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NABW-WEST SUBURBAN GROUP
HILTON INN--ALLGAUER'S
LISLE, ILLINOIS
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I. INTRODUCTION - GRACIOUS INTRODUCTION

A. THOUGHT I WOULD TALK ABOUT JUST A FEW OF THE
CHALLENGES AND CHANGES CURRENTLY FACING THE FEDERAL
RESERVE SYSTEM

1. THE IMPLICATIONS OF THESE CHANGES ON THE
MARKETS, ON FINANCIAL INSTITUTIONS AND ON THE
PUBLIC AT LARGE
2. GIVEN THE NATURE OF OUR ACTIVITIES, THE FEDERAL
RESERVE PLAYS A VERY KEY ROLE IN THE AFFAIRS OF
OUR COUNTRY - PERHAPS NOT FULLY UNDERSTOOD

II. LET ME START BY QUICKLY REVIEWING THE STRUCTURE OF THE
FEDERAL RESERVE SYSTEM - AND THERE IS A REASON FOR MY
TAKING TIME TO DO THIS

A. DESCRIPTION OF THE FEDERAL RESERVE SYSTEM, BANKS,
BRANCHES, GEOGRAPHIC, ET AL

1. EACH BANK A GOVERNMENT CORPORATION - SEPARATE
 - A. STOCK OWNED BY MEMBER BANKS
 - B. BOARD OF DIRECTORS - 9
 - C. 3 CLASSES - THE ELECTIVE PROCESS
 2. BOARD OF GOVERNORS - 7: 14 YEAR STAGGERED TERMS
 - A. APPOINTMENT/CONFIRMATION PROCESS
 - B. CHAIRMAN/VICE CHAIRMAN
 3. INTERRELATIONSHIP BETWEEN BOARD OF GOVERNORS
AND THE BANKS
 - A. RESERVE BANK BOARDS OF DIRECTORS HAVE AN
IMPORTANT GOVERNANCE RESPONSIBILITY
 - (1) YET SOMEWHAT DIFFERENT THAN A REGULAR
COMMERCIAL BANK DIRECTOR
 - B. OPERATIONAL AND PROCEDURAL CONTROLS
- B. THE IMPORTANCE IN HIGHLIGHTING THIS STRUCTURE
1. CHECKS AND BALANCES

- A. EVERYTHING WE DO SUBJECTED TO CHECK AND
BALANCE
 - B. AN EXCEPTIONALLY IMPORTANT, YET LITTLE
UNDERSTOOD, FEATURE FOR SUCCESSFUL
OPERATION OF A CENTRAL BANK - MONETARY
POLICY
 - (1) ORIGINAL ACT - WELL DESIGNED
2. IN TURN, THIS HIGHLIGHTS THE INDEPENDENCE OF
THE FEDERAL RESERVE SYSTEM - EXCEPTIONALLY
IMPORTANT FEATURE
- A. CREATED BY CONGRESS - CAN BE CONTROLLED BY
CONGRESS
 - B. THROUGH FREQUENT TESTIMONY, VARIOUS
REPRESENTATIVES OF THE FED, MOST NOTABLY
THE CHAIRMAN, REPORT TO CONGRESS
 - (1) THERE IS NO SHORTAGE OF DIALOGUE

C. YET WE DO ENJOY A SIGNIFICANT DEGREE OF
INDEPENDENCE IN THE CONDUCT OF OUR AFFAIRS

(1) WHICH, FRANKLY, WE JEALOUSLY GUARD

3. AS CONGRESS MOVES ALONG IN THIS SESSION, THIS
ISSUE WILL ASSUME A HIGHER VISIBILITY

A. ALREADY THERE ARE INDICATIONS THAT THEY
WILL RE-FOCUS ON THIS ISSUE

B. THERE IS THE RISK THAT WE COULD GET CAUGHT
IN THE MIDDLE AS THE FISCAL DEFICIT/TAX
REVENUE IMBROGLIO INTENSIFIES - AND IT
SURELY WILL

