Remarks of

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Reflections of a New Member

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I feel certain that you would be disappointed if, among these reflections, you did not learn something about the manner in which one learns that he has been selected as a possible nominee to be a member of the Federal Reserve Board. You are of course keenly aware that on so grave an occasion, events must proceed according to protocol, that there is a certain minuet of state to be gone through, to assure that all is done in a becoming way.

So I thought you perhaps would be interested to know just how this came about in my case. I can, in this as in all that I am saying to you, speak only for myself, of course, and not for my colleagues on the Board. As for myself, I was busy in my Los Angeles office one morning early this year when my secretary sent word that there was a gentleman outside to see me. She said he had no appointment, but that he claimed he had been sent to see me by the White House. This exceeded in imagination anything in my extensive experience, as head of the trust department of a large commercial bank, of the devices used by salesmen to get in without an appointment. So, in a spirit of admiration, I made time for him. It was in this stately manner that I started on my way to the Federal Reserve Board.

What I want to convey to you today are a few of my initial impressions, first, about how the Board goes about its work, and, following that, some aspects of the Board's work that strike the newcomer as of particular interest.

How the Board Goes About Its Work

The newcomer to the Board -- and I think this would be true of anyone coming to the Board -- is moved by the working atmosphere he finds: a committee of seven men faced with an almost overwhelming quantity of widely different kinds of work, vitally affecting the economy in general, and many particular businesses, proceeding in what strikes me as an almost painfully careful, pragmatic and determined way.

Let me hasten to add that I say pragmatic not because economic theory is ignored. Quite the contrary. The Board is chaired by one of the world's renowned economists. Three other members of the Board are economists. The Board's staff is led by distinguished economists. Nevertheless there is recognition by all -- and insistence by Chairman Burns -- that the Board's decisions must be able to pass the test of real world conditions, and that theory is an instrument among others -- not a rule -- in making decisions.

The Board, by the nature of its subject matter and of the extensive effects of its decisions, does its work in what can only be described -- by a newcomer at least, perhaps later the sounds sort themselves out somewhat -- as a welter of advice from monetarists, anti-monetarists, those in and out of government with particular interests in special geographic or economic sectors, and from those whose interest in foreign economic policy effects is overriding. Under the same set of circumstances, as seen from these various angles, the Board may be advised to hold steady on the course it has been following, to veer one way or the other, or even to move in an opposite way, or to rest on its oars, while the situation clarifies.

Further, the Federal Reserve is independent, but, as Chairman Burns has reminded, independent within, not of the government. That means the Board must make monetary policy within the context of matters over which it has no control, such as spending and tax policies of the government. Further, the Board, like other arms of the government, must be responsive to watershed decisions by the American people as to their expectations of their government, exemplified, for instance, in the Employment Act of 1946. That is, the Board must make monetary policy in found conditions, and the effectiveness of its decisions is tempered by those conditions.

Given all this, there may be times when even old hands at the Board feel they are rather alone on a stormy sea. But even the newcomer soon finds this is not so. The Board is very much not alone. One strong impression the newcomer receives is of support by a very substantial staff that knows the Board's responsibilities, and is imbued with the principle that it is the Board's task to determine policy in the broad public interest. This being the case, the matters the Board must debate and decide come to it in staff memoranda that separate problems into their policy elements, provide background, define alternative courses of action, and state definite recommendations. Further, the Board draws, particularly in its regulatory and supervisory functions, upon a large reservoir of talent and experience at the twelve Federal Reserve Banks, and their Branches.

One other important item of atmosphere. The newcomer finds that the Board's independence rests upon a marked degree of independence of mind among the Board's members. He finds that this makes for diversity and individuality in the Board's discussions, but that it does not prevent timely decision and action. The reason is that there is unity in the Board upon one primary thing: that the Board's responsibility is to the broad public benefit to be gained from a sound banking system in a sound and competitive economy. This leaves a great deal of room -- all of it thoroughly used -- for debate as to what makes for soundness and competitiveness. But it also means that the searching of even the starchiest consciences can result in majorities, or even unanimous decisions, although they may be collections of agreement for different reasons.

