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THE ROLE OF THE FEDERAL RESERVE IN MODERN BANKING

Challenge and central banking go hand in hand. We at the Atlanta Federal Reserve Bank believe that the Federal Reserve System--our central bank--is constantly facing and successfully meeting new challenges. On the purely technical level we are today faced with the possibility of operating in a checkless and cashless society. In matters of monetary policy we are confronted with the problem of bridging gaps between the changing financial world and ever changing outside world.

What is money? Long ago, it was coins and currency. But today, a wide variety of credit instruments perform the essential functions of money. Day by day, the substance of money is becoming less and less palpable. More often than not, transactions are carried out with no actual movement of legal tender. Payment is made and received by bookkeeping entries at banks. In recent years the introduction of high-speed sorters and computers has accelerated this process enormously.

The computer has brought automation to the bank. Some believe that all bank transactions will be computerized eventually. Each customer will then have a new kind of telephone with a special credit-card unit. Instead of paying by check or money, one will insert his credit card into the telephone and his account and that of the seller will be appropriately debited and credited by their respective banks. Accounts will be balanced almost instantaneously.

If banks do not assume leadership in this credit revolution, other institutions will. Retail outlets and credit companies are already deep into the field. Some foresee the day when each business may install an electronic system linking it with other businesses through a central exchange. Then, each business can make instantaneous credit checks and offer its customers the convenience of universal credit cards. Currency, checks, cash registers, and sales slips can be almost entirely eliminated.

The credit revolution will have a tremendous effect on the banking system. Banks may be either the greatest beneficiaries or the greatest victims of this revolution. Banks who surrender to the revolution will be those who see automation merely as a replacement for the man who wears the green eyeshade. Although automation cuts the cost of doing routine work and increases the volume of work which can be accomplished, its effects are purely mechanical. The beneficiaries of automation will be those who recognize it as the greatest upheaval since banking's inception 500 years ago.

The mechanical side of the computer revolution has already made radical changes in banking. Checks are now sorted by magnetic ink characters. A volume of checks thought beyond the capacity of the banking system a few years ago is routine today. Handling costs per transaction have been slashed. But greater changes are yet to come.

In the future a customer may visit his bank no more often than the telephone office. Check sorting and re-sorting, shipment of checks from bank-to-bank or bank-to-customer, storage requirements for checks, kited checks, endorsements, and float will be antiquated. Manual processing will be minimal. Banks may handle payrolls, bill and process many types of contracted payments for insurance, rent, and mortgage. Necessary coin and currency will be supplied from commercial establishments regularly serviced by money truck pickup and delivery.

Automation has already begun at the Atlanta Federal Reserve Bank. The Bank and its branches have installed six computer systems. Realizing that we had been doing largely man's work with our computers, we are now studying how we can tailor our work to the computer. In other words, we are trying to use the computer as a machine rather than an extremely fast man. We are sharing what we have learned about bank automation with our member banks by offering two programs to aid them in reducing costs and providing better service.

In our Functional Cost Analysis service we give member banks comparative earning and cost figures for a group of banks of similar size and deposit structure. In this way a bank can compare its efficiency with that of similar banks. By determining the relative profitability of various bank functions, management will know where to concentrate its efforts. The second program involves the assistance of the Federal Reserve Bank in finding the various automation alternatives available and the provision of tools whereby the commercial bank can make an enlightened evaluation of these alternatives.

We are only scratching the surface, however, and need to glean as much information as possible from others who are experimenting in the field. I understand that a bank in New York is now doing bookkeeping and billing for a local doctor through teletransmission. The use of microwaves of similar techniques holds promise for expanding such services to large parts of the world. Of course, no one knows how many of today's dreams will become reality tomorrow, but we must be prepared to cope with whatever comes to pass.

At the same time that we are adapting to technological change, we must foster economic growth and a stable dollar. We must act in our most important role--that of a governor on the nation's "economic engine." Like the mechanical governor, our job, quite often, is to prevent the engine from going too fast and overheating. At other times, we must prevent it from going too slowly by controlling its fuel of money and credit.

Both the capacity and the structure of our economy are constantly changing.

And so, just as the System's operations must be altered in the face of a technological revolution in banking, we must alter the flow of money and credit when economic conditions change. If the Federal Reserve allowed the supply of money and credit to increase less rapidly than the nation's output of goods and services, we could well be accused of contributing to economic recession. On the other hand, we all know that in many situations a greater rise in the supply of money and credit than in goods and services helps fuels of inflation.