III. THE FUNCTIONS OF THE FEDERAL RESERVE BANKS

A. THREE DISTINCT AREAS OF ACTIVITY

1. FOR COMPLETELY SEPARATE AND DIFFERENT REASONS

2. ALL GOING THROUGH A PERIOD OF SIGNIFICANT CHANGE

3. YET EACH OF THESE ACTIVITIES, AT LEAST
TANGENTIALLY, RELATES TO MONETARY POLICY - THE
PRIMARY RESPONSIBILITY AND ONE OF ABSOLUTELY
OVERRIDING IMPORTANCE

IV. AS A START, OUR BASIC OPERATIONS, THE PROCESSING OF
VARIOUS WHOLESALE ACTIVITIES FOR FINANCIAL
INSTITUTIONS, OF MAJOR MAGNITUDE

A. LET ME USE A CURRENT ISSUE, NAMELY ELECTRONIC FUND
TRANSFERS, AS AN EXAMPLE OF HOW ULTIMATELY THIS
RELATES TO MONETARY POLICY

1. YOU MAY BE AWARE THAT WE ARE INCREASINGLY
FOCUSING ON THE EFT AREA AS ONE BEARING SPECIAL
CONCERN

2. BECAUSE WE OPERATE THE FEDWIRE, WHICH IS
DIRECTLY COMPETITIVE WITH SEVERAL PRIVATE
SECTOR NETWORKS

- A. THERE IS THE IMPRESSION THAT WE ARE
ATTEMPTING TO EXPAND OUR PRESENCE - OUR
MARKET POSITION - TURF
3. RATHER, WE HAVE BEEN INCREASINGLY CONCERNED
ABOUT THE RISKS INHERENT IN THE WHOLE WIRE AREA
 - A. ENORMOUS VOLUMES - WEEKLY DOLLAR VOLUME ON
4 SYSTEMS EXCEEDS ONE TRILLION DOLLARS
 - B. A BREAKDOWN IN THE WIRE AREA ON ONE OF THE
NETWORKS COULD HAVE A DESTABILIZING EFFECT
ON THE FINANCIAL MARKETS
4. IF A MAJOR INSTITUTION FAILED OR WAS IN SOME
WAY UNABLE TO SETTLE ITS POSITION DURING THE
DAY OR AT THE END OF THE DAY, A DOMINO EFFECT
COULD OCCUR
5. OUR ONLY RECOURSE WOULD BE TO LIQUEFY THE
FINANCIAL SYSTEM

A. THIS WOULD HAVE OBVIOUS MONETARY POLICY
IMPLICATIONS

6. THIS SUBJECT ONE THAT IS UNDER VERY CURRENT
REVIEW. OUR HOPE IS THAT A SURVEILLANCE
STRUCTURE CAN BE PUT IN PLACE THAT WILL DEAL
WITH OUR CONCERNS

A. YET NOT IMPEDE THE EFFICIENCY OF THE SYSTEM

B. OUR INVOLVEMENT IN OPERATIONS, NOT ONLY THE WIRE
AREA BUT CHECK COLLECTION AS WELL, PROVIDES THE FED
WITH AN IMPORTANT ENTREE IN THE PAYMENTS MECHANISM