The Board's
Responsibilities

The newcomer to the Federal Reserve Board has one instant, undoubted and irreversible impression: the Board's work load is enormous both in size and diversity.

As you are probably aware, the Board of Governors of the Federal Reserve System is a body, headquartered in Washington, charged with supervising the Federal Reserve System, and vested with powers for influencing bank credit, comprised of seven governors, appointed by the President and confirmed by the Senate, for terms of 14 years, so arranged that one term expires each two years.

You are also aware, I am sure, of the Board's main statutory responsibilities, so I will touch upon them only briefly.

The Board's -- and the System's -- chief responsibility under the law is the determination of monetary policy. What does that mean? Board Chairman Arthur F. Burns has given this description:

> "Our obligation as a central bank is to promote monetary conditions conducive to full employment, rapid improvement in productivity, reasonable price stability, and equilibrium in the balance of payments...also... to serve as lender of last resort."

The Board has available to it three principal and several main subsidiary tools for achieving these objectives. The first, most used and most pervasive of the monetary tools is open market operations. Open market operations -- chiefly, the buying and selling of government securities -- affect the volume of bank reserves, money and bank credit and conditions in the credit market.

Open market operations are directed by the Federal Open Market Committee, consisting of the seven members of the Federal Reserve Board, and five of the 12 Reserve Bank presidents. All Reserve Bank presidents, however, attend the monthly meetings of the FOMC, and all take part in the discussion that sets the basic course of open market operations until the next meeting.

Open market operations are carried on from day to day. Less frequently, the System uses two other principal monetary tools. One is variation of the discount rate -- the interest rate at which the Federal Reserve Banks will lend to member commercial banks. This tends to affect the cost of credit. The Reserve Banks and the Board share responsibility for setting the discount rate.

The other principal monetary tool -- variation by the Board of the ratio of member bank reserves to their deposits -- directly influences the availability of credit.

Three supporting devices are used in varying degrees. They are responsibilities of the Board. All three are devices for selectively influencing the cost or use of credit. One is regulation of the amount of cash down payment that must be made in purchasing or carrying stocks -- the margin requirement, currently 55 per cent. Another of these selective controls is the authority the Board has to regulate the maximum rate of interest member banks may pay on time and savings deposits.

The third selective instrument is a voluntary program, intended to assist the U.S. balance of payments, the Voluntary Foreign Credit Restraint program.

This brings us to the Board's supervisory and regulatory responsibilities, which I will not attempt to describe, to keep within time limits. The Board is responsible for supervision of state chartered banks that are members of the Federal Reserve System. State bank supervisors and the Federal Deposit Insurance Corporation share the responsibility for supervision of state banks. The Comptroller of the Currency supervises nationally chartered banks, and all national banks are required to be members of the Federal Reserve System.

The Board puts its responsibilities under the Federal Reserve Act into effect through regulations that have the force of law. Some, such as Regulation D specifying bank reserves, are monetary in nature. Others, such as Regulation J, specifying check collection procedures, are rules for carrying out public services under the Federal Reserve Act. Still others, such as Regulation Z -- specifying the way in which disclosure of charges to borrowers must be made, under the Truth in Lending Act, and Regulation Y, affecting bank holding companies under the Bank Holding Company Act of 1956 as amended, notably in 1970 -- have been promulgated to carry out special assignments given to the Board by Congress.

Let me turn now to an aspect of the Board's and the System's work that may be of special interest to you -- modernization of the payments mechanism.

Improving the
Payments Mechanism

It is downright exhilarating to find that as a member of the Federal Reserve Board you have joined a Federal Reserve team that is leading, with the cooperation of nearly all commercial banks, a massive effort to modernize the nation's payments mechanism in a race against time. Let me give you some background.

