The Federal Reserve--Roles
and Goals for the Seventies

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It is a privilege to be with you this evening. I have been looking forward with pleasure to this opportunity to talk with you about some of the problems confronting the Federal Reserve System over the next few years.

A nationally known consultant argued early last year that the Federal Reserve System had as much relevance to either the political or financial realities of today as a mustache cup. These are fighting words! Obviously, I wouldn't have accepted the Presidency of the Chicago Reserve Bank, if I had thought that this was true. I presume that you don't agree with him either. At least I hope you don't! But I did want to find an appropriate forum to set the record straight. I can think of no better group to talk to about the System's relevancy than the Bankers Club of Chicago.

We are all aware that in this day and age the charge of irrelevancy has become almost commonplace. Our institutions are viewed by some as being outmoded, rigid, and misdirected. They are charged with being incapable of meeting the changing needs of our present society. They are judged to be hopelessly inadequate as innovators.

Not the Federal Reserve System! At least I don't think so. It would take more time than I have tonight to detail all of the areas of responsive change in the System and its activity over the years.

Add to this the time that it would take to enumerate and discuss the unfolding problems and areas of the Fed's concern about the future and you have at least a two-day meeting.

Tonight, I want to talk as briefly but as meaningfully as possible only about the roles and goals of the Reserve System for the 1970s, as I see them. I expect to keep to a reasonable time schedule. I don't want to end up like the minister who typically treated his congregation to a sermon so lengthy that it tried the patience of even the most devout parishioner. Finally, in desperation one Sunday, a member of the congregation arrived at church early and removed several pages from the minister's manuscript as it lay on the pulpit. The minister, not knowing that several pages were missing, proceeded with his sermon, which that day was on Adam and Eve. He got to the bottom of a page reading "And Adam said to Eve . . .;" he turned the page and realizing that the next page didn't follow, shuffled through his papers repeating several times "Adam said to Eve." Then almost in desperation he said "And Adam said to Eve---there seems to be a leaf missing!"

Well, I don't think I have any leaves missing. I took the precaution of stapling them together. Although I won't be able to cover the Fed's roles and goals entirely to my and to your satisfaction tonight, I hope at least that we can start a dialogue that will continue after this evening.

<u>The objective of Federal Reserve policy</u>. The basic objective of the Federal Reserve System is to facilitate the achievement of the social and economic goals of our people and our government through its contribution to an appropriate economic environment. These are obviously not the same words that were used in the preamble to the Federal Reserve

Act or in the Employment Act. But they are meant to convey the same sense of purpose. Hopefully, they also convey the view that in this changing society we must focus on a broad view of our functions if we are to meet our responsibilities.

It must be remembered by System officials, bankers, and the general public alike that the primary function of the central bank is the promotion of the public interest. Each decade brings more rapid change, innovations, and new dimensions of sophistication in the approach to our objectives. These changes have and will vastly modify our interpretation of those objectives and how the System's functions relate to the whole fabric of society--not just to the economic process or our financial machinery.

My restatement of this System objective does not, of course, essentially modify the three general areas of more specific System responsibility; namely, a smoothly running payments mechanism, banking supervision, and monetary control. But I feel that we should interpret these goals so that they convey the sense that we will be reaching for them in an environment not only where needs are constantly changing but where the most effective action may be blocked by relics of a bygone era in the form of legislation, structural rigidities, or just plain lethargy. In other words, the goals are familar but their implications in today's environment are far different from what would have been suggested ten years ago. And obviously the priorities among them also have shifted. We must constantly rethink those priorities and the options open to us in achieving them.

Each sector in the economy, of course, sees these objectives in a different light. Moreover, it is easy to think of methods of achieving each separate objective that may look promising, but yet may be mutually inconsistent. Compromises have to be reached. The trade-offs need to be clearly understood.

The paramount responsibility of the Federal Reserve, as the central bank of the United States, is to provide the reserve base that will enable or encourage the commercial banking system to generate the appropriate total supply of money and credit. I stress the "total supply of credit," because in this view of the central bank's responsibility, the task of allocating the supply among would-be borrowers is left to the decision of individual bankers and other suppliers of credit interacting freely in the market place. In recent years, the efficiency of the allocation function has been called into question and some changes may be due. There are two possible approaches--one is for the Federal Reserve to take a more direct role in guiding credit flows; the other is to improve the market's ability to achieve the kind of credit and resource use that appears to be most needed. In my view, the second approach is greatly to be preferred. But it depends for its success on competition, knowledge, and mobility of both money and people. To the extent that it cannot be made to work to the satisfaction of the majority of our people, pressures will mount to steer funds in the direction of socially desired objectives, whatever those may be at the moment. But this approach entails serious problems of possible errors in human judgment, of conflict among experts as to the proper course of action, and of mushrooming government controls to make initial controls work and to plug loopholes that tend to render the original rules inequitable or ineffective.