1. PAYMENTS MECHANISM - ARCANE - PIPELINE -
OBVIOUSLY AN AREA OF CONCERN TO US

2. THE MONETARY POLICY IMPLICATIONS BECOME NOT
ONLY OBVIOUS BUT TERRIBLY IMPORTANT

SECOND AREA

V. SUPERVISION AND REGULATION

- A. REGULATION - THE DEVELOPMENT OF RULES BY WHICH
FINANCIAL INSTITUTIONS ARE GOVERNED AND CONTROLLED
- B. SUPERVISION - THE ENFORCEMENT OF THESE REGULATIONS
AS THEY RELATE TO THE INSTITUTIONS FOR WHICH WE
HAVE PRIMARY RESPONSIBILITY
- C. THE FINANCIAL SERVICES INDUSTRY IS GOING THROUGH A
PERIOD OF SIGNIFICANT STRUCTURAL CHANGE
 - 1. THE MARKETPLACE CHANGES ARE OCCURRING FAR MORE
RAPIDLY THAN THE REGULATORY/LEGISLATIVE CHANGES
 - A. WITHIN THE PAST FEW MONTHS - IMPORTANT
DEVELOPMENTS - WHOLE AREA LITERALLY SEETHING
 - 2. ONLY JUST BEGINNING TO SEE THE IMPACT OF THIS
 - 3. THE EXAMPLES OF OTHER INDUSTRIES THAT HAVE GONE
THROUGH DEREGULATION ARE INSTRUCTIVE
 - 4. BANKING WILL BE NO DIFFERENT
- D. THE FINANCIAL SERVICES INDUSTRY IS FACING AN
OVERCAPACITY PROBLEM

1. REGULATION HAS PROVIDED SUPPORT FOR A GREATER
NUMBER OF INSTITUTIONS THAN NATURAL MARKET
FORCES COULD HAVE PERMITTED
2. DEREGULATION WILL EXPOSE ALL INSTITUTIONS TO
MARKET CONDITIONS THAT THEY HAVE NEVER
EXPERIENCED BEFORE
 - A. A CONSOLIDATION AND REDUCTION IN THE NUMBER
OF PARTICIPANTS WILL BE A NATURAL
- E. CLEARLY, THESE DEVELOPMENTS WILL TOUCH ON THE
SAFETY AND SOUNDNESS OF THE FINANCIAL SYSTEM
 1. FAILURES THAT DESTABILIZE FINANCIAL
INSTITUTIONS COULD HAVE AN IMPACT ON THE
MARKETS AND FINANCIAL CONDITIONS
 - A. MONETARY POLICY, THE LOGICAL RESPONSE TO
THIS PROBLEM

B. ONCE AGAIN, AN ISSUE THAT SEEMS VERY
MECHANICAL IN NATURE HAS MONETARY POLICY
IMPLICATIONS

THIRD AREA

VI. ECONOMIC RESEARCH AND MONETARY POLICY - WE ARE IN ONE
OF THE HAPPY PERIODS WHEN MOST THINGS FROM BOTH
ECONOMIC AND MONETARY POLICY PERSPECTIVES ARE IN
REASONABLY GOOD ORDER, YET THIS SEEMINGLY BENIGN
ATMOSPHERE MAY WELL BE MASKING SOME VERY SERIOUS
CHALLENGES

VII. IN A BROAD SENSE, ECONOMIC OUTLOOK CONTINUES TO BE
FAVORABLE

A. THOUGH CURRENTLY EXPERIENCING A PAUSE

1. NO REASON TO CHANGE BASIC FORECAST OF
CONTINUATION OF EXPANSION AT LEAST THROUGH 1985

A. BUT I WILL ADMIT TO A GROWING LEVEL OF
APPREHENSION

B. GNP +3 - 3-1/2%

1. DOWN FROM LAST YEAR'S 6%

2. THIRD YEAR EXPANSION

C. UNEMPLOYMENT - 7% OR LITTLE UNDER BY END OF THE YEAR

1. HIGH - BUT VAST IMPROVEMENT

D. INFLATION - C.P.I. CURRENTLY 3-1/2%

1. SOME INCREASE DURING BALANCE OF YEAR

2. BUT NOT AS MUCH AS MIGHT HAVE ANTICIPATED GIVEN

PHASE OF CYCLE

VIII. BUT THE UNEVENNESS CONTINUES - PARTICULARLY TRUE IN
MIDWEST - VERY DISTURBING - DICHOTOMY GROWTH - SERVICE
SECTORS WEAKNESS - HEAVY PRODUCTIVE

