MONETARY POLICY AND BANKING
Remarks by Robert P. Forrestal, President
Federal Reserve Bank of Atlanta
To the Graduate School of Banking for Community Bank Management
Kennesaw State College
March 23, 1994

I. A Federal Reserve Bank like the one in Atlanta is involved in three main businesses. (Chart 1)

A. Providing financial services for depository institutions and the federal government.

1. Clear checks, supply and process cash, and transfer funds and securities electronically.

2. Bank for banks: holds reserves, makes loans through "discount window."

3. Fiscal agent for the U.S.Treasury: auctions for securities, maintain Treasury Department checking account, clears checks drawn on that account.

B. Supervision and regulation of the activities of bank holding companies and certain commercial banks.

1. Is primary regulator for state-chartered Federal Reserve member banks and all bank holding companies.

2. U.S. activities of foreign banks, foreign activities of U.S. banks. (Following on the BCCI debacle, Congress has made stricter laws re foreign-banking activities via the Foreign Banking Supervision Enhancement Act with the main increase in responsibility assigned to the Fed.)

3. Shares oversight of commercial banks with the comptroller of the Currency and the FDIC.

a. The Administration has proposed a Federal Banking Commission to take over this function, which would take the Fed out of the business of supervision and regulation of banks. I am opposed to this proposal because the formulation of monetary policy depends heavily on knowledge of the banking system.

b. Without the hands-on knowledge of banking that we obtain from regular examinations of large and small banks, the Fed's understanding of the nation's financial system would soon become abstract.

c. We would quickly lose our insight into the pressures, demands, and changes taking place in the vitally important process of matching deposits and credit demands.

4. Explain examination process.

a. Safety and soundness according to CAMEL.
b. Separate examinations for compliance with consumer regulations, such as CRA.

5. Mandates capital requirements and processes applications for bank mergers and acquisitions.

6. Note that Fed can't prevent individual banks from failing--our concern is the industry as a whole rather than single institutions.

7. Acts of Congress become Fed regulations (e.g. Expedited Funds Activity is enforced as Reg CC).

C. Contributing to the formulation of national monetary policy

1. One of the two tools of macroeconomic policy, the other being the government's fiscal policy.

2. Will discuss mechanics of monetary policy process in more detail in a moment.

II. Overview of System

A. Fed has dual nature that makes it at once public and private in its operations. (Chart 2: Organization of the System)

B. Partially reflected in the differences between the Board of Governors in Washington and the District Banks.

1. Board members are appointed by the President with the advice and consent of Congress.

2. District Banks are organized like private corporations: governed by their own boards of directors, sell services to banks through our financial services business. Presidents are elected by boards, but must be approved by Board of Governors.

C. Public service type activities--supervision and regulation of banks and monetary policy formulation--jointly carried out by the Board and the District Banks.

III. Monetary Policy Formation and Implementation

A. Fed seeks to influence anticipated economic activity by affecting the demand for and supply of money and credit.

1. Decisions are made as to how much, if at all, pressure on bank reserve positions should be increased or decreased.

2. Three tools for implementing strategy:

a. Adjust reserve requirements

b. Adjust the discount rate, the tool over which directors of the District Banks have the most influence

c. Open market operations
(1) Operations consist of buying and/or selling large quantities of government securities, thereby adding and subtracting, respectively, from banks' reserves.

(2) Most open market activity is aimed at making short-term adjustments in the reserves of depository institutions.

3. Banks become more willing to supply credit, and interest rates fall when pressure on their reserve positions is eased through any of these three tools.

4. When we provide fewer reserves for a given period, we push them toward borrowing at the discount window.

B. Over time, Fed policy affects economic activity, but it is not the only factor influencing the economy at any given time.

1. The government's fiscal policy--budget and taxation--carries its own consequences.

2. In global economy, the policies of foreign governments have an impact on the U.S. economy.

3. Other factors whose effect is very difficult to foresee--oil supply shocks and demographic shifts--also add to the mix.

4. Thus two major points about the process of devising this strategy bear emphasizing at the outset:

   a. The environment of the policymaker is dominated by uncertainty.

   b. Fed policy has its effects with a lag; thus, successful policy entails maintaining a vision of the economy in terms of optimal performance under the conditions we project 6 months to 18 months down the road.

