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"Monetary Policy in an Environment of Change"

Address by

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It is a pleasure to be here today with you. I am particularly pleased to have this opportunity for a discussion with a group of bankers because each of you -- large and small -- is being deeply and swiftly affected by changes in the provision of banking services, changes that are here today and will certainly not be gone tomorrow. On the contrary, tomorrow's banking environment is bound to be different to a startling degree in the services banks provide to the public, how they provide those services and the rising competition from outside of commercial banking that must be dealt with successfully, as I believe your bank will, in order to continue to serve the public.

On several occasions, we have all discussed these changes at some length, -- in the context of a bird's-eye overview of forces altering our financial system as they affect the nation's financial system. Today I want to look at the other side of the coin: the implications for monetary policy of the swift evolution or revolution that is transfiguring the financial system of this nation. For there can be no mistake: change is thrust upon us by the deregulation of banking, the coming metamorphosis of a segment of the industry into something more competitive, your entry into fields previously the exclusive preserve of contiguous financial industries, and the provision of banking services by powerful nonbanking institutions. You recognize the march of events that is moving us toward a breakdown of the barriers to interstate banking -- these forces and factors are all shaped by the transformation in the scope and reach of services made possible by the onrushing information-handling revolution. I deeply believe that these trends, reinforcing each other, have profound implications for the making and effectuation of monetary policy.

A further current complication to the economic stabilization job of the monetary authority must be considered -- the unprecedented funding requirements arising from the megadeficits in the federal budget in coming years. Consider with me today the relation to monetary policy of three streams of events: the upheaval in the financial services landscape, the many suggestions, in part resulting from those upheavals, for altering supervision and regulation of the financial system, and the nation's economic agenda as set forth in the federal budget.

In the last several years, private financial management has exhibited agility and innovation in the presence of a severe need for both qualities. Much of the impetus for change can be traced to innovators surmounting the artificial obstacles to the market's will; that is to say, the cost of circumventing aging statutory constraints -- such as "regulatory" ceilings on interest -- have become far less than the gains in market share and profitability likely to be realized.

This relationship between the costs, including opportunity costs, to your customer of continuing to honor outmoded and uneconomic constraints and the benefits they were invented to bestow half a century ago, has not changed simply due to the corrosion of time. It has changed because market and attitudinal circumstances have changed. The extreme heights to which inflation rose, and with it interest rates, in recent years, has been a major and focusing factor. These events swiftly brought about an education in the public, which realized the extent to which the statutory limitations on deposit interest rates were damaging -- to both individuals and business -- and has resulted in heightened consumer and business sophistication in the management of their cash.

Technological progress has both enhanced and validated change giving the public an adequate real return and breaking the old statutory bonds. Several examples illustrate the point. Deposit interest rate ceilings that fell far behind increases in market yields inspired a whole new industry, money market mutual funds. These funds provided access to highly liquid assets carrying market yields. This industry grew from $10 billion in assets in 1978 to over $200 billion in assets by the end of 1982. The prohibition of interest payments on demand deposits led banks and their customers to find new instruments -- NOW accounts, sweep arrangements -- to reduce the costs of holding transactions balances, and gave transactional capabilities to balances with savings characteristics. In the process, the traditionally distinctive functions of commercial banks were called into question, and the demarcation of who does what was blurred further as nondeposit financial firms used their financial and technological expertise and interstate marketing systems to offer bank-like services. As two examples of this trend among many, the CMA account developed by Merrill Lynch provides ready access to credit and checking, while debit cards offered by various vendors serve a payments function.

The banking regulators, with the help of Congress, have met these challenges to the traditional and statutory restraints of banking by a massive program of deregulation under the Depository Institutions Deregulation and Monetary Control Act of 1980. With the authority provided by this legislation, the regulators have freed up banking substantially, notably in the deregulation of deposit interest rates and the granting of broader powers to depositories. It is highly significant that as of the end of April, nearly $400 billion of the $1.1 trillion outstanding in small time and savings deposits at banks, savings and loan associations and mutual savings banks was in accounts that did not exist before 1982. The Garn-St Germain legislation also liberalized the constraints on savings and loans and mutual savings banks by permitting them to issue demand deposits and to acquire commercial loans and other assets. We may opine that deregulation should have been married to gradualism. However, you will be able to compete and I believe management can use the new tools effectively in communities of various sizes.