A. GOOD BUSINESSES ARE DOING QUITE WELL - BAD
BUSINESSES ARE DOING VERY BADLY

1. ANYTHING AGRICULTURALLY ORIENTED - DISMAL

B. NONETHELESS, IN A TOTAL PERSPECTIVE THE RESULTS ARE
VERY GOOD

1ST RISK

IX. BUT THERE ARE SOME SIGNIFICANT RISKS TO THE EXPANSION

A. RESURGENCE OF INFLATION

1. 1979-'80: 13-14%
2. MIGHT HAVE EXPECTED THAT DECLINE WOULD BE
TEMPORARY
3. BUT, AS NOTED, OUTLOOK FAVORABLE
4. WAGE COSTS
 - A. RECENT EXPERIENCE
 - B. PRODUCTIVITY
 - C. UNIT LABOR COSTS
 - D. CHANGE IN ATTITUDE BY UNIONS
5. PRICE ESCALATION - MODERATE
 - A. CAPACITY UTILIZATION
 - B. INTENSE MARKET PRESSURES

(1) INCREASES JUST DON'T STICK

2ND RISK

B. OCCURRENCE DOMESTIC FINANCIAL STRAINS

1. CONTINENTAL

A. REGULATORY RESPONSE - RISK CONTAINED

2. OHIO

A. WELL CONTAINED

B. BUT DEVELOPED PRETTY RAPIDLY

(1) DISCREET GROUP OF INSTITUTIONS

(2) LIMITED GEOGRAPHIC AREA

3. BUT LOAN PROBLEMS AGAIN EMERGING AS A THREAT -

AGRICULTURE

A. LOCALIZED - BUT A PROBLEM

4. REAL ESTATE - CATEGORY THAT KEEPS COMING BACK

AGAIN AND AGAIN

A. SIGNIFICANT VACANCY IN COMMERCIAL PROPERTIES

CHICAGO 8MM-12.5MM/2-4MM; HOUSTON 40MM

5. ENERGY

A. PRICE EROSION

6. FINANCIAL MARKETS ARE PRETTY BRITTLE

A. ATMOSPHERE IS ELECTRIC

(1) OHIO - INDICATIVE

3RD RISK

C. RENEWED PROBLEMS WITH THE HEAVILY DEBTED LDC
COUNTRIES

1. SIGNIFICANT PROGRESS - MEXICO

2. BUT BRAZIL/ARGENTINA - PRESSURES - RECONCILE
INTERNAL SOCIAL NEEDS/EXTERNAL DEBT REPAYMENT

X. BUT THE BIGGEST RISK BY FAR - THE SO-CALLED TWIN
DEFICITS - DOMESTIC FISCAL AND TRADE

A. THE IMBALANCES ARE BECOMING UNMANAGEABLE AND ARE
REALLY THREATENING

- B. LET ME GO ASIDE FOR A MOMENT AND COMMENT ON THE
SURPRISING, INDEED, METEORIC, RISE IN THE
INTERNATIONAL VALUE OF DOLLAR THAT HAS OCCURRED
OVER PAST TWO YEARS
1. UNTIL RECENTLY - ONLY GO UP
 2. DESPITE EXPECTATIONS TO THE CONTRARY
- C. IN HINDSIGHT, NOT SURE THE INCREASE SHOULD BE SUCH
A SURPRISE - THE ENVIRONMENT WENT THROUGH ENORMOUS
CHANGE
1. VOLCKER APPOINTED JULY 1979 - EARLY MESSAGE -
MONETARY POLICY - TOUGH CONTROL - 3 MONTHS
LATER - FOMC
 - A. OPERATING CHANGE OCTOBER 1979
 - B. WE WERE GOING TO BE SERIOUS ABOUT INFLATION
 2. REAGAN ELECTED IN 1980 - SIGNIFICANT MANDATE
 - A. RETURN TO FUNDAMENTAL VALUES

