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Banks and Money

Remarks of George W. Mitchell

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at the

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Banks and Money

Banks are unique among financial institutions because of their special responsibility for money. Their day-to-day operations involve essential money functions. Both monetary responsibilities and money mechanics have always been shared by banks with sovereign governments although the respective roles of each have often changed over the history of banking. At times, the public has preferred banker's money to the sovereign's money. At other times, the preferences have been reversed. In modern times, banker's money in one form or another has been subsidiary to and dependent on the sovereign's monetary decisions and arrangements, but it has become the dominant form of money in our present-day society.

To illustrate the point in historical perspective, it is interesting to note that during the decades just prior to the Civil War in the United States, the Federal Government had abdicated its monetary responsibilities so far as bank money was concerned. State-chartered banking institutions for deposit and note issue then provided the major money resources of the nation. While some of this bank money was "sound," much was not because of inadequate State banking laws and incompetent bankers. This unsatisfactory condition led to the enactment of the National Banking Act just a little over 100 years ago, and to the imposition of a prohibitive tax on State bank notes. By these steps, the Federal Government reasserted its monetary authority and began to reassume its monetary responsibilities.

A by-product of the National Banking Act of the mid-1860's was that "State banks converted to national banks in droves, and State

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banks were widely believed to be on their way to extinction" in the words of Friedman and Schwartz. This expectation grew out of the great importance then attached to the privilege of note issue by banks, a privilege now reserved by the Federal Government and presently exercised by the Federal Reserve System. But events in 1867 did not produce the results then anticipated, mainly because of the unexpectedly rapid emergence of deposits as a popular form of money. State banks found they could operate very effectively without the privilege of note issue; and so they, as well as national banks, grew and prospered. The public's response demonstrated that deposits were a more efficient form of money than notes and, therefore, the key to bank growth lay in attracting depositors. This public preference for deposits is even stronger now than it was then. In 1867, deposits were 55 per cent of the total money supply and today the proportion is close to 80 per cent.

I refer to these historical facts only to suggest that while money is an essential feature of our society, its form may change. At one time or another we have used specie (gold and silver), Government issue, bank notes, and bank deposits as our major types of money. Other forms are possible. Credit cards, overdrafts, or metering devices could perform all or most of money's transaction function. Of course, much of money's liquidity function has already been shifted from money to near monies. More important, today, perhaps, than changes in the form of money are changes in its use and management by the public. Taken together, changes in form, use and manage-

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ment may conceivably be so powerful as to impel major alterations in the institutions that make money their business.

I believe that day has come. We are now in the midst of a change in money mechanics and management that has several vital implications for bank policy makers. The irresistible force at work is the rapidly evolving application of computer and communication technology, a force that does not depend on banking or any other single sector of our economy for acceptance but generates its own potential with new service products and reduced costs. The technology is now well established in most innovative sectors of our economy and is assuming a wide range of tasks, including those far beyond the capacity of a non-computerized operation as well as those that embody the simplest clerical skills and any given standard of accuracy.

Some bankers are going to exploit this technology with great imagination, determination and success; and, if some do, others will profit from their experience. The foreseeable result for banking, as I visualize it, is an automated clearing system in which bank customers arrange scheduled payments (credit transfers) from their accounts by advising their own bank whom to pay, how much, and when. The bank's computer (owned, leased or shared) will complete the transaction electronically through local clearing exchanges or through the Federal Reserve System's wire transfer network.

Credit transfers are not a novel device. The System's credit transfer mechanism has been in existence for a long time, and when our new equipment now being contracted for is installed

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in 1970 or 1971 we will have an enormously expanded intercity money transfer capacity. Moreover, we will also have the ability to install in modular units as much additional capacity as is needed for all nonlocal transfers, whether of the credit or debit (check) type.

