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BANKING: WHAT THE LAST TEN YEARS
MAY TELL US ABOUT THE NEXT TEN YEARS

Remarks by

Robert C. Holland

Member, Board of Governors of the Federal Reserve System

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I am very pleased to join with you today in this Twenty-Second Bankers Forum. It affords an unusual opportunity to share with a distinguished group of bankers and financial analysts in a contemplative setting some personal thoughts on what has been happening to our financial system over the past decade and what these last ten years may presage for the future.

All of us are aware that this has been an eventful decade for the financial system. Far-reaching changes have taken place which have sharply altered banking and finance both at home and abroad. A significant number of the changes we have witnessed are, I believe, manifestations of powerful longer-term trends. Many of these trends have yet to peak and can be expected to continue to influence the shape of finance and banking for years to come. Thus, while the past ten years have seen substantial alterations in the very nature of the business of banking, we should not expect the pace

The views expressed herein are solely my own and do not necessarily represent those of my colleagues on the Board of Governors. I do wish to acknowledge, however, the helpful assistance in the preparation of these remarks provided by Mr. Paul M. Metzger, Assistant to the Director, Office of Managing Director for Operations, and the chief long-range planner on the Board's staff.

of change to slow. On the contrary, it may well quicken.

This kind of financial environment poses for policy-makers many and difficult choices that have had to be made among worthy competing objectives. As so frequently happens in the decision-making process, the inexorable pressures of time, and of the need to deal with many difficult questions simultaneously, have often led to ad hoc decisions being taken. Such decisions made in response to the exigencies of the moment may sometimes prove to have been the best that could have been made. Too often, however, critical decisions have proven to have been less than optimal because their antecedents have not been fully appreciated and their future implications have not been thought through sufficiently. Financial decision-making of the past decade could have been better conducted, in my view, if decision choices had been more consistently examined in the context of the significant longer-term forces that were gathering

momentum in those years. If we are to improve the quality of our decisions about banking in the future, it therefore seems particularly important that we attempt to derive lessons from the past ten years which can better illuminate the many significant choices we will surely have to make.

We cannot, of course, be sure that our efforts in this regard will be entirely rewarding, for no one can speak with a high degree of certainty about what the future may bring. The randomness of chance events and the mounting complexities of the financial and banking systems will insure continued uncertainty about the future. But I do believe that it can be mutually helpful to the decisions that you and I will be making to exchange ideas about the implications of the past changes we have lived through for the shared future which our choices will help to shape.

I would ask you therefore to view my remarks today not as an attempt to speak definitively, but rather evocatively, in the expectation that what we say today can provide impetus to a useful dialogue on

some of the issues that will be facing all of us with an abiding concern for improving the functioning of our banking systems.

My comments will be based primarily on the United States experience over the past few years because it seems best for me to speak from my strongest personal knowledge. Since the United States is a significant factor in the world's banking and financial systems, and because many of the problems and opportunities which we face also exist in one degree or another in numerous other countries, I trust my observations will have some general applicability to the future of banking at large.

The problem of inflation

Looking back over the past decade, it is clear to me that, of all the longer-term economic trends that were gathering momentum, the one most threatening to banking was the massing of the forces of inflation. I need not recite the details of that painful era for this knowledgeable audience.

It is sufficient to call to mind the determined nature of that onslaught of inflationary pressures -- sometimes ebbing a bit but repeatedly renewed by a fresh onrush of demand-pull and cost-push forces in vicious interaction, here and there complicated by waves of public expectations. It drove prices to historic highs, created economic disruptions that spawned the worst world-wide recession since World War II, and afflicted the United States' economy and many others with an unprecedented combination of simultaneous high rates of inflation and unemployment.

While some of these price pressures have diminished in this recession year, enough other inflationary factors are hard at work to remain a cause of grave concern. We have learned, to our sorrow, how powerful a cumulative build-up of inflationary pressures over a number of years can be.

Unhappily, this decade has also driven home anew the high economic and human costs of inflation and its consequences. Spurred by the increasing awareness of those costs of inflation, governments

have tried one combination of policies after another to control inflation within tolerable limits. But time and again they have underestimated the power of their adversary, or they have been inhibited by various side effects of anti-inflationary programs that seemed excessively damaging or unfair. In such circumstances, harnessing inflation that has gathered momentum over so long a period and is of world-wide dimensions has proven to be extraordinarily difficult.

For the banking system to which most of us give much of our day-to-day attention, the importance of this decade-long bout with inflation is two-fold. First and most fundamentally, inflation erodes the value of banking's "stock in trade." When money deposited in a bank for safekeeping progressively loses its value, the role of that institution in society is being subtly compromised. Second, and more pragmatically, vigorous efforts to fight inflation have typically included programs of monetary restraint -- sometimes severe. Periods of really tight money pose formidable operating problems for banks -- and the fact

that some other organizations may be having even greater difficulty is small comfort to banks under stress.