3. AS A RESULT OF FED'S OPERATING CHANGE - RATES
BECAME MORE VOLATILE
 - A. ROSE TO ASTONISHING LEVELS
 - B. AS INFLATION CAME DOWN - NOMINAL RATES CAME
DOWN, BUT REAL RATES INCREASED
 - C. DOLLAR TOOK ON A NEW ATTRACTIVENESS -
RETURN WAS HIGH
 - D. PERHAPS SINGLE MOST IMPORTANT REASON
4. RECESSION ENDED IN LATE 1982
 - A. MARKETS GAINED CONFIDENCE IN OUTLOOK FOR
ECONOMY
 - B. PARTICULARLY SO WHEN REALIZED THAT
INFLATION WOULD REMAIN UNDER CONTROL
5. AND POLITICALLY, WE CONTINUED TO OFFER AN
ATTRACTIVE ALTERNATIVE - SAFE, SOUND
 - A. NOT THE CASE WITH MANY OTHER COUNTRIES

D. THE POINT IS - EARLY 1980S PROVIDED AN ENORMOUS ENVIRONMENTAL CHANGE

1. VASTLY DIFFERENT THAN LATE 1970S

A. RAMPANT INFLATION

B. ERRATIC ECONOMY

C. WEAK ADMINISTRATION

2. THE STAGE WAS SET FOR THE INCREASE THAT OCCURRED

XI. EXCHANGE RATES, PARTICULARLY WITH FLOATING EXCHANGE RATES, ARE, OF COURSE, A FUNCTION OF SUPPLY AND DEMAND - THESE PRESSURES ALSO MITIGATED IN FAVOR OF AN INCREASE IN THE VALUE OF THE DOLLAR

A. DEMAND

1. DOLLAR HAS LONG SERVED AS PRINCIPAL MEDIUM OF EXCHANGE

A. 70% OF WORLD TRADE IS SETTLED IN DOLLARS

2. ARE EXPERIENCING WORLD WIDE ECONOMIC EXPANSION

A. INTERNATIONALLY MORE MODEST THAN DOMESTIC

B. BUT CERTAINLY ENOUGH TO PUT PRESSURE ON
DEMAND FOR DOLLARS

3. DEMAND PRESSURES BECAME PRETTY HEAVY

B. SUPPLY

1. OPERATIONAL CHANGE - OCTOBER 1979

2. CLEAR SIGNAL THAT SUPPLY OF BANK RESERVES,
THEREFORE DOLLARS, WOULD COME UNDER RESTRAINT

3. THE OPERATION OF DOMESTIC MONETARY POLICY
BASICALLY ESTABLISHES THE FRAMEWORK OF SUPPLY
ASPECTS AS THEY PERTAIN TO EXCHANGE MARKETS

XII. AS A CONSEQUENCE, VALUE OF DOLLAR ROSE INEXORABLY

A. BECAME SELF-FULFILLING PROPHECY

1. TRADERS BOUGHT AND SOLD WITH ENSURED
PROFITABILITY - ASSURED PROFIT

2. SPECULATIVE ACTIVITY - DEMAND

B. RECENT INTERVENTION

1. CANNOT CHANGE FUNDAMENTALS
 - A. VOLUMES TOO LARGE
2. BUT DOES INTRODUCE AN ELEMENT OF UNCERTAINTY
3. MAY WELL HAVE BEEN AN UNDERLYING REASON FOR
RECENT DECLINE
- C. BUT DESPITE PRESS COMMENTS THAT FROM A MONETARY
POLICY PERSPECTIVE INTERVENTION IS INFLATIONARY
 1. IT EXPANDS THE MONEY SUPPLY
 2. REALLY NOT THE CASE
- D. TECHNICALLY, AND UNLESS CORRECTIVE ACTION IS TAKEN,
INTERVENTION DOES ADD TO THE MONEY SUPPLY
- E. WHEN THE FEDERAL RESERVE INTERVENES (ON BEHALF OF
THE TREASURY), SAY, AGAINST THE D.M.
 1. WE ENTER MARKET AND SELL DOLLARS FOR D.M.
 2. WE PAY FOR TRANSACTION BY CREDITING THE RESERVE
ACCOUNT AT A U.S. BANK