As more financial firms offer bank-like services, particularly payments services, and as more deposit accounts and instruments compete freely with open market yields, the implications for the setting and implementation of monetary policy grow more serious. These changes affect the transmission mechanism for achieving shorter-term monetary growth targets intended to promote sustainable economic expansion and price stability. They also impinge upon the ability of the central bank to carry out its crucial role as the ultimate source of assured liquidity for business and finance.

Implementation of monetary policy has become more complicated in this environment. A large variety of new types of deposits is filling the continuum between "transactions" and "savings" instruments, and the old distinctions drawn among them thereby become cloudy. Liquid money substitutes permit the public to minimize amounts held in more traditional transactions accounts. This rapid and large-scale change in the way the public -- both individual and corporate -- holds its money and performs transactions means many things to many people. To the monetary authority it means a number cf things also, but, probably most important, it means that the relationship of "money" to spending and to income has become altered -- diminishing, certainly at least during a transition period, the reliability of past behavior as a mechanical guide to monetary policy for the present. There is little doubt that growth in monetary aggregates affect and influence growth in nominal aggregates including the gross national product. Extensive study within and outside the Federal Reserve is taking place to quantify further these relationships and their lead times.

For one thing, complex issues arise to the extent that money substitutes are held in nondepositories that are not required to post reserves at the Federal Reserve. Ideally, any balances functioning as transactions accounts would be subject to uniform reserve requirements. All issuers of such accounts would thereby have an equal "cost" of doing business and the impact of monetary policy as transmitted through reserve positions would be evenhanded and more predictable. Innovation has taken us far afield from this ideal world; some transactions balances are lodged in interest-bearing "sweep" receptacles, some are now held outside depository institutions, and some are in highly liquid instruments that are converted readily to transactions accounts. But these are not the only, or perhaps even the most important, results. The success of these innovations bears implications not only for monetary control and equity, but also for the element of risk in the financial system.

So much for -- very briefly put -- some of the complications for monetary policy of banking deregulation, the future coalescing of commercial bank and savings institutions, and the rapid, massive innovations in the way money and credit can be held and used.

I want now to turn to my second and related subject: changes that have been made in recent years and others that are being put forth or considered in the relationship of the central bank to the Congress -- which is the central bank's creator and to which the central bank is subordinate. Much of the attention focused on the central bank concerns its responsibilities for economic stabilization. Understandably, as our economy has become more interdependent with the global economy, as fiscal policy has been rethought and reevaluated and with the drastic alteration of the financial system, questions have arisen that fall into a general category of "How can we make the central bank function better and more responsively?" That is, plainly, a loaded question with everything depending on your definition of "better" and "responsively." Nevertheless, that is a question that must be dealt with.

Section 12 of the Federal Reserve Act, better known as the Humphrey-Hawkins amendments, passed in 1978, reflects this emphasis. It requires the Federal Reserve to maintain a rate of growth of money and credit over time that advances the economy's long-run potential, and to report semiannually to each house of Congress on monetary and credit aggregate ranges. This focus on the Federal Reserve's economic stabilization function in no way diminishes the Federal Reserve's vital function as provider of essential liquidity to the economy.

The latter role was most prominent in the minds of the framers of the Federal Reserve Act of 1913, who had seen the economy reel from repeated banking "panics" in which a key factor was the lack of any institutionalized and adequate means of providing liquidity in the face of contraction. The Act describes the Federal Reserve's primary functions as "to furnish an elastic currency. . . (and) to establish a more effective supervision of banking . . . . The establishment of the Federal Deposit Insurance Corporation in the 1930s was another response to the debilitation of the economy and an interruption in the ability of banks to discharge their payments responsibilities and preserve depositor wealth.

