critical review of the competitive structure of business and organized labor in this country is long overdue. Such measures to improve the responsiveness of prices and wages to the objective realities of the marketplace will not be easy, nor can they all be accomplished quickly, but that is all the more reason to proceed immediately and forcefully. Economic controls and/or unemployment are too high a price to pay for market imperfections.

International considerations have always played a significant role in the formulation of United States monetary policy. Now, of course, we are dealing with a new set of circumstances. The Administration has agreed to propose a specific devaluation of the dollar to the Congress as soon as there is adequate progress in the discussion of trade arrangements. However, difficult and probably prolonged negotiations with respect to the general shape of the monetary system, including the convertibility of the dollar, lie ahead.

What the international role of monetary policy will be in the period ahead cannot, of course, be answered definitively since the outlines of the new system are as yet only vaguely visible. However, a few points seem clear even

now. Confidence in the dollar is essential if the dollar is to retain its important role as the principal intervention and transactions currency, and as a medium for investment. By far the most effective single way of assuring such confidence will be for the nation to succeed in stabilizing the dollar's internal value, i.e., by winning the present battle against inflation. Monetary policy's role in this will be very important, along with those of fiscal policy and the current program of direct controls over wages and prices.

In this connection it seems worth pointing out that a devaluation, such as that of the dollar *vis-à-vis* the other major currencies, carries with it costs as well as benefits. The major benefits are obviously in the area of a better payments equilibrium and a stimulus to export industries, as well as some relief from import competition. But these benefits are achieved only gradually over time. Meanwhile devaluation means higher prices for everything purchased abroad at a time when we are striving hard to stem inflationary pressures. History is full of instances where nations have thrown away the benefits of devaluation by permitting a generalized increase in costs and prices to nullify the competitive advantage of a lower exchange rate. I hope we can steer clear of this pitfall.

Another area where monetary policy will inevitably play a part is that of capital movements, especially flows of short-term funds. After all, the international financial crisis of 1971 began with an enormous flow of funds to take advantage of interest rate spreads, and only later took on the character of exchange rate speculation. It was a disparity in monetary policies on the two sides of the Atlantic, reflecting a difference in phasing of the economic cycle, that had a great deal to do with setting off the initial movements. This brings us to the old question of the relative priorities to be given to domestic and international considerations.

In pursuing our domestic economic and social goals, we should not lose sight of the need for as much international coordination as can be achieved. We must recognize, however, that the scope for better "harmonization" of various countries' monetary policies is narrow. In theory, greater use of fiscal policy for domestic needs might free monetary policy for a larger international role; but, since effective flexible fiscal policy is more theory than fact in nearly all countries, it is hard to conceive of a widespread willingness to give priority to international factors in setting national monetary policies. Perhaps the best we can hope for is to try to avoid extreme interest rate disparities to the extent that this does not seriously interfere with our domestic objectives.

It is often suggested that the answer to problems such as these is simply to adopt floating exchange rates. Yet I would point out that the progressive hobbling of exchange markets by controls and other devices that were employed after August 15 of last year was further proof—if any was needed—that governments regard the rate of exchange of their currency as too important and too sensitive a price to abandon it wholly to determination by often random and transitory market forces. Indeed, there was a clear effort on the part of most countries to restrain the rise in their exchange rates in the post-August 15 period. It was to counter this natural temptation of countries to manipulate their exchange rates that rules governing the setting of par values and limits of fluctuation around those par values were written into the Articles of Agreement of the International Monetary Fund. More than anything else the Fund Articles represented an internationally acceptable code of behavior. From this point of view, the essential element in the Washington agreement of December 18 was not the particular mix of exchange rates, but rather the reestablishment of a minimum set of rules governing international behavior with respect to the exchange markets.

In my judgment it goes without saying that the United States balance of payments must remain a very serious concern to our nation. I am glad to note the current efforts of the Administration to press vigorously for a lowering of artificial trade barriers abroad; no doubt there will be some opportunities over the longer run for reciprocal actions on our part. Certainly the nation as a whole stands to gain from any lessening of the protectionist tendencies that have become all too apparent, both here and abroad, in recent years. By the same token I hope that further progress can be made toward a more equitable sharing of the burdens of defense in the Western world. There is reason to hope that the rate realignment, coupled with progress on the trade and defense fronts, will foster attainment of reasonable basic equilibrium in the major countries' payments as a whole. Even in that event, there may of course be short-term problems for one country or another abroad, and I would hope that we will be prepared to assist by using the international credit arrangements that have been developed in recent years.

In any event, it is essential that there be a continuing spirit of mutual interest and cooperative effort. With all its faults, the unprecedented post-World War II economic growth reflected in no small measure an outstandingly successful experiment in international cooperation. The enthusiasm with which the world welcomed the recent agreement on new central exchange rates is symptomatic of the worldwide desire for international stability. In recent years there has been growing evidence of shortcom-

ings in the mechanical working of the Bretton Woods system. The new arrangements now evolving will, we hope, have certain improved features better attuned to the realities of today's world. I should also note, however, that many of the limitations attributed to the Bretton Woods system owed less to its own weaknesses than to mismanagement of domestic economies or the reluctance of major countries to utilize fully the options open to them in the system—and that no system can "work" for long without the support of well-conceived national policies.

As I said at the outset, 1972 will no doubt bring its own problems and challenges. We are in a period of rapid social and economic change that will require many adjustments on the part of all of us. This is especially true of those of you in the banking industry who have such a vital role to play in both local and national affairs. However, the response of the banking community to the wrenching developments of recent years has convinced me that your industry is capable of performing effectively in the new environment.

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