What relief from this kind of banking difficulty can the future promise us? It is clear in my view that the problems of the financial system would be much less if on average over the years ahead fiscal policies were to be significantly more anti-inflationary than has been true over the past decade. I would like to be an optimist on this score, but I shall defer to my colleague on the panel, Dr. Ture, to supply an objective appraisal of fiscal prospects.

Absent a marked fiscal change, I do not believe the trends of the recent past promise much relief from the kind of episodic financial pressures we have been experiencing. To put the same point another way, without a significant change in financial policies and instruments, it is likely that market forces will lend to recurring episodes of very high interest rates, sharp interest rate fluctuations, and marked shifts of funds among institutions and markets. Indeed, there is

a chance that such movements will become even more extreme in the years ahead.

The past decade has already given us some idea of the distasteful effects of that kind of monetary climate. As you know, when tight money policy is utilized to reduce inflationary pressures, and interest rates climb very high, there tend to be disproportionately heavy impacts on the housing market, on the State and local bond markets, on small businesses, on new and marginal borrowers, and on those industries such as the utilities which require long-term commitments of funds.

The commercial banking industry performs the necessary but burdensome role of the fulcrum for a tight monetary policy. As a result of the constraints imposed on banks by a tightened monetary policy, profits are foregone, losses are suffered, and customers are turned away. Certain other types of financial institutions and aggressive retailing concerns have sometimes been able to expand their shares of the national credit market at the expense of the banking industry by meeting

credit needs that, under these circumstances, bankers cannot fill. There are, too, familiar costs of tight monetary policy in terms of social programs that may suffer from reduced funding and increases in unemployment that often tend to place disproportionate burdens on such sectors of the economy as the construction industry, on new and marginal workers, and on many of the economically disadvantaged.

A dilemma is posed by the fact that programs undertaken to reduce the financial inequities that are created by efforts to combat inflation may also tend to reduce the anti-inflationary effectiveness of restrictive monetary policy. There is an extremely difficult trade-off to be made here of which bankers as well as public policy-makers should be keenly aware. Under these circumstances, understandable attempts by banks to obtain revisions of or to circumvent governmentally-imposed constraints in order to ease the burden placed on them by a restrictive money policy are likely to weaken the ability of monetary policy to slow inflation.

What we need to learn from our decade-long experience in fighting inflation, is how to redesign both the mechanisms of the banking system and of monetary policy complementarily. That is to say, we need to learn how to equip and adjust our financial machinery better so as to alleviate the worse inequities of both inflation and tight money pressure, but in such ways that we can implement effectively anti-inflationary monetary policies when we need to do so. One aspect of that redesigning effort should address how we can better equip our banking system now with the built-in capacity to reduce the various disturbing financial "ripple effects" of inflation more effectively.

Each thoughtful observer pondering this challenge is likely to develop his own particular family of reform measures. My own thinking has run tentatively in the direction of such ideas as low-cost but universal monetary reserve requirements on all domestic deposit-type liabilities; extension of analogous monetary requirements to deposits denominated in foreign currencies, including Eurodollars; limited use of variable-rate debts

or debts with profit-sharing features to allow varying distributions of income risk between borrower and lender; more overt use of governmental interest subsidies for unduly disadvantaged borrowers; and a somewhat expanded role as lender of last resort for the central bank. But I do not wish to pursue the pros and cons of any particular reform measure here; I want to avoid being enmeshed in the controversies over specific measures at this stage in order to preserve our focus on the more general principle of the need for complementary monetary and banking reforms.

That doing this will not be a simple or an easy task is clear; that it must be done, is also clear. It may make this difficult undertaking somewhat less intimidating if we remember that all balancing efforts of the type I have suggested cannot hope to be perfect. The financial and social inequities which I have described can, I believe, be reduced, but in this prolonged struggle with inflationary forces, we cannot expect to be so skillful or so fortunate as to be able to avoid them entirely.

Increasing mobility of funds

The design of a fairer and more counter-inflationary financial system will be complicated by another longer-term trend. Over the last decade funds have gained an unprecedented degree of geographic mobility. This change is, I believe, a significant measure of the extent of improvement in our ability both to marshal funds and to gather and analyze information about the great diversity of credit needs and potential borrowers throughout the United States, in other nations, and among different areas of the world.

This greater capability has been reflected in the increased mobility of funds between financial institutions, both for their own use and for the use of their customers. For example, institutions have become better equipped to meet their own requirements for short-term funds through the growth of the Federal funds and Eurodollar markets.