As you are well aware, the nation currently makes the vast majority of its payments transactions by check. As an indication of our present dependence upon the check for money transactions, we use about $63 billion of circulating currency in an economy of well over a trillion dollars. The check today works well and economically. The housewife can manage the family funds through a checking account with seldom more than a few hundred dollars in it -- and it is often drawn down almost to zero -- for something like $2 to $3 service charges a month. Businesses, particularly those large enough to be expertly managed, receive funds quickly enough through the check payments system, but can make payments through it with a predictable enough lag, to permit close management of deposits and a consequent low time cost of money. Small businesses find their checking accounts convenient and cheap for about the same reasons as a family does -- it permits a certain amount of conservation of funds through timing of payments, and it doesn't cost much. Further, the check is a convenient legal receipt, showing time of payment, amount, receipt of payment, and even purpose.

Banks have kept their check handling costs down with highly automated equipment. This has involved substantial outlays for advanced check processing and bookkeeping technology, including the computer. For banks not on an immediate payments basis, the check payments system as it has operated in recent decades has meant the investment use of some $2 billion of Federal Reserve "float" -- the value of checks drawn on them for which the Federal Reserve has deferred payment a day. This, invested at, say 4.5 per cent, means earnings of something like $125 million a year for the banking system as a whole.

You might ask: Why rock such a comfortable boat?

Because it carries a time bomb.

Currently, the nation is writing about 26 billion checks a year. On the average, after these checks reach a bank, and before the check gets back to the account of the maker, they have to be handled about ten times -- even when use is made of the best available machine sorting and magnetic ink recording of vital sorting information. That may take anywhere from several days to two weeks. Then the check has to be debited to the proper account, and mailed at the end of the month to the account holder.

Magnetic ink encoding and machine handling of encoded checks, which became general in the 1960's, made it possible for check use to grow to its present proportions without becoming a paper glut in the financial digestive system. Nevertheless, the process is still labor intensive. The Federal Reserve is currently in the process of making available to most banks in the country the services of Regional Check Processing Centers. These Regional Centers are being established for the most part in existing Federal Reserve Banks or Branches. The RCPC's will serve the largest possible areas around them that they can reach and return cleared checks to, overnight. We expect that, with the help of the regional check processing system, most of the 100 million checks written daily will be cleared and presented for payment on the day after they first reach a bank.

The exceptions will be checks from banks too remote to service on an overnight basis and most checks going outside the area served by an RCPC. But some 70 per cent of all checks are drawn and paid within 100 miles of the first bank of deposit. The inter-region or inter-District checks will have to be sent to another check processing center serving the area of the bank on which they are drawn. Checks from nonmember banks are accepted and processed directly by the RCPC if they are to be paid to a bank within the RCPC area. If they are to go outside the RCPC, they must be moved via a member bank.

However, regional overnight check clearance is no more than an interim measure, because of the time bomb hidden in the check payments system. That time bomb is the fact that check usage appears to be increasing by at least 7 per cent a year. That is, it will double in 10 years. This means that by the early 1980's, and probably before, we will be writing some 50 billion checks a year, unless something is done to decrease our dependence on checks. That is too much paper to contemplate, even assuming that nearly all checks are handled by the most efficient machine methods, and processed and cleared as efficiently as may be through the RCPC system. All of you are familiar, I know, with the nearly disastrous results when the securities industry permitted its paper traffic to build up to unmanageable proportions without taking timely steps to modernize its handling of transactions. This is a situation the banking industry has already invested heavily to avoid, and one, I am glad to say, that banking continues to keep clear of through the cooperation of most banks with the Federal Reserve's efforts to lead the way toward a more efficient payments mechanism.

Should this paper torrent build up unbridled, the housewife will find that her cheap and convenient checking account is becoming an expensive luxury, because the unit cost of handling a check must rise in a situation where available efficiencies have been realized, but volume continues to grow. Not only will the cost of a checking account become a significant item in the family budget, convenience also will wither, as the mounting burden of check traffic jams all transfer points and transportation facilities, checks are lost, mis-routed, slowed down -- salary, dividend, social security and welfare checks will arrive erratically or not at all -- and errors multiply in bank accounting to the point where banks are under siege from confused and outraged clients.