The credit-type transfers have many obvious advantages over the check, but it makes very little difference so far as the electronic equipment is concerned whether the transfer is in this form or in the conventional check form. The only requirement for achieving computer-age efficiency is that once the authorization instrument--whether a check or some other type of instrument--comes to a bank, no attempt be made to have the physical processing of such instrument laboriously duplicate (trail along behind) the path of lightning-fast electronic settlement.

In a system of this type, deposits would still be money but the amount needed for any given level of activity could be very much reduced, with depositors managing their payments and receipts on a much more closely scheduled basis. This situation would be in sharp contrast to that described by a commercial banker in Latin America with whom I recently visited. The annual rate of inflation in his country has varied from 25 to 60 per cent in recent years and I was trying to find out how a commercial bank could get resources with which to operate under such circumstances. "Well," he said, "it's very simple. For any loan or service we have a high compensating balance requirement, and beyond that we live on float. We

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do this by encouraging our customers to believe that presentation is likely to occur within a week, instead of the two weeks it usually takes."

I don't know how large a role this type of float plays in determining the size of demand deposit balances in the U.S. today. Judging from turnover rates in financial centers, which have been running as high as 130 times per year in New York City, it must be a declining factor in well managed corporate accounts. But an electronic settlement system would make possible still further economization of such balances as well as considerably lower holdings for individuals, governments, nonprofit groups and noncorporate businesses. These groups, in the aggregate, probably have three times as much in demand deposits as corporations.

The erosion of demand deposits in many sections of the country has been a steady process in the postwar years. Taking the country as a whole, at year end in 1947, demand deposits (excluding interbank) were 73 per cent of the commercial banking system's deposit resources, a decade later they were 69 per cent, and today they are 51 per cent. A good many factors other than automation are involved in the relative decline in demand deposits--higher interest rate levels, restrictions on bank service areas, competition from nonbank intermediaries and the financial markets have all contributed to that trend. The prospect for further relative declines in demand deposits due to changes in money mechanics and to other factors is sufficiently realistic to justify concern for the future role of banking.

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But before we start to view the present plight of the banking system with undue alarm, let me cite some global statistics indicating that up to now the banking system's postwar "renaissance" has not been going too badly. Since banks deal in debt or credit it is appropriate to gauge their success in terms of the credit they have outstanding compared with that of other financial institutions and instruments. Banking's share of this market rose from 28 per cent in 1960 to 31 per cent in 1967, that of nonbank financial intermediaries from 39 to 40 per cent in the same period.. These increases were absorbed by a decline in the market share supplied directly by the public.

How have banks managed to finance the maintenance of their share of the credit market on a relatively declining demand deposit base? The answer, as you well know, has been a very substantial increase in the volume and variety of their non-demand liabilities. This development is epitomized by a whole new string of terms that have entered everyday banker conversation, such as CD's, RP's, Euro-dollars, Golden Passbooks, and that old governmental favorite in a new set of private clothes, savings bonds.

These liability innovations have helped the banking system, on average, to maintain its share of the market up to now, yet in point of fact their exploitation has been highly uneven among banks. The chances for long continuing the recent rates of advance in these areas are being increasingly curtailed by market, institutional, and environmental limitations. Furthermore, as I am sure

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you would be the first to remind me, there are other very serious threats to banking's market position emanating from regulatory postures, and some of you might point particularly to those of the Federal Reserve Board. What would I say to that?

I assume critics would be concerned specifically with such substantial issues as Regulation Q ceilings, regulatory barriers to various liability innovations such as capital debentures, promissory notes, and other attempts on the part of banks to penetrate money and capital markets to secure funds to take care of their loan customers. Some bankers would doubtless mention a too-strict policy on operating subsidiaries and on chartering, on branching, and on holding company and merger applications.

All of these barriers to your attempts to grow, or at least hold your own, are man-made in the sense that they represent regulatory judgments imbedded in the law or annexed to it, and I am sure at least some of you feel these should be removed or modified, preferably by interpretation but by legislative action if necessary. Let me touch on a few of these issues from a policy, and not a legal, standpoint--not speaking in any sense for the Board of Governors, but only for myself.