Enhanced sophistication has also led to an increase in the movement of funds between financial institutions and credit markets. The volume of savings that has been diverted from depository institutions to marketable securities by the higher interest rates carried by the latter at times in recent years has been a sobering warning to all who have heretofore been advocates of sequestering savings in insulated, special-purpose thrift institutions. The increased mobility of funds has been progressively overreaching the physical structure of our banking system, which remains constrained by local and State boundaries. Most larger banking organizations have already effectively expanded many services to encompass regional and national credit markets. These changes can be expected to gather momentum as we move towards implementation of an electronic payments mechanism. Such innovations should continue to exert powerful pressures on local and State restrictions on banking and hence should increase the mobility of funds between financial institutions and credit markets throughout the United States.

Moreover, the geographic limitations being circumvented or transcended by these financial innovations are not solely those within our own country. We have witnessed a growing interdependence among the various national economies and financial systems. Barring unforeseeable social or political disruptions, I believe this trend will continue to gain strength, particularly among the industrialized nations.

Large banks with multinational operations have come to have access to sources of funds in money markets all over the world. These institutions are able to bid for substantial sources of funds at their offices in one country and transfer the funds through their internal networks to an eventual user of funds in another country. This flexibility in financing arrangements by U.S. banks and by banks of other countries has had the beneficial effect that depositors in some countries are offered higher rates than otherwise on their savings while borrowers have obtained credit on better terms than they might have received

if their range of choice had been confined to purely local banks. In many ways, this "internationalization of banking" has had the procompetitive effect of increasing the number of participants in various banking markets.

On the cost side, the internationalization of banking has meant that some countries have lost a measure of control over conditions in their credit markets. The comparatively uncontrolled Eurodollar and other Eurocurrency markets have become attractive sources of intermediation between ultimate borrowers and lenders, in part because financial institutions operating in these markets are not required to bear the burden of required reserves and some of the other costs of banking regulation that fall upon domestic banking enterprises.

The majority of future efforts to impose legal constraints on the mobility of money and credit either within the United States or between nations seem to me likely to be frustrated. The demand for funds will exert sufficient pressure to spur financial institutions

and others to seek innovative means to circumvent artificial constraints. Successful restraints on the mobility of funds appear to me far more likely to come from the action of interest rates rather than any efforts at non-price rationing.

This means, unfortunately, that in inflationary times when both public and private credit demands expand rapidly and tend to press interest rates higher, monetary policy will have to bear an unusually heavy burden. As funds, drawn by higher interest rates, move with increasing ease across international boundaries, they promise to complicate still further our future efforts at restraining inflation.

Service innovations

Another distinguishable force at work reshaping the financial system has been the increasing sophistication of customer demands. The nature of these demands has become evident in several ways. Banks and other financial institutions have had to face increasingly affluent and increasingly knowledgeable individual and

corporate customers who are insisting on a return on their money, and therefore tending to draw down demand deposits to minimal working capital needs. These same customers are requiring more elaborate and complete financial services, placing pressure on their financial suppliers to provide more integrated and convenient services for a still wider range of customers.

The pressure of these demands has already tended to blur the once-sharp lines that distinguished some types of banks from others, or commercial banks in general from mutual thrift institutions. While some degree of specialization appears likely to persist in the future in response to special public needs, more and more financial institutions will probably seek to broaden the services they offer in order to meet those more complex customer demands of which I have spoken.

The implication of this development is that in the future we can anticipate that since distinctions will be more difficult to make among different types of institutions, and since they will offer similar arrays of financial instruments, emphasis will tend

to be placed on the more marked differences among those instruments. For example, variable interest-rate instruments may be offered by many types of financial institutions. The difference between a fixed and a variable rate instrument may thus tend to become the crucial one, rather than the difference between the types of institutions that issued them. The same may come to hold true also of loan arrangements that do or do not involve "equity kickers."

A major feature of the service innovations that we are likely to see will be increasing applications of electronics and computer science. The electronic transfer of funds holds, in my view, major ramifications for the conduct of monetary policy, for to the extent that payments become electronic, instantaneous and automatically financed by transfers out of interest-bearing instruments, M_1 ceases to be a useful aggregate by which to gauge monetary policy. In time, M_1 , made up as it is of noninterest-bearing currency in circulation and demand

deposits, may come to play a role similar to that presently filled by currency, or even by subsidiary coin. That is, M_1 may eventually provide a satisfactory reflection of small routine transactions taking place in the economy, but it will neither affect nor reflect dependably the extent of the discretionary spending that is occurring. In contrast, the measure of liquidity most directly related to discretionary spending may come to be some amalgam of at least all deposit-type holdings, perhaps plus some fraction of the immediately convertible debt paper of others, with possibly even some allowance for the credit lines immediately available to borrower-spenders.