Small businesses will suffer the same insults, with the difference only that payments due to them will be larger in number, and therefore more of a problem, than to the average household. Larger businesses -- especially those with large volumes of small payments making up their cash flow -- will find the efficiency with which they can control their bank accounts falling, with more and more of their money lying idle they know not where. They will be forced to try to compensate by demanding special lock box and other devices for getting quick attention for checks due to them. This will throw an additional burden of handling on the check system. As this deterioration of the quality and economy of the check payments system progresses, the banking system will lose public confidence, and their clients will invest in and use to the maximum, alternate direct means of payment. Further, banks will find themselves battling in the labor marketplace for an ever increasing share of a shrinking and more expensive labor force of clerical workers to handle checks.

I think a fair analogy can be drawn if we ask ourselves where we would be by now if the dial telephone had not been invented. One of two things would have happened. We would nearly all be switchboard operators, spending much of our time placing telephone calls, or, the use of a telephone would have become such an expensive luxury that only a select few would be able to afford it. In either event, the telephone business would be relatively small and unpromising.

That is the rationale behind the Board's determination to modernize -- revolutionize, if you will -- the nation's payments system. The Fed and banking are, where the transfer of funds is concerned, inventing the dial telephone, with all that means to the public in terms of holding costs down and keeping convenience up in a situation otherwise bound to get out of hand. Beyond the RCPC, in part growing out of it -- for every RCPC is to be equipped to interconnect electronically with all others for eventual wire transfer of inter-district payments -- lies electronic funds transfer.

The beginnings are with us now. Here in California, as you probably know, banks and clearing house associations of San Francisco and Los Angeles, with the backing, encouragement and assistance of the Federal Reserve, have brought into being an electronic funds transfer system known as Automatic Payments and Deposits, called in its planning stages, SCOPE. Its completion was announced in August by Chauncey T. Medberry, speaking for the Los Angeles Clearing House Association, and it was activated earlier this month. Automatic Payments and Deposits permit individual bank customers in the state to authorize their employers to deposit their pay into their checking accounts automatically each pay day. Individuals will also be able -- and are encouraged -- to switch from paper to paperless payments by authorizing payment by their banks of their recurring, predictable bills, such as mortgage payments, utility bills, insurance premiums and loan payments. Instructions for making such transactions are recorded on electronic computer tape. The Federal Reserve supplies automated clearing houses where the tape recorded transactions can be cleared by computer, and eventual balances shifted in reserve accounts on our books.

All this is strictly optional with the customer. He can stay with the check if he wishes to do so -- and foot the rising cost. But there are a number of advantages to the public mentioned in the announcement of APD arrangements. These included the safety and convenience of automatic payroll deposit, elimination of a trip to the bank, as well as less risk of loss of the check, or check forgery and theft.

This, by the way, brings out the somewhat ironic fact that large-scale and common electronic payment, instead of payment by check, or currency, may carry with it a public benefit of untold magnitude independent of the benefits of a better payments mechanism. That is, drastic reduction of crime. Just as holdups of bus drivers have been virtually eliminated where exact change systems have been put into effect, when shops and individuals need to have little or no cash in the till, or in the pocket, and send and receive few if any checks through the mail, the holdup man and the mail thief will be largely out of business. It may be one of the quirks of history that the commercial banks and the Federal Reserve System, working together to modernize money transfers, will have a greater effect upon crime in the streets than could the police.

There are other benefits to electronic transfer. In fact, all three parties to a payment benefit -- the payor, the payee and the intermediary. The bank can merchandise new services to its customers. Some of these I have already named. Many others will come with time, imagination and experience. Think of the drafts issued by goldsmiths in Renaissance Italy -- the dawn of the check system -- and the manifold paper payments instruments that have since been developed, and you get some idea. All those later instruments came into use because they were conveniences to the public, and could be supplied by someone at a profit. So will electronic payments develop. One of the biggest public and business gains -- unless reduction of common money theft is the biggest -- will be reduction of fraud. The chief immediate field here is instantaneous electronic identification of the purchaser and verification of his liquidity -- no more bad checks. Ask any supermarket manager. He will tell you this would lift a great burden from his shoulders.