Much depends on whether or not the economy is running close to capacity. A few years ago new money and credit helped put idle men and machines to work. Today we have very little unemployment, and industry is operating at near full capacity. In this situation too much credit could result in higher prices and perhaps runaway inflation. Furthermore, interest rates were rising well before the Federal Reserve started to dampen the growth of commercial bank reserves, which determine the amount of money and credit in the banking system.

At no time has the Federal Reserve reduced the quantity of available funds for loans. Total reserves held by the banking system are still increasing, although at a growth rate insufficient to meet all demands imposed on commercial banks. The Federal Reserve's actions indeed have been quite modest and thoroughly defensible. The only alternative would have been to expand reserves rapidly enough so the rise in supply of money and credit would have matched the increase in demand. But, since the economy was very near full capacity, this would only have raised prices even further. It would not have increased employment or output significantly, but would have led to uncontrollable inflation.

There are several reasons for the increase in demand for funds. Federal expenditures are larger than ever before because of the war in Viet Nam and new domestic programs. Spurred by a boom in profits and a backlog of unfilled orders, investment spending by business is growing at a phenomenal rate. Local government spending is rising rapidly--much faster than is Federal spending. Rising personal incomes have brought increased consumer spending.

The impact of this spending is seen in various economic indicators. Manufacturing plants are operating near capacity. Prices are rising after several years of relative stability. The consumer price index, which had been increasing at an annual rate of around 1 percent, has doubled its rate of gain. And, as I have already indicated, interest rates--at levels unmatched since before the Depression of the 30's--have seldom been higher. The pressure behind this rise was excessive demand for funds. If, by increasing the supply of money and credit more rapidly, the Federal Reserve had satisfied demand, the lid most surely would have blown off under the pressure of even higher prices. There are no "winners" during an inflation. Creditors lose because they are repaid with dollars worth less than those they lent. Savers lose because the dollars they withdraw are worth less than those they deposited. Consumers lose because prices rise. Businessmen find costs higher, planning more difficult, and risk increased due to the greater uncertainty of future conditions. Many of the nation's resources are funneled into wasteful uses, as prices and profits rise on some goods because of scarcity rather than an increase in value. The rise in our price level makes our goods less competitive in the world market and foreign goods more competitive in the U.S. market. The point is clear. We need a stable dollar, not only domestically but for the balance of payments as well.

How does this figure in the current monetary situation? More specifically, how do we maintain balance in today's financial markets? For over a year, credit demands have increased much faster than the supply of lendable funds.

This great increase in demand for funds has pushed interest rates up. Money has become an expensive commodity.

When people today say money is tight, they really mean that credit has become high-priced. If you are willing to pay for it, credit is available. In the present situation tight money is really a "misnomer." "Tight" implies less money, and we do not have less money today, only more expensive money.

Money has become more expensive not because the Federal Reserve System has reduced its supply but because it has not increased the supply of money by as much as the economy demanded. Interest rates were rising in response to a significantly faster increase in demand than in supply well before the Federal Reserve increased the discount rate.

Is monetary policy the only way to contain inflation? No. Economists have long realized that fiscal and monetary policies can be used together to promote balanced economic growth. Both operate by affecting aggregate demand for goods and services. A tax increase will dampen growth in demand just as will a reining in on money and credit by the Federal Reserve System. Unlike monetary policy, fiscal policy, once on the books, takes effect quickly. It also acts more directly. Since monetary policy operates through the market, it cannot, like fiscal policy, take into account particular cases where there may be inequities and hardships. Such inequities develop when excessive demand is curbed by monetary policy alone because its impact is limited to those sectors of the economy which are sensitive to changes in interest rates.

We in the Federal Reserve System would welcome some fiscal aid in seeking to achieve our objectives of a sound and growing economy. Until such help arrives, we must rely on monetary policy, our only tool. With it we hope to limit credit expansion to a level compatible with real economic growth. Of course, the Federal Reserve has no intention of carrying out this policy to such an extreme that it brings on a recession or a depression. The System hopes it can steer the economy back onto the path of sustainable growth. This is the goal of the Federal Reserve System. Our role remains the same through boom and recession: We must help preserve the integrity of our monetary system in the public interest. The manner in which the System performs this role, however, must change as the economy changes. Using flexibility and independent judgment, we at the Federal Reserve Banks believe we can beneficially influence our nation's economic life.