5. Long-term objectives represent desired values for real income--usually expressed in terms of real GDP--and for employment and prices.

   a. In general, we work on the assumption that the more ease there is in the amount of available money and credit, the more stimulus is provided for GDP growth; growth in turn reduces unemployment.

   b. Excess ease in money tends to be associated with inflation.

C. The Fed uses certain barometers of the relative ease or tightness of money in the economy as policy guides.

1. During the late '70s, one group of barometers--the monetary aggregates, M1, M2, and M3--became institutionalized as intermediate targets for monetary policy. (Chart 3: Definitions of the Monetary Aggregates)

   a. The Humphrey-Hawkins legislation of 1978 requires the Fed Chairman to report target ranges for growth of the three Ms in his semiannual testimony to Congress.

   b. Because of deregulation and financial innovation, these measures no longer provide reliable guidance.

2. Thus, in 1986 we stopped setting targets for M1, looking more closely at M2 and M3 instead.

3. Today, policy does not rely on the monetary aggregates as heavily as in the past, but the Ms are taken into account as part of an extensive examination of current and projected economic conditions.

4. Note importance of Fed Funds rate as indicator of pressure on banks' reserves; also the most direct window for "Fed watchers."

IV. The Federal Open Market Committee (FOMC)

A. Members are the Board of Governors and the presidents of the 12 District Banks.

1. Describe voting president rotation. (I am a voting member this year. Last time was 1991.)

2. Note that all presidents participate, along with their research directors, and provide regional information supplied in part by directors.

B. FOMC assesses an elaborate forecast of the economy prepared by the Board's staff based on a large-scale model of the economy.

1. Also need to consider exogenous factors that are not predictable--for instance, what Congress might do.

2. A full-scale simulation that projects for a period of 4 to 8 quarters is done about 4 times a year; estimates are updated prior to each FOMC meeting in response to new data.

3. The forecast indicates the income, employment, and inflation that are expected to be consistent with a particular policy and assumptions about exogenous factors.

C. District Bank research staffs conduct their own discussions of the economy prior to the FOMC meeting.

1. We debate the exogenous variables and also have a small mathematical forecasting model that projects GDP, employment, and prices.

2. Directors report monthly on very recent developments in their industries and localities.

D. At FOMC meetings, there is an extensive discussion of the District Banks' forecasts along with discussion of the Board's forecast.

1. The FOMC typically reaffirms the objectives for the monetary aggregates.

2. Starting in the late 1970s, except for a few periods, the FOMC has steadily reduced the ranges for the aggregates to signal its desire to reduce inflation.

3. In 1993, we reduced the ranges twice bringing them to 1 percent to 5 percent for M2 and 0 percent to 4 percent for M3. In contrast, the ranges

were considerably higher eight years ago at 5-1/2 percent to 8-1/2 percent for both aggregates. (Chart 4: Money Supply-M2, 1990-1994)

4. This past year M2 and M3 ended up at the lower end of their specified ranges, as they did the year before.

E. FOMC does not aim to achieve the growth within the specified ranges irrespective of what is happening in the economy.

1. In the fall of 1982, for example, we purposely did not respond to above-range money growth. The country was in the deepest recession of the post-World War II era and actions to restrain money growth would have meant greater pressure on bank reserve position and rising interest rates.

2. In 1985, when depository institutions were permitted to introduce checkable accounts that paid interest, we experienced abnormal patterns of M1 behavior that caused us to put less weight on M1 and eventually to move to M2 as a more reliable indicator of money growth.

V. How an FOMC meeting works

A. Open Market Committee meetings have been held in some form since the 1920s, but the FOMC as we know it today was established by the Banking Act of 1935.

B. Meetings are held eight times a year--I just returned from one yesterday. The next one will be held May 17, 1994.

1. Description of meeting: Chairman enters; report of foreign desk; domestic operations; summary of staff outlook; discussion; coffee; policy alternatives (note blue book, green book, beige book, gold book); go-round; vote.