The Federal Reserve System Steering Committee on Improving the Payments Mechanism is headed by Governor George W. Mitchell. He has been leading the nation toward a modernized payments system for years, beginning in the late 1960's with conversion of the Federal Reserve's own communications system to computerized means able to handle greatly increased traffic and capable of further upgrading to handle the truly vast quantities of messages that will be involved when electronic transfer becomes a common fact. Governor John E. Sheehan and I serve with Governor Mitchell, and several Reserve Bank Presidents and other System Officers on this committee.

As you are probably also aware, California's APD has come into being somewhat in advance of a similar, but geographically more limited, electronic payments system which private banks in Atlanta, Georgia, have put together with the help of the Federal Reserve Bank of Atlanta. Let me mention one innovation there that may be of considerable significance in getting public acceptance of preauthorized, electronic payments. This is what is called the "billcheck". The customer of a large transactions volume company, such as a utility, receives his bill. If he has agreed to it in advance, attached to the bill is an authorization stub. Say the bill is for $18. The customer can write $18 on the stub, authorizing payment of the whole amount of the bill. Or, he can authorize payment of any part of it. Or, he can put it in the well-known circular file. In other words, the customer retains all the options he has today in writing a check, or ignoring a bill.

But the payments system is unburdened of a lot of paper. The company receives the stub, transfers the authorization to an electronic tape, together with the customer's bank account identification, and sends the tape with this and thousands of other payments to the Fed's automated clearing house at Atlanta for payment. I should also mention two experiments, one near Columbus, Ohio, and one at Syosset, New York, in point-of-sale electronic funds transfer. In these limited experiments customers have seemed well pleased to make their transactions in this way, although the preliminary studies in the Atlanta District indicated that there is a considerable job of education to be done to sell the idea of electronic funds transfer to the housewife, businessmen, employees and bankers. One reason is that the check payments system is working efficiently and at low cost now, so that few hear the time bomb ticking. This does not excuse the banking system, nor the Federal Reserve, from preparing for the time when money transaction by check becomes impractical as a general proposition.

The Regulatory Basis

It might have been added that among the improvements in the payments system that must be made on a timely basis is that of putting all banks on an equal footing as to check collection. We cannot stretch the viable life of the check payments system through the Regional Check Processing Center system, nor, even more, can we first reduce and then move towards phasing out checks, in favor of electronic transfer of payments, if some banks are on an immediate payments basis, and others on a deferred basis.

It was for that reason that the Board last Spring -- March 28, to be exact -- made public a proposal to amend Regulation J to correct the inequity among banks -- rooted in horse and buggy transportation days -- that allows banks not in or very near cities with Federal

Reserve facilities to defer payment for their items at least a day after the checks are presented to them.

This would wring out of the payments system approximately $2 billion of float -- representing amounts owed by some banks to others, compensated to the collecting banks by early credit -- in effect, a loan by the Federal Reserve. In view of the fact that reserves would be reduced by that amount, the Board acted at the same time to reduce reserve requirements of member banks.

This was done despite the fact that detailed, bank-by-bank studies of check collection, conferences by Federal Reserve Bank officers with thousands of bankers, visits to hundreds of banks and broad scale research carried on at the Board, revealed that few, if any, banks would be seriously disadvantaged, and that probably no bank would be put in a position where its ability to serve its community would be substantially impaired. Moreover, the Board took this phase-in action to assist nonmember banks despite the fact that State banking commissioners had been on notice, for almost six months, of the impending change in Regulation J. Finally, the Board acted to ease the transition although demand deposits are growing with the economy, and that any diminution of investible funds through loss of float would soon be made up by growth of deposits.

Implementation of these changes to bring about greater equity among banks and improve bank services to the public -- and to help prepare against the time when funds transfer by check becomes impractical -- were delayed by legal challenges by some banks, but are now scheduled to go into effect November 9. We in the Federal Reserve System feel that the benefits to the public of these regulatory changes are so clear, and that so much provision has been made to guard against substantial loss to any bank or community, that we should proceed with them as speedily as practicable.

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