From this legislative history came the various forms of government regulation and supervision of depository institutions designed to minimize the possibilities of large-scale failures that could jeopardize the payments system, the public's savings, the efficient functioning of financial markets, the expansion of commerce and industry and the increase in jobs and income dependent upon that growth. Regulation of nondeposit financial institutions involves a somewhat different purpose: it is focused on protecting the public from misuse of resources and abuse of trust, but the safety and soundness of these institutions are not protected by regulation, supervision and insurance in the same way as the safety and soundness of depository institutions. When weak firms fail, the private sector is liable to bear a larger share of the consequences than is the case with depositories. Along with regulations intended to protect the public against undue concentration of resources, regulation of banks and other depositories clearly reflects the special place accorded them as the center of the financial system, the institutions whose primary function is to provide the seminal credit that is the lifeblood of industry and commerce.

For some years to come, the share of various payments system "markets" served by nonbanks will remain moderate. Likewise nonbank financial services provided by banks will build over the years, but "transactions" services and "commercial", e.g. short term business lending, will be particularly your province as bankers. On the asset side, the greatest volume of private international credits are more likely to be provided by commercial bankers than by investment bankers or thrift executives. Euromarkets will serve bankers to a greater degree than others. The interbank markets are not likely to become the interinsurance company markets. In sum, we must recognize both the coalescing toward a common center and the residual core of functional differences among types of institutions. "Broader powers" newly on the statute books do not become instant assets on the balance sheet.

Deposit insurance and the Federal Reserve's role at the normal discount window and as lender of last resort -- the ultimate source of liquidity -- recognize the special nature of the bank as depository. Deposit insurance was designed to promote confidence that wealth stored in depositories would be available when desired. It is appropriate today to review its role and what part market discipline could play. The presence of deposit insurance eliminates credit risk from covered deposits and thereby allows the operation of depository institutions at interest costs below those paid by other, uninsured, intermediaries. Yet money market deposit account pricing has yet to reflect this advantage. Obviously, you in banking need to recapture market share lost to money market funds, and future MMDA rates could be set in differing relationships with competitive rates. There is little question in my mind that restoring your ability to compete is beneficial. Further, I do not accept the argument that smaller institutions cannot survive and pay market rates. Regulation Q was not promulgated by the Roman Emperor Diocletian (Price control was, and it wasn't effective then, either).

The Federal Reserve exercises its lender of last resort role through the discount window to assure that financial weakness in one institution does not impair systemic functions due to lack of liquidity. Through the discount window, funds can be disbursed to eligible depositories to permit them to meet temporary liquidity shortfalls that they could not cover from other sources. And it is also understood that the Federal Reserve stands ready to channel funds through depositories to nonbank borrowers in extreme situations that threaten to carry repercussions throughout the financial markets--as in the case, for example, of the Penn Central bankruptcy a decade ago.

Through its regular open market operations, the Federal Reserve influences the general liquidity of capital markets on a continuing basis.

We welcome the review that is in progress, in and out of the Congress, of developments in recent times in the financial markets, and their relation to the central bank. Re-examination of the existing legislative framework is beyond doubt an urgent matter. Much of the institutional change that has taken place is innovative and needed, and has come about through a combination of technological developments, and market innovations, plus the opportunities opened up by deregulation. However, we are anxious that this review should take a broad perspective, considering the total domestic financial and payments systems, and the interrelation of the various aspects of the international financial system and of the economy at large.

We strongly suggest that the on-going review take into account, in a balanced fashion, all of the central bank's responsibilities for economic stabilization and liquidity of the economy. It is clear that the process of deregulation -- much of which we have recommended for many years -- has evolved to meet certain specific objectives. We are now at a stage in which broad considerations are appropriate. How do particular regulatory/supervisory measures fit into the fundamental requirements of monetary policy? To the maintenance of a safe and stable financial system? To an assurance of equitable and competitive access to services by consumers and businesses? To the preservation of effective means for transmitting the influence of monetary policy to the economy at large?

An ancillary, but important consideration is the relationship -- sometimes doubted -- of the formulation and effectuation of monetary policy with the regulation and supervision of banking institutions.