In what ways then can the Fed be expected to provide the environment within which banks can meet the needs of agriculture, housing, urban areas, state and local governments, the federal government, and the international payments mechanism? The System must affect the environment through its influence on the structure of banking, through its responsibilities with respect to the performance of banks, and through its influence on the availability of credit.

I'm not going to talk about inflation specifically tonight. But I'm sure you'll all agree that better control of inflation than we had in the 1965-68 era is absolutely essential to the achievement of our goal of a healthy environment for the 1970s. Nor should the absence of any comments tonight on the respective roles of commercial banks and other financial institutions be interpreted as indicating any lack of concern as to the future of banking in America. Suffice it to say that each of you have as vital a role in the future of America as you ever have.

I certainly don't come to you tonight with a series of neat solutions to any one of the issues of the 1970s--much less solutions to all of them. The best anyone can do, as he looks into the future, is to search a wide range of possible problem areas--challenges, as I prefer to look at them--and to identify the ones that are most likely to produce difficult choices in the future. There are several I would like to examine in some detail.

Banking structure. Among the problems faced by the Federal Reserve few are more difficult or of greater potential importance to the economy than those having to do with banking structure. Together with the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the fifty state banking departments, the Federal Reserve is responsible for assuring that developments in banking structure--a term encompassing the number and size distribution of commercial banks, their pattern of branching, and the types of activities they conduct--are compatible with the broad goals of depositor safety, technological efficiency in banking, efficient allocation of financial resources throughout the economy, and the prevention of excessive concentrations of economic power.

The System's specific responsibilities with respect to banking structure are spelled out in the federal banking laws. In particular, I refer, of course, to the Federal Reserve Act, the Bank Holding Company Act of 1956, and the Bank Merger Act of 1960, plus their subsequent amendments. They include, among many others, rulings on applications for mergers and acquisitions of banks by holding companies; administration of the Regulation Q ceilings on interest rates on time deposits; and the determination of whether proposed new activities of banks are "so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto . . . ."

Especially since the early 1950s, a major purpose of the Federal Reserve has been to encourage, within limits consistent with the safety of the banking system, vigorous competition among banks. Competition has been promoted as the guarantor of good performance. It also assures protection against arbitrary and unfair decisions in allocating credit among competing borrowers. The basic presumption has been that competition is best served by maintaining an adequate number of independent sources of banking services in each local market and by preventing mergers and acquisitions that contribute even marginally to the share of resources controlled by the largest banking associations in markets where concentration is already high. I foresee no change in the general emphasis of the present policy in the coming decade.

One major obstacle to the achievement of these goals has been the existence of state laws that restrict the Federal Reserve's range of discretion in merger and holding company cases by foreclosing alternatives that would be preferable from a competitive standpoint. For example, geographic restrictions on branching often result in a merger being approved that might otherwise be denied in the hope that the bank to be acquired somehow might be purchased by a bank not now competing in the same market. Similarly, home office protection clauses in state branching laws often result in the denial of mergers promising substantial improvement in efficiency because there is no possibility of potential entry to offset the loss of an independent source of banking services. Although federal law has long deferred to state law in the matter of branching, the question should be raised as to whether or not such deference precludes the attainment of anything approaching an optimal structure of banking. As a result, occasions may arise for a reconsideration of the System's strict neutrality in matters of banking being considered by our state legislatures.

For the immediate future, and for some time to come, the Federal Reserve's greatest challenges in the area of banking structure and competition will be found in its administration of the new Bank Holding Company Act expected to be enacted before Congress adjourns its current session. Since 1967, banks have been forming one-bank holding companies, now exempt from federal regulation, to organize or purchase subsidiaries, some of which are engaged in activities that banks, themselves, are precluded from engaging in. While acknowledging the desirability of a considered broadening of existing restrictions on bank activities, neither the Congress nor the federal banking agencies are willing to see the line between banking and commerce obliterated. Not only does the common control of purveyors and users of credit raise serious conflict-of-interest possibilities, but the very size of the banks involved and the scope of their planned activities appear to some to threaten too great a concentration of economic power.

Unless the law that emerges from the present Senate and House conference is much different than expected, the Federal Reserve will be called upon to decide whether existing or proposed activities of companies owned by one-bank holding companies "are functionally related to banking in such a way that their performance by an affiliate of a bank holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased competition, conflicts of interest, or unsound banking practices."

It is difficult to exaggerate the importance of the Federal Reserve's responsibilities under the proposed legislation. Even after the Federal Reserve Board has issued its initial rulings defining those activities that are "functionally related to banking," following hearings that may be quite lengthy, it will still be necessary for the System to process individual applications for acquisitions of nonbanking subsidiaries. It is expected that the present casework load of the Board of Governors and the Reserve banks might be doubled or tripled, requiring an impressive amount of recruiting and training of new personnel.