C. Each voting president in turn is charged with monitoring the Fed's open market operations.

1. Daily conference call.

2. New York desk manager typically discusses current financial market conditions and his proposed action for the day.

VI. FOMC's short-term response functions as a guide to the manager of the System Open Market Account.

A. The manager of the Open Market Account, who is an official at the New York Fed, reports directly to the FOMC.

1. He and his staff--about 60 people all told--are responsible for executing policy decisions.

2. In the short run, FOMC may tolerate more rapid or slower growth in monetary aggregates than specified.

3. For example, if we expect income growth to accelerate to an unsustainable pace, we might want to make policy more restrictive to prevent a build-up in inflation.

a. Several alternatives: could move to restrain bank reserve growth now; could restrain growth a little bit now, raising the possibility that more might need to be done later.

b. Staff shows alternatives to the FOMC, and members are thus permitted to incorporate their own judgments of the economy into their decision.

(1) Those who are fairly certain the economy is accelerating would choose to tighten.

(2) Those less certain about the degree of change in the economy could opt for gradual adjustments.

(3) Those who disagree with the forecast could choose to make no change in policy or even to ease.

c. Each alternative contains short-run specifications for a reaction function for the Desk--one that is related to the policy thrust the committee has chosen.

d. They also condition the response to incoming information.

4. These specifications define the conditions under which the System will supply reserves.

a. If, for example, market participants thought we were being "too easy," the yield curve would get steeper, reflecting expectations that interest rates would need to rise by more later on. This can be seen in the yield curve for October 16, 1987--the Friday before the dramatic stock market correction. (Chart 5: Yield Curve)

b. If they thought that we were being "too tight" and that the economy would weaken significantly, then long-term interest rates might decline relative to short term ones and the yield curve would flatten. (Broken line on Chart 6: Yield Curves for 8/3/90 and 3/22/94)

c. Note on this graph that on August 3, 1990 (broken line), the spread between the 3-month and 30-year instruments was only about 1/2 a point. The present yield curve is much steeper.

5. Procedures also allow flexibility to cope with unexpected events, as after the stock market crash in October of 1987.

VII. The most recent directive

A. Reading the records of policy actions taken as printed in the Federal Reserve Bulletin can give you a picture of what data FOMC members considered to be the most relevant economic data during a given period.

1. The most recent meeting that is a matter of public record was held February 4. But since those minutes will not be released until later this week, we will be looking at the minutes from the Dec. 21, 1993, meeting.

2. If you will look at pages 17 and 18 of the handout in your binder, I will highlight some of the key points. (Go to highlighted copy).

VIII. Banking and monetary policy

A. Having covered how monetary policy is created and changed, I will now turn to how it is carried out.

B. Obviously to those who are bankers, the transmission mechanism for monetary policy has traditionally been the banking industry via the three tools I have already discussed:

1. Setting reserve requirements for commercial banks
2. Setting the lending rate (discount rate) and lending money to banks
3. Buying and selling government securities in the open market to alter banks' reserves

C. One of the goals of monetary policy is to increase non-inflationary, or real, growth, and commercial banks serve as agents of economic growth by channelling funds to borrowers.

1. Because of the role of commercial banks in credit intermediation, the Fed is concerned about their health.

2. That is also why the Fed continues to have an important role in bank supervision.

D. Another area where the central bank and commercial banks interact is the payments system.

1. Commercial banks participate in the U.S. payments system by extending short-term credit as financial intermediaries in the payment, transfer, and settlement of financial instruments, such as interbank deposits and government securities.

2. The Fed participates in the payments system with its Fedwire, which clears large-value interbank transfers and checks.

IX. Current and future banking issues

A. U.S. banks are in as good condition today as they have been in a long while as they have addressed the excesses (real estate loans, in particular) of the past decade. They have also benefited from a sustained period of low interest rates, engineered mainly by the Fed.

1. Banks have added billions of dollars to their balance sheets.

2. Their earnings in 1993 far exceeded their earnings in 1992.

3. The quality of assets has improved, particularly for money center banks that were affected by a large ratio of past-due assets to total assets.

4. Stock prices for banks are up, and long-term debt ratings have been upgraded.

B. However, as I see it, there are a number of big issues confronting banks, which I will outline here and then explain my position on each.