From the viewpoint of monetary policy makers, it seems likely that the magnitudes of such monetary or liquidity aggregates would continue to be important as ingredients of economic stimulus. In this environment, central bank actions would surely need a broader base in order for monetary policy to maintain some effectiveness.

Since a growing variety of interest-bearing deposits and credit instruments may come to satisfy the economy's liquidity needs and affect its saving-spending decisions, it may become advisable to extend monetary reserve requirement to more of such instruments as well. In my view these reserve requirements could be effective monetarily even if set at a relatively low percentage level. As more nonbank institutions provide credit and deposit-type liabilities to corporations and consumers alike and come to approximate the functions of banks, it becomes increasingly inequitable, as well as decreasingly useful, to rest the full weight of monetary policy controls on the commercial banks. A movement toward broader reserve requirements on such interest-bearing liquidity instruments might eventually be perceived as both a rational and equitable step to meet the growing need to strengthen a nation's capacity to better execute its monetary policy.

Soundness limits

One of the most painful lessons that financiers have learned -- or relearned -- during the past decade concerns the need to limit risk. Time and again a heady combination of innovative credits or other services, liberal financial analyses, unconfining accounting controls, and optimistic assumptions about the business environment produced unhappy results in the unexpectedly rough economic weather that ensued. The financial pages of the world's press have been sprinkled with stories of individual firm losses as a result of underestimated financial risk.

Everyone is fortunate that such instances have been no more frequent than they have. But the implication has seemed clear that safeguards against excessive risk need to be strengthened as a matter of simple prudence in preparing for the years ahead. Many private financial managements have already moved vigorously in this direction, with particular emphasis on credit standards, quantity limits and audit controls.

Public officials charged with bank supervision are also carefully reviewing their procedures. In many facets of the examination and supervision process, the changes that seemed called for have been straightforward and uncomplicated. Numerous such changes are already in place or in process. In at least two basic areas of supervisory standards however, the issues posed are sufficiently complex so that any definitive reform will have to come more slowly.

A particularly important standard is that relating to capital adequacy for banks, bank holding companies and other financial institutions. Speaking from my own experience as a bank regulator, we recognize that our task is to insure that the capital of banking institutions will be adequate to meet eventualities that may materialize. To require too little capital in banks would create a hazard for the entire financial system; but to require too much capital would reduce their efficiency and possibly damage their ability to compete. Our analysts are struggling manfully to develop improved means of judging how much capital is enough in this altered world.

The adequacy of liquidity is also a matter that will be of persisting importance to the soundness of our financial system. Recent events have only too graphically demonstrated the dangers that can arise when financial institutions fail to make adequate provision for unanticipated delays of payment, losses of income, or flights of funds. But how should liquidity be judged in advance of the eventuality for which it is needed? Here too, regulators need to clarify standards, and work is pressing ahead in this area.

Finally, let me say a word about the implications of these improved standards of soundness of the lender-of-last-resort function of the central banks. By reducing the level of risk in financial institutions' assets and assuring that they maintain adequate capital and provide appropriate liquidity, regulators can help to insure that few calls need to be made upon the central bank as the lender of last resort. While we stand ready to assist member banks (and others under certain exigent conditions) should the need arise,

it is decidedly in the public interest that this occur as infrequently as possible. On the other hand, the portents of the past decade suggest to me that there will be enough untoward and emergency experiences impacting our financial systems for our central bank lending officers to keep in practice.

Conclusion

What I have said here today expresses my personal conviction that strong evolutionary forces have been working, and will continue to work, major transformations of our financial and banking systems. I do not believe that public policy-makers in this field are so powerful as to be able to prevent or to dominate those forces of change I have described. Nor are they all-wise enough always to be right in what they attempt to do.

Rather, I see the policy-maker's role as one of attempting to enable constructive change to take place in the financial system in response to, and within the constraints imposed by, public demand.

It is a particularly challenging and sometimes frustrating job, for it requires us to foster as best we can an environment conducive to desirable change, while at the same time acting to moderate the attendant shocks and to prune those inevitable offshoots of change that threaten to be financially or socially destructive. To perform this often delicate balancing act well requires more than ability and ingenuity. It demands that we look beyond the confines of the current environment to the possible longer-term ramifications of our actions, and it impels us to act always in the light of our best assessment of what the future may bring. Our overriding obligation is to do what we can within our limited ability to insure that the transition from yesterday to tomorrow will be orderly, equitable and sound.

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