The chartering-branching-merger issue seems to me the easiest to deal with on broad policy grounds (it is not always so easy on a case-by-case basis). Since I believe the banking

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system will increasingly have to face the competition of the market and nonbank intermediaries, it seems to me to follow that paternalistic regulatory or statutory protection against interbank competition is not going to breed a generation of bankers who can hold their own in the broader competitive environment. Therefore, I am in favor of liberal chartering, branching, and market-extending merger policies when both public and corporate interests can be served. Most of the merger and holding company cases that come before the regulatory agencies are approved; nearly all of the rejections are on anti-competitive grounds.

The major problem is to accommodate a transition into today's economic environment by that part of the banking system that is neither competitive nor particularly skillful at serving the convenience and needs of its own community. This should be done without increasing, and most desirably by decreasing, existing pockets of banking concentration insofar as that concentration applies to services that can only be supplied for practical purposes by other local banks. Judgments on these matters are colored by appeals to nostalgia, simplistic applications of concentration ratios, exaggerated descriptions of decrepit managements, as well as by economics and facts. The best approach usually depends on the existing economic and banking environment.

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For example, the bank holding company format seems to me to offer the best solution to better service and improved efficiency in those states that have a strong tradition for unit or limited branch banking. It can solve succession, capital, portfolio management and overhead service problems without diluting the local direction of loan policy or discarding an appropriate degree of local autonomy.

Turning to another of the items in my hypothetical indictment, much of the criticism made of regulatory restrictions against innovative steps taken by banks to acquire loanable resources overlooks the environment in which such approval has often been sought. A novel device for attracting funds introduced at a time when inflationary forces have the upper hand and monetary restraint is severe is almost certain to be viewed as a loophole to be sealed off rather than a better and more efficient way of marshalling loanable resources. Or, in such circumstances, it may be regarded as a predatory raid on weakened competitors.

In the Sixties, several new borrowing and deposit instruments did come into use with limited or no regulatory interference. For example, the federal funds and Euro-dollars markets have been given complete freedom. The negotiable CD has been under the Regulation Q ceiling constraint, but the ceiling has been a

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limiting force only in periods of severe monetary restraint. Certainly this instrument can hardly said to have been stunted by regulation given the $21 billion peak to which it had mounted by early this year, an amount equivalent to 15 per cent of all private demand deposits.

But absence of regulatory restraints on these liability instruments did not mean an absence of banker problems or potential central bank problems. All of these instruments during their period of development were overused and misused by some banks. Usually, too great dependence was placed on the assumption that short-term funds would always be available at a viable price and, therefore, they were appropriate to finance term loans or the purchase of municipal securities. In some cases, lenders lulled by the daily option of renewal did not exercise even elementary precautions in extending credit in the federal funds market.

Experience has cleared up the worst abuses of the instruments but the exposure to liquidity embarrassment and potential crises remains a cause for concern. Under ordinary circumstances, institutions can accommodate losses of funds from arrangements or contracts that involve instant liquidity without difficulty, but in a period of rapid rise in interest rates and great financial uncertainty the same institutions heavily exposed to day-to-day options of their depositors and creditors, no matter how sound their asset structure nor how

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adequate the discount facility support from the Federal Reserve, could be severely damaged.

Regulatory strictures on the diversification and more aggressive use of liability instruments are not, therefore, imposed for the purpose of restraining the growth of banks but for the purpose of protecting our financial structure from the disruptive effects of disintermediation. Borrowing short and lending long is a powerful financial device for accumulating resources and putting them to uses that often would not otherwise be accommodated. It has, however, the potential to maim or destroy institutions that use it incautiously.

These views that I have been expressing on your problems are not intended to be admonitory or advisory to you but merely informatory of a central banker's attitude toward some of his problems that interlace with yours. Neither of us will reach the millennium of solving all of our difficulties, only of working on them.

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