OPENING COMMENTS
BANKER/REGULATORY RAP SESSION
CONFERENCE OF STATE BANK SUPERVISORS
APRIL 29, 1980

I WOULD LIKE TO COMMENT BRIEFLY ON TWO FAIRLY RECENT DEVELOPMENTS THAT ARE OF PARTICULAR SIGNIFICANCE TO YOU AND TO THE FED--THE CREDIT RESTRAINT PROGRAM AND THE RECENTLY PASSED MONETARY CONTROL ACT.

I SUSPECT THAT THE "SO-CALLED" MEMBERSHIP LEGISLATION--WITH ITS "SO-CALLED" SHORT TITLE OF THE DEPOSITORY DEREGULATION AND MONETARY CONTROL ACT OF 1980--HAS CAPTURED MORE OF THE ATTENTION AT THIS MEETING THAN THE CREDIT RESTRAINT PROGRAM. BUT SINCE THE PORTFOLIOS OF FINANCIAL INSTITUTIONS HAVE BEEN SO SEVERELY IMPACTED BY DEVELOPMENTS IN THE FINANCIAL MARKETS AND THE ACTIONS OF THE FED HAVE SUCH HIGH VISIBILITY IN THOSE DEVELOPMENTS, I FELT THAT IT MIGHT BE HELPFUL TO OUR DISCUSSION TO MAKE A FEW OPENING COMMENTS ON THIS AREA.

THE FIRST THING THAT I WOULD LIKE TO EMPHASIZE IS THAT THE RAPID ESCALATION OF INTEREST RATES THAT OCCURRED UNTIL VERY RECENTLY, REFLECTED AN INCREASE IN INFLATIONARY EXPECTATIONS <u>AND</u> THE EFFORTS OF THE FED TO BRING INFLATION UNDER CONTROL. IN THE EARLIER PART OF THE YEAR, UP UNTIL ABOUT MID-MARCH IN FACT, WE EXPERIENCED LARGE INCREASES IN CREDIT DEMANDS. AT THE SAME TIME, THOSE OF US AT THE FED IN ATTEMPTING TO MEET OUR MONETARY TARGETS WERE BEING RELATIVELY LESS ACCOMMODATIVE IN SUPPLYING RESERVES. THE LOGICAL RESULT WAS THAT INTEREST RATES CAME UNDER INTENSE UPWARD PRESSURE.

IN TYPICAL FASHION, RESTRICTIVE MONETARY POLICY HAD AN UNEVEN IMPACT. RESIDENTIAL CONSTRUCTION, AGRICULTURE, SMALL BUSINESS AND MUNICIPALITIES BEGAN TO SUFFER EARLIER AND MORE SEVERELY. MANY LENDERS COULD NOT PROVIDE CREDIT EITHER BECAUSE THE BORROWER WAS UNABLE TO PAY OR BECAUSE LOCAL USUARY

CEILINGS BECAME BINDING. FURTHER, MANY FINANCIAL INSTITUTIONS LOST LOANABLE FUNDS TO THE MONEY MARKET AS RATES IN THAT MARKET ROSE ABOVE THE LEVELS THAT THEY COULD PAY. ALTHOUGH SOME OF THE OBSTACLES TO PAYING COMPETITIVE RATES HAVE BEEN REMOVED, MANY SMALLER INSTITUTIONS SAW NORMAL SAVINGS INFLOWS SHRINK.

ALL OF YOU ARE KEENLY AWARE OF IMPACT THAT THESE DEVELOPMENTS HAD ON THE BALANCE SHEETS OF THE BANKS THAT YOU SUPERVISE. AND YOU HAVE NO DIFFICULTY, I AM SURE, IN PROJECTING FUTUTE IMPACTS ON YOUR BANKS FROM A CONTINUATION OF THE "HEAD-ON" CONFRONTATION OF ESCALATING CREDIT DEMANDS AND FED EFFORTS TO RESTRAIN MONETARY GROWTH.

ONE UNACCEPTABLE ALTERNATIVE WAS FOR THE FED TO ABANDON ITS EFFORTS TO RESTRAIN MONETARY GROWTH. THE RESULT OF UNRESTRAINED MONETARY GROWTH WOULD CLEARLY HAVE BEEN MORE INFLATIONARY PRESSURES WITH EVEN MORE DISASTROUS RESULTS FOR OUR FINANCIAL INSTITUTIONS.

THUS, