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POLICIES FOR FINANCIAL INSTITUTIONS FOR THE SEVENTIES

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I welcome this opportunity to discuss with you monetary policy and financial institutions in the environment of the 1970's. Like many of you, I find crystal-ball gazing constructive as well as enjoyable because it requires us to take a long and hard look at the present--to see if we can identify the forces which are shaping tomorrow's world.

We are in the midst of a period characterized by rapid change, including changes in our financial markets and financial institutions. Not surprisingly, the current situation appears less than satisfactory to many. While credit markets have reacted relatively well compared to past periods of unusual pressures, they have experienced wide price fluctuations and, frequently, even the appearance of near-disorganization. There have been strong public pressures on governments to attempt through regulatory action to return us to some semblance of prior relationships which perhaps nostalgically appear more idyllic.

Creation of the Commission on Financial Structure and Regulation has been announced and its chairman appointed by the President. So now seems to be a better time than usual to look forward and see what problems lurk and how--or whether--we can adapt our current financial institutions to the future.

My own analysis can be summarized briefly.

-- Heavy pressures currently are being exerted on our financial markets and institutions. These pressures are not temporary.

-- We've made *ad hoc* attempts to patch up the existing structure through new laws, new regulations, new institutions formal and informal, special credit allocations, and a menagerie of subsidies to deal with special credit needs. We've taken an *ad hoc* approach because we've thought we were dealing with a short-term or cyclical problem.

-- *Ad hoc* patch jobs are rarely efficient. In fact, they may do more harm than good.

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-- In this coming decade, there will be a need to accumulate vast amounts of savings. Our financial institutions and capital markets will be under constant pressure to allocate available credit in a manner consistent with our national goals and priorities. This will require a rationalization of the current hodge-podge of market forces, national and state laws, regulations, taxes, subsidies, and controls that allocate credit. Priorities will have to be clarified, properly determined, and carefully introduced into the financial structure if they are to be met successfully. In my conclusion, I discuss several actions which might aid in these tasks.

Change and Dissatisfaction

Even the briefest glance at our financial markets and institutions shows rapid transformations in progress. The past 10 years have witnessed an unprecedented volume of innovations.

Financial and credit markets are filled with an expanding array of new institutions and techniques. Every time the guardians of traditional financial institutions glance back, they see a new group gaining on them. Just as chemical firms boast of the amount of current sales derived from products which didn't exist a few years ago, so today's financial innovators can make similar claims. A major share of today's lending and borrowing is done through techniques and institutions introduced or expanded in the recent past.

Goals and methods of operations have been sharply altered. New forms and types of lending abound. Negotiable certificates of deposit, Euro-dollars, and commercial paper have become important sources of funds. The one-bank holding company, mortgage investment trusts, new investment concepts for fiduciaries and pension funds, and a proliferation of multinational and even international lending arrangements are all examples of major transformations.

Government-owned or government-sponsored lending agencies have grown from a minor to an extremely important source of funds. By the first quarter of this year, for example, more than half of the volume of net residential mortgage funds was raised through such agencies rather than through traditional financial institutions.

In part, these movements simply reflect the passage of time. As institutions have shifted from the conservative liability and asset management engendered by the experience of the 1930's, a major restructuring of balance sheets has occurred. For many of today's senior executives,

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the Great Depression is little more than a piece of history. Some of the new investment patterns result from the desire of even conservative lenders to obtain "a piece of the action" represented by equity participation. Some of today's developments arise from the growth and greater internationalization of business and capital markets. Some new financial operations result from an increased public concern over shortcomings in the way financial markets function traditionally, and their apparent inability to meet the needs of certain sectors of the economy.

Perhaps most significant, however, is the fact that interest rates have reached record levels and have experienced sharp fluctuations. Interest rates paid on recent long-term borrowings would have seemed impossible to many only a few years ago. The volatility of these rates has drastically altered the problems and operations of many institutions. It brought forth stabilizing efforts by the government in the form of interest ceilings. Market adjustments to regulatory moves have been widespread as institutions have attempted to avoid their impacts.

Growth and innovations have, moreover, been accompanied by an increasing dissatisfaction with the manner in which our financial system is operating. Some dissatisfaction is clearly a reaction against high interest rates. Some comes from disappointed borrowers. Institutions themselves become unhappy when they lose markets to competitors, old or new.

A feeling of confusion and discomfort with the existing financial world has expressed itself in many ways. The bitter debate on the one-bank holding company bill is one manifestation of this uneasiness. Fights over usury laws and interest ceilings have been heated. Truth-in-Lending, consumerism, and debates surrounding credit cards are other signs of discontent. There have been broad expressions of national concern over the vulnerability of residential housing and other areas believed vested with high public benefits to fluctuations in the availability and cost of funds.

The willingness--if not eagerness--of Congress to vote credit subsidies, to authorize new institutions, and to attempt to force existing institutions to reallocate funds in special forms are each significant evidences of the disquiet arising from the inadequacies of our existing financial structure. The explosive growth in the role played by federal lending agencies is another sign of such concern.

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The Types of Change

While recognition of innovations is becoming more widespread, recognition of the forces causing them still lags.

Some changes, as we have just seen, result from the normal evolution of our institutions. Financial methods and markets grow and develop as do other parts of the economy. Time is wiping out the traumatic experience of the 1930's.

It is probably more significant that other structural shifts have been required by the decision to fight and pay for the Vietnam War without a major increase in taxes or controls. The financial markets have had to carry the burden of shifting funds and purchasing power among sectors of the economy. This task could not be accomplished without strains and operating vicissitudes as interest rates and credit rationing sought to reallocate resources among competing claimants.

It is probably even more important that financial institutions are now operating in a vastly different environment. The problem of allocating resources in a full-employment economy with an excess demand for both savings and capital is quite different from an economy--the kind we've been familiar with--in which full employment is achieved only at cyclical peaks while intermittent periods of slack dominate credit considerations. Investment demands have been expanding rapidly. Businesses are investing heavily even though many appear to have large amounts of excess capacity. The country is committed to a major effort to achieve large and expanded housing goals, to rebuild our cities, and to solve our transit problems. Recognition of the problems of pollution and our failure to conserve basic resources create demands for additional investment in both the private and public sectors.

All of these factors require alterations in the operations and responsibilities of our financial markets and institutions. They must encourage accumulation of the savings necessary for this investment. If savings remain inadequate, as they seem to have been recently, the mechanism must allocate credit among competing demands.

As an aside, I think the sharp rate movements in our financial markets these past few months are an indication that even close observers failed to disentangle the skeins of these various developments. As a result, forecasts of changes in the supply of and demand for credit and of consequent movements in interest rates were poor.

The sharp reductions in interest rates early this year represented an almost Pavlovian reflex reaction to indications that Federal Reserve policy was becoming less restrictive. The anticipated impact of this shift

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in Federal Reserve policy on credit markets was tremendously over-emphasized. This over-emphasis, in my opinion, came about because observers, seeking to match present events with earlier ones, failed to separate the results of Fed action, cyclical market forces, and shifting expectations.

In the past, these usually moved together with cumulative rapid and large impacts on rates. This time, in my view, the Federal Reserve moved not so much because of changed cyclical forces but to position its policy better with respect to the economy's long-run needs. The market, however, mistakenly assumed that banks would be flooded with credit. Many participants took large speculative positions. This process apparently drove rates down below a level consistent with underlying supply and demand. Demand for credit has remained strong, so far, reflecting still rising capital spending and corporate unhappiness with low liquidity.

When it was recognized that the Fed had no intention of attempting to flood the banks with reserves, the speculative positions became a gamble instead of what participants thought would be a sure thing. The process of liquidating these positions caused a sharp rate reaction. Some recent commentators on these moves seem to me to have again over-emphasized the Fed's role. Too frequently, the Fed is either credited or blamed for movements that are almost entirely the result of market forces.