Whatever the actual dimensions of the task turn out to be, it is clear that the Federal Reserve will play a crucial role in determining the future evolution of the financial system. I can assure you that we in the System take a sober view of our far-reaching responsibilities in implementing the new legislation.

International responsibilities. Another area of significant interest and importance to the System and to me personally is the role of the Federal Reserve in the international financial sphere. Over the past decade, the Federal Reserve System has become increasingly involved in international financial relations. The involvement reflects a growing concern about the impact of our country's balance of payments deficit on the viability of an international monetary system in which the dollar has long been the focal point.

The United States has run a deficit in its balance of payments almost continuously over the past 20 years. For almost a decade hardly anybody was concerned about it. Indeed, the deficit in the 1950s was viewed rather with satisfaction both by the world at large and by the U. S. Government.

To the individual nations abroad our deficit represented the means by which they could replenish their war-depleted reserves with a currency that has been accepted throughout the world as a universal means of payments and a store of value. Our deficit enabled these countries to move away from severe restrictions on their foreign trade which, in turn, permitted them to flourish economically--often beyond their fondest expectations.

To the United States, the deficit was also a source of satisfaction at that time in that it enabled the Government to carry out its plans for economic and military aid. In those years, over $60 billion were given by the United States to other countries to lessen economic deprivation and to encourage the free world to defend itself against potential subjugation by International Communism.

Throughout the Fifties, the monetary policy maker did not worry about the balance-of-payments problem. Formulation of monetary policy was governed almost exclusively by domestic considerations-employment, prices, and growth. In the late Fifties and beginning of the Sixties, however, the situation changed drastically. With restoration of currency convertibility the restraint on foreign investment wasremoved. The U. S. investor no longer had to be concerned about his ability to repatriate the proceeds of these investments. Thus he felt free to take advantage of profit opportunities promised by the establishment of the European Common Market. As a result, the private capital outflow accelerated tremendously in the late Fifties. On the other hand, the rapid growth of income in Europe and the reduction of trade barriers enabled producers abroad to move toward large scale production and thus to compete more effectively against U. S. producers, both in the United States and abroad.

The U. S. balance of payments deficits increased and led to a rapid rise in the ratio of our foreign liquid liabilities to our gold reserves. Our short-term liabilities passed our gold stock in dollar volume in 1961 and have been increasing ever since; at the same time our gold stock declined.

These developments gave rise to concern about the ability and willingness of the United States to maintain its convertibility commitment which culminated in the 1960 "gold rush." As you will recall, this speculative purchasing in the London gold market was in anticipation of revaluation of gold by the United States as a means of easing the burden of the convertibility commitment.

The speculative attack was "beaten back." But it became clear that U. S. national economic policies had to become more intimately concerned with the country's balance of payments.

This concern took various forms. Special rules regarding off-shore procurement of military supplies were devised to minimize the deficit arising from military transactions. Other special measures of this nature were put into effect. But above all, both monetary and fiscal authorities began to conduct their policies with balance of payments consideration being added to the more traditional domestically oriented goals of policy set forth by the Employment Act of 1946--high levels of employment, stable growth, and--implicitly--stable prices.

Thus, since early 1960 the Federal Reserve entered--or rather re-entered--the international area. Its activities, and the development of its policies, evolved along two distinct paths:

(1) the use of traditional monetary policy tools for purposes of influencing the balance of payments;

(2) the development of new tools to deal with the problems arising from the deficit.

As I have already suggested, balance-of-payments objectives were <u>added</u> to the already established goals of monetary policy. This merely increased the possibility of conflict between, what may at times be mutually inconsistent and unattainable objectives.

Confronted with these conditions, the task of monetary policy was a difficult one. What the task boiled down to was an attempt to find a satisfactory middle ground between the opposing forces of domestic considerations and the balance-of-payments considerations. Inevitably, with a sluggish domestic economy in the early Sixties, the scale in this trade-off balance tipped in favor of domestic considerations. But because of balance-of-payments considerations, expansionary policies were pursued with sufficient moderation to result in the maintenance of a relatively stable price level through the early 1960s. This paid dividends in the balance-of-payments sense. Stability of our price level relative to that of our foreign competitors enabled us to maintain our competitive position in the world markets and thus contributed to the improvements in the trade account. In addition, the Fed tried through "operation twist" to discourage international short-term capital outflows believed to be sensitive to short-term interest rate differentials and at the same time encourage domestic investment that was presumed to depend upon the long-term interest rate level by selling bills and purchasing bonds.

By late 1965 the domestic economy began to show signs of overheating and monetary policy gradually swung to tightness. We moved into a period where the external and domestic objectives were in obvious harmony but the success of policy to contain the inflationary trends is in doubt.

Although in my book, fiscal policy failure in that period far out-distanced whatever shortcomings monetary policy may have had, the fact remains that we have experienced severe inflationary pressures and that these have had an adverse influence on our balance of payments, specifically the trade account. Our trade surplus, which rose steadily between 1960-64 and reached 6.8 billion in 1964, virtually disappeared, largely as a result of sharp increases in imports that the overheated economy was sucking in.

This year, we have seen some improvements. But the problem of finding a healthy balance between the domestic and international objectives of national policy will remain a paramount challenge for us at the Fed in formulation of monetary policy for years to come. For we know that the U. S. economy cannot prosper without a viable trade and financial relationship with the outside world. Similarly, the outside world must, for years to come, depend heavily on a healthy dollar--backed by a viable U. S. economy--for its continued growth and prosperity.

In the area of development of new tools to deal with the strains confronting the international monetary system, the Federal Reserve has, in the past, made important contributions. The development and imaginative use of a network of mutual credit lines between central banks--the so-called swaps--have been one of the major defenses we have developed to deal with speculative pressures on the monetary system we have witnessed in the past few years. These arrangements have been an outgrowth, and are only one of the examples, of intensive participation of the Federal Reserve in international consultations with other central banks. In addition, out of these consultations concrete measures of international cooperation have emerged such as the Gold Pool Arrangements in the early Sixties, the General Agreement to Borrow that strengthened the facilities of the IMF, and last year, the IMF special drawing rights that hold special promise of a better functioning international monetary system.

We still have a long way to go in solving the problems encountered in the monetary relationship among nations. The continuously changing kaleidoscope of challenges will, in the years to come, require imaginative building upon the base of mutual cooperation among monetary authorities in dealing with them. I expect to participate actively within the framework of the Federal Open Market Committee in the search for solutions acceptable to independent nations in our interdependent world.

The international challenges that we at the Chicago Fed shall be facing in the next decade are not only those arising from the position of our bank as an integral part of the Federal Reserve System. Our responsibilities also arise from our position as a leading regional bank.

Our Seventh Federal Reserve District leads the nation in the export of manufactured and agricultural goods. We have in our District corporations that have been real trail-blazers in the development of multi-national business--one of the most significant developments on the international scene during the past decade.

With this increasing international orientation of Midwest industry has come the profound transformation of banking in our District during the past decade. Our banks have responded to the growing international banking needs of their customers by establishing international banking facilities both here and abroad. While in the early Sixties, international banking facilities were offered at only a few Midwest banks--and in many instances in name only--now, at the beginning of the Seventies we have 24 banks with significant loans abroad. Our banks have established 20 overseas branches. Ten Edge Act subsidiaries have been set up for purposes of undertaking equity investment abroad. Numerous other arrangements--such as representative offices, ownership participation in foreign banks and an enlarged network of correspondent relations with foreign banks--have firmly established Midwest bankers as a progressive group.

These developments have entailed new challenges in virtually all functions at the Chicago Fed. Our bank's examination department, discount department, reserve analysis, research--all have had to respond to the broadening of the horizons of our banks. In discharging our responsibilities as a regulatory agency, our people had to adjust to a modus operandi of our banks that included Eurodollars, international letters of credit, and a host of others.

But these challenges have not only been accepted by our trying to keep in step with our District banks. We envision our challenge to be more aggressive than that--the challenge to provide leadership and encouragement to our banks and industry alike in this area of their endeavour. Recognizing the vital role that efficient international banking plays in a healthy growth of international economic relations, we plan, to the extent possible, to encourage positively the growth of international banking in our district.

As a first step in this direction we intend to begin publication of a weekly international letter this January. We have been aware of the pressing need of Midwest banks, businesses and the public for timely and accurate information on international economic developments. In our work we have developed a number of sources of information both here and abroad and in our international letter we hope to share with you the information available to us.

We want to participate with our banks in finding solutions to the problems they encounter in their effort to grow to full-service international operations. We are fully cognizant of the importance of these international relationships to the Midwest and to the nation--indeed, to the world at large.

Obviously, I have only scratched the surface on issues and areas for our concern. But time is running out and I'll end here with the hope that I can continue this dialogue with each of you. Any attempt to cover a topic of such breadth in a few minutes is obviously foolhardy. But I do hope that you leave with the view that the System is very much alive, kicking, and relevant. As for myself, I intend to do everything possible to see that we accept the challenge provided by the changing environment. A fundamental reappraisal of many of our current policies and regulations is definitely in order. As you look back over this decade from the vantage point of 1980, I am confident you will find that the Federal Reserve Bank of Chicago has played a vigorous role in meeting the greater responsibilities arising from our transition into what may be called our post-industrial economy.