1. Declining market share
   a. Commercial banks have been losing business to competition from

financial services firms in the United States and international banks and financial services firms.

b. The share of credit assets intermediated by commercial banks has declined from nearly 60 percent at the end of World War II to less than 25 percent today.

c. To prevent this decline from becoming extreme, I believe well-capitalized banks should be granted new powers to compete with non-banks.

2. Risk management

a. Mutual funds -- Must be sure bank customers realize these new bank offerings are not insured as are deposits.

b. Derivatives -- Difficult-to-understand subject. However, does this mean that bankers do not become involved with these products because they don't understand them? Or, worse yet, do they become involved without understanding them and hope that somebody in their bank does?

(1) We just had a conference on the subject of financial markets and derivatives.

(2) Looking at the papers from that conference, I can tell you that the major point about derivatives is that bank management must both understand derivatives and actually manage their use. Too risky to be left to lower-level staff.

(3) Specifically, banks need in-house independent derivatives risk analysis units reporting to senior management and the board of directors, serving a purpose similar to internal auditors.

c. Interest-rate risk

(1) Accurately measuring this risk has become more important for the health of banks. Two economists at the Atlanta Fed (Hugh Cohen and Steve Smith) have done some interesting research, which shows that some commonly used interest-rate risk measures and hedges do not work as well in an environment of declining rates or when short-term and long-term interest rates move in different directions.

(2) It probably goes without saying that I cannot emphasize enough the importance of managing risk.

3. Regulatory burden

a. Very detailed laws promulgated by Congress, such as FDICIA and FIRREA, make it difficult for banks to do business on an equal footing with other competitors.

b. I am sympathetic to the problems commercial banks have in dealing with certain regulations. The Fed has always believed that banks need more flexibility, not less.

4. Interstate banking

a. Although I understand the concerns of community bankers about increased competition from large banks, I believe that interstate banking is something that we have needed to rationalize our banking system.

b. It may be hard to swallow, but community bankers must indeed compete with larger banks. Research done at our Bank shows that small banks can compete with larger banks on basic banking services and are *better* at niche banking than most large institutions. Thus, I have no doubt that you will be able to compete quite well.

5. International finance

a. In an economy that is becoming increasingly tied to the global economy, even small businesses that are the bread and butter of community banks now have special needs beyond the standard business loan.

b. Community bankers may be asking, How can we help our customers in these international areas when we do not have ties with a headquarters bank as many branches of big banks do?

c. I cannot answer that question for each bank. I can only point out the growing needs of your customers and suggest that it is important to find ways to satisfy their needs so that they do not take their business to your big-bank competition.

C. To sum up, increased competition for the traditional customers of the banking industry is making it more difficult every day for both small and big banks to thrive.

1. In this kind of unforgiving environment, community bankers need to be thinking about your area of special service, your niche. Who are you going to aim at?

2. However, it is important to remember that we will always have banks in one form or another because there will always be a need for institutions to intermediate credit between savers and borrowers.

X. Outlook for the economy in the year ahead

A. In 1993, real GDP expanded by just under 3 percent on an annual average basis.

1. The average annual unemployment rate fell to 6.8 percent in 1993.

2. The CPI increased on an annual average basis by 2.9 percent.

B. The economy should grow at a moderate pace of slightly more than 3 percent on average in 1994.

1. The jobless rate should drop about 1/2 a percentage point on average even though certain methodological changes by the U.S. Department of Labor will raise the stated rate somewhat.

2. Inflation should be between 2 1/2 and 3 percent.

C. Expansion will be supported by renewed strength in residential construction, consumer spending (particularly on durables), and strong increases in equipment, especially computers, for business fixed investment. Imbalances have been worked down substantially (balance sheet, real estate, banking).

D. Weak points are defense spending, commercial construction, net exports.

E. Inflation

1. Price pressures still look moderate.

2. Nonetheless, fighting inflation is a primary focus of the Fed--and much moreso than any other agency, and we must remain ever vigilant.

3. Thus, even in the current economy, we must proceed cautiously and be prepared to tighten monetary policy, lest we lose all the gains we have made against inflation in recent years.

XI. Conclusion, Questions and Answers