One of the most important considerations in this area is that the achievement of particular objectives in the regulatory and supervisory area, should be conditioned by a view of these objectives linked to a wide perspective of financial markets, and an appreciation of the more generalized effects likely to result from actions directed at individual depositories. This requires the direct and up-to-date knowledge of the complex interactions among financial institutions and markets, and a sensitivity to the interdependence among markets and sectors, including the international funds markets.

Supervision of depository institutions puts the governmental supervisor in direct and frequent contact with depositories on a case-by-case basis. At one level, such contact provides assurance of compliance with regulations designed to serve a desired overall objective. At another, that contact provides a flow of information back to policymakers and yields important feedback on the efficacy of policy actions and any strains that might be arising.

Actions in the supervisory, regulatory and monetary policy realms tend to affect one another. An example of this interdependence comes from the effect of monetary policy on interest rates, asset values, and the level of economic activity; these effects in turn obviously may affect the condition of depository institutions and may, in this way, also have secondary effects on the economy.

Awareness of this interdependence affects short-run policy considerations, such as the speed with which monetary aggregates are returned to target paths, or decisions whether, or in what degree, to accommodate near-term liquidity needs in light of financial market conditions. It also bears implications for the longer-run strategic design of monetary policy, as a healthy financial system obviously increases the flexibility available to monetary institutions, through which monetary policy is transmitted directly to other sectors of the economy.

Regulation and supervision of bank holding companies is another example of the interdependence of the Federal Reserve's responsibilities for the overall functioning of the financial system and the safety and soundness of individual banks. An expansion of bank holding companies into a new area may have implications not only for those holding companies and their affiliates directly involved, but also for other participants in the financial markets that may be competing with these institutions or using the services they provide. Bank holding company developments can affect the entire financial system by the way in which financial business is transacted, the geographic scope of competition in financial services, the degree of interdependence among major market participants, and the strength and stability of those participants. It is essential that bank holding company regulation be formulated not only in light of potential effects on the competitive position of the organizations directly involved, but also in light of its effect in shaping a financial system that can adapt to innovations, absorb occasional shocks, and convey monetary policy intentions in a predictable way to other sectors of the economy.

The changes pervading our financial system are profound and exciting. Some will withstand the test of the marketplace, others won't. Unfortunately, this period coincides with federal budget deficits so huge as to be likely to exert unprecedented strains on the financial system after current economic slack has been taken up. The Federal deficit is expected to average 5% to 6% of GNP both this year and next, and despite a continuing recovery, remain in that range during 1985 and 1986. The prospect of persistent megadeficits over the next five years implies considerable risks and major challenges for our regulatory system. Moreover, those deficits alone promise to complicate monetary policies designed to promote economic growth and reasonable price stability. Nominal interest rates have remained at elevated levels relative to the current pace of price inflation, inhibiting the capital formation necessary to improve productivity and compete vigorously in world markets.

We are pleased that the ongoing reviews inside and outside the Congress that I have referred to are being undertaken. They are needed to unshackle us from past provisions of law and regulation that have become hobbles. At the same time, we recommend that these reviews will result in a modernized legislative and regulatory framework that has certain clear characteristics that have been important in the past and

that continue to be important. Among these are:

-- Recognition of the unique role in the economy that depositories play;

-- Flexibility of law sufficient to permit financial institutions to adapt smoothly to innovation but that also permit regulation and supervision of the financial system of a scope and kind calculated both to let the market do its work and to give every reasonable protection to the safety and soundness of our financial institutions;

-- Recognition of the many inter-connected roles the central bank plays, and the need for the central bank to be free to come down on the side of policies aimed at lasting economic growth and prosperity in real terms.

Such a framework is essential, in my view, to the stability of our financial markets, and to the full functioning and effectuation of monetary policy in its basic roles as promoter of a sound and productive economy and protector of the economy's liquidity.

If indeed this is the kind of reformulation that issues forth in the end, we shall have, in my opinion, opened the way to a long-lived period of high employment, high productivity, profitable business, small as well as large, and safe and profitable investment of our savings and profits.