3. THIS STEP IS OPERATIONALLY EXPANSIONARY - WE
ADD TO RESERVES JUST AS IF WE HAD PURCHASED
TREASURY SECURITIES AND HAD PAID FOR THEM IN
THE SAME MANNER BY CREDITING A RESERVE ACCOUNT
 4. BUT THIS OPERATION IS COMPUTED INTO OUR
ANALYSIS OF RESERVE PATHS
 5. WE WILL THEN UNDERTAKE AN OPERATION TO TAKE OUT
THE RESERVES CREATED BY THE INTERVENTION
- F. SAME IS TRUE FOR INTERVENTIONS BY FOREIGN CENTRAL
BANKS
1. THE COMMUNICATIONS ARE EXCELLENT
 2. ROUTINELY OFFSET ALL FOREIGN EXCHANGE
TRANSACTIONS INVOLVING DOLLARS
- G. IN SHORT, EXCHANGE INTERVENTIONS CERTAINLY ADD AT
LEAST A THIRD DIMENSION TO CONDUCT OF MONETARY
POLICY
1. BUT THEY DO NOT CAUSE US TO LOSE CONTROL

2. IF THE AGGREGATES ARE HIGH IN RELATION TO
RANGES FOR YEAR, IT IS NOT DUE TO EXCHANGE
INTERVENTIONS

- XIII. AS ALWAYS, ALL THIS BRINGS ME BACK TO THE ROOT CAUSE OF
SO MANY OF THE ADVERSE FACTORS WE ARE DEALING WITH -
THE FISCAL DEFICIT - BORING AND TIRESOME
- A. INCREASINGLY DIFFICULT - MANAGE MONETARY POLICY -
HOSTILE FISCAL ENVIRONMENT
- B. WE ARE FACING SOME VERY SIGNIFICANT MONETARY POLICY
CHALLENGES - THE CRITICAL CHALLENGE THAT WE FACE
1. AGGREGATES, PARTICULARLY M-1, HAVE EXPERIENCED
STRONG GROWTH FOR PAST 4 MONTHS
2. MAY WELL HAVE MODERATED IN MARCH, BUT STILL,
M-1 AT TOP OF RANGE ESTABLISHED FOR YEAR
- C. IN BRIEF, THE FOMC HAS A CHOICE BETWEEN SEEMINGLY
BAD ALTERNATIVES

1. IF WE BEGIN TO EXERCISE RESTRAINT - MAY WELL
CAUSE RATES TO INCREASE
 2. ADVERSE EFFECTS ON DOMESTIC ECONOMY
 3. EXACERBATE THE EXCHANGE PROBLEM
- D. IF WE DON'T BEGIN TO CONTROL THE GROWTH OF
AGGREGATES
1. WOULD HAVE UNFORTUNATE IMPLICATIONS FOR
INFLATIONARY OUTLOOK
 - A. TRAGIC MISTAKE
 2. IN TURN, NEGATIVE IMPACT FOR THE DOMESTIC
ECONOMY AND INTERNATIONAL SENTIMENT ON THE
DOLLAR
 3. FACING VERY DIFFICULT PERIOD - WE WILL FACE
STRONG PRESSURE TO INFLATE OUR WAY OUT OF THE
BURGEONING DEBT LOAD

E. BUT WE HAVE COME THROUGH SOME SIMILAR PERIODS OF
CHALLENGE

1. WITH GREAT SUCCESS - '81-'82, 1984
2. CONFIDENCE THAT WE CAN AGAIN THIS YEAR
3. ON THAT OPTIMISTIC NOTE

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