Reshaping the Financial Structure for the 1970's

Based on the rapid pace of change, the recognition of new problems, and the rising dissatisfaction with the current financial structure, there is a growing demand that our markets' innovative forces be aided in reshaping our financial structure. This requires a basic understanding of how our financial system performs. We want to be able to remove the problems plaguing us while aiding the system to develop to meet the needs of the next decade.

As a start, we must clarify the objectives we want to achieve. What are our real national priorities? How large a role is our financial system expected to play in helping us reach these goals? And then, we must decide how much change we are willing to introduce into our present system and how fast change is to be permitted to take place.

Few recognize the complexity of our existing financial system. Daily, we each encounter bits and pieces of it, but its total magnitude and scope far exceed our usual horizons. We speak of our system as a free market. However, the basic form, magnitude, volume, and location of these market decisions are strictly circumscribed by a tremendously complicated framework. Our financial system consists of a wide variety of institutions

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and markets operating within a structure established by history, national and state laws, regulations, taxes, and subsidies. Almost every institution and market in our financial structure is subject to different but overlapping statutes and regulations. Some laws and procedures severely restrict competition, while others actively encourage it.

Our existing structure has developed to meet differing purposes under changing economic concepts. Some regulations reflect attempts to ensure the solvency of financial institutions and to avoid the panics and crises of the past. Others were developed to implement the concept that monetary and credit policy should play a vital role in stabilizing demand and in avoiding the extremes of inflation and depression. Some regulations are based upon a belief that specialization among institutions or guaranteed local markets are to be encouraged. Such specialization may help to ensure solvency, aid stabilization, or it may merely reflect the desire of managements to be left free in their own pastures not subject to the competitive pressures of other types of institutions.

On top of the variety of purposes which have led to the existing structure, we seem now to be asking the system to take on the task of allocating scarce funds in such a way as to meet the priority needs of the economy. To an increasing extent, financial institutions are expected to ensure that those who receive credit are not simply old customers, or large corporations whose accounts are profitable, but rather those whose claims come closest to matching some general concept of national goals and priorities.

We may be demanding too much of our jerry-built structure. Changes are necessary so that our system can both operate more efficiently and better meet national needs. What is required is a structure so shaped that decentralized market decisions, acting within it, will bring us as close as possible to an efficient achievement of our national priorities.

This problem may be far more complex than many assume. Simply altering one or a few obvious institutional arrangements may do more harm than good. Candidates for improvement include all facets of the existing structure--laws, regulations, taxes, subsidies, legal monopolies and oligopolies, and many other forces which interfere with our reaching national goals.

Analyzing Change

Before analyzing these problems further, let me state my basic thesis. I believe that the present structure can and should be improved. In moving forward, however, we ought to minimize doing damage to what we have. We must transform our institutions and regulations. What we want is to alter the structural confines so as to use the power of free market choices to bring about an adequate and hopefully best solution.

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In the process of planning change, we ought to avoid the enticement of accepting the simplified theoretical view of either extreme. To many, it is intellectually simpler to adopt either the textbook model of pure, perfect competition or the opposite superficial perfection of far-reaching controls. The middle ground is always hard to defend against those who can promise Utopia by following a simplified ideology. Unfortunately, however, the economy is complex--not simple.

We have an existing system. By taking account in a generalized systems approach of where we are, and the possibilities and costs of movement, we are much more likely to arrive at useful solutions than by attacking on over-simplified grounds individual situations which appear wrong. Single rules or regulations frequently appear far more likely candidates for change when considered alone than when analyzed in terms of the entire structure.

What does economic analysis tell us about possible choices in altering the structure? It warns us against over-simplification. It helps to show where we can hope to improve the ability of the market to make more desirable choices and, conversely, where such alterations may be harmful.

As an example of the difficulty of analyzing possible changes, let us consider the current debate over the desirability of removing interest rate ceilings--so-called Regulation Q. One frequent error of the uninitiated into economic theory (although clearly not those engaged in this debate) is to assume that any regulation which gives results different from those which would apply in the absence of regulation is inefficient. Clearly, if this were so we could rapidly reach the millenium by repealing all laws and regulations affecting economic activity. A completely unregulated economy might be preferable to our current one, but history and most economic theory argue the opposite. One cannot even be certain that repealing a given regulation, even if it obviously interferes with market choices, will move us closer to an optimum. Each potential change requires analysis.

The problem, as we have seen, is that the textbook model says that the efficient system which arises from perfect knowledge, perfect flexibility, and perfect competition, is worth striving for. In our existing system, however, we lack perfect knowledge, we have a large number of monopoly elements, and we lack flexibility. As a result, we seldom know for certain whether removing a given regulation will make us better or worse off.

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Everyone recognizes that a Regulation Q interest rate ceiling means some markets and some institutions gain funds and resources at the expense of others. This is the purpose of any regulation and not a telling argument against it. The question remains of whether the system would be improved if the flows went in a different direction. This is a question of fact that is quite different from the assumption that because a regulation influences flows differently from those that would exist without it, it must _ipso facto_ be bad.

Basically, the question that must be answered is: Whose ox is being gored? and whether or not this results in unnecessary or unfair costs. Regulation Q has played a major stabilization role. This may no longer be necessary or it may not be an efficient method of obtaining the desired results. Or the inequities it imposes on small savers may be too great. This means that as in most problems of change, we need to compare alternative approaches. Proving some evil in most regulations is rather simple. This is no proof that a particular one should be abandoned. Unfortunately, at times, when no system is completely satisfactory, we may have to settle for the least harmful approach.

Typically, economic theory outlines the great advantages of unfettered competition. Thus, as many argue, the first attempts to improve our present system should take the form of increasing competition among institutions. Easier branching and chartering, removal of local monopolies and oligopolies, increasing the ability of institutions to operate in a wider variety of financial instruments from which they may now be restricted would all seem to be ways of decreasing the monopoly elements which play so large a role in our markets and thus might be major improvements.

There are problems, however. One question frequently faced is that of the chicken and the egg. Which regulations follow from market imperfections and which create them? Do expected benefits depend on first doing away with existing areas of constricted competition, or can we achieve gains by changing some regulations even in the present imperfect markets? Furthermore, much analysis tends to be static. It looks at the imperfect present and the ideal future, but ignores the road between. It also tends to neglect problems of stabilization in a dynamic economy. Yet--as we have noted--these problems brought about many of our current laws and regulations.

Solvency and stabilization have been regarded as important values vying with competitiveness. Fears of cumulative impacts as distrust and insecurity spread played an important role in shaping the present structure. No one was eager to see institutions locked into long-term assets driven to bankruptcy as interest rates rose rapidly. These concepts require a reexamination. Many may be out of date. It must be recognized, however, that decisions as to the need for existing rules can rarely be made on purely _a priori_ grounds.

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Another problem arises because our current structure reflects an awareness that a purely competitive market may take us very far from desired social goals. We live in a world in which income, wealth, and power are unequally distributed among individuals and institutions. This means that on both theoretical and practical grounds major governmental decisions which restrict unlimited market forces may be valuable because they prevent inequitable solutions which might otherwise result.

Having just experienced Earth Day and the growth in interest in air and water pollution, we all recognize that the market mechanism as presently constructed does not register all the costs (or benefits) of certain activities. This same dichotomy between private costs and benefits and social costs and benefits arises in many of the decisions made in our financial markets. The recognition of this fact has been one of the driving forces behind the demand that we alter our existing financial structure.

Financial Managers' Role in Analysis

I welcomed the opportunity to talk with you today because, in addition to forcing me to think through current trends, it enables me to ask for your aid and cooperation. I feel strongly that financial leaders have not been as helpful as they might be in the analysis of the type of problems we are discussing today. This seems to me a waste. Financial managers have wide knowledge of existing markets. They are deeply involved in the credit allocation problem. Based on this they ought to be able to offer excellent advice leading toward logical solutions.

Too often, however, the few suggestions offered have been of limited use. Experience and expertise have been used primarily to defend the *status quo*. In debates over how our financial structure ought to develop problems too often are examined only from a personal-interest point of view. As a result, the impact upon those trying to arrive at better solutions is small.

To be useful, business leaders cannot start with the assumption that their function is primarily to protect the *status quo* and the way in which things are now being done. If such limited goals are followed, business leadership will be under continuous attack for its failure to recognize the national interest. We have seen what difficulties this can lead to in the auto industry's handling of legitimate complaints over pollution, safety, and repair costs. Rather than responding tardily and under extreme pressure, wouldn't everyone be better off if business used its expertise to try to draw up the best possible future irrespective of where we are now? Expertise should also be used to point out how we can best move from here to there with a maximum of gain or a minimum of harm.

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In some cases, careful analysis may show that there may be no harm--only gain. It is true that facing competition is not the most enjoyable situation for a businessman particularly if it means losing profits from existing monopoly elements. Similarly, change is uncomfortable if we fear that it means competitors will have a better chance. A period of movement does require new thoughts, perhaps better management, more challenge, more problems.

Whether it results in more or less fun depends, of course, on the individual. It is not necessary, however, to assume that as a result of change, our existing business or capital investment will fail to earn its fair return. Theory says that capital will earn a competitive return in the long run regardless of changes in the ground rules. While problems may arise for those who are enjoying non-competitive returns, monopoly yields are likely to disappear over time in any case. Schumpeter has well pointed out that attempts by business to maintain the status quo, particularly through the use of government laws and regulation, are among the most critical dangers to the capitalistic system.

Conclusion

Having said all this, mostly by way of trying to identify the problems affecting existing structure and obtain a perspective on how the problems arose, it is incumbent on an analyst to at least outline a few possible solutions:

-- First, what about the prospective demand for capital? If the major financial problem of the Seventies is indeed a capital shortage, then the federal government itself clearly must find ways to increase savings. This can be done most efficiently and simply by the government lending more of the funds needed for capital investment, government-sponsored agencies, mortgages, etc., while maintaining as a minimum a balanced budget.

-- Second, what about special devices to meet priority goals of our society? We have been attempting to aid preferred sectors through a broad array of techniques: specialized government agencies, institutional preferences, and direct or indirect subsidies. The results are conflicting and confusing. Much of the government's money is wasted by being channeled to households and corporations who do not require aid or subsidies. Clearly, there's a need to make existing techniques more visible, to bring them into full view, catalogue them, clarify the reasons for them and, hopefully, improve the way we use them.

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-- Third, what about our selection of priorities? We need to give more careful consideration to how national priorities are to be established. When they are established, we need to decide whether they should be given special access to credit by priorities, taxes, subsidies, relative costs or similar tools of policy.

-- Fourth, what about the complaint, heard so frequently and of late, so loudly, that our financial institutions are caught in a web of confusing, overlapping and even obsolete laws? In candor, even those of us charged with implementing existing statutes must work very hard to find our way through the existing body of laws. It is clear there is a need for at least a technical codification of our financial statutes--and surprisingly, this is a task which has already been done for us in large measure. In 1957, after several years of research, analysis, and debate, the United States Senate enacted something called the Financial Institutions Act. It would be useful and timely to see this measure brought up to date and made into Public Law.

-- Fifth, what about stabilization efforts? The need here is to reduce the burden placed on credit markets by forcing them to fluctuate widely in attempts to offset destabilizing forces elsewhere. We need to put more emphasis on increasing stabilizing forces within other sectors.

-- And sixth, what about competition? Well, as I've already suggested, we need to recognize the monopoly elements introduced into our financial markets by existing laws. We need to make existing institutions more effective, or phrasing it more correctly perhaps, permit them to become more competitive. We should act to eliminate protected markets in terms of fixed prices, of geography, and of institutions.

Our financial structure has been changing rapidly. We should not despair because of current problems. We must recognize that the rate of change has severely challenged the existing system. It is up to all those participating in this fascinating, complex market to bring forth their views and ideas as to how we can move from where we are to the structure which will meet the needs of the decade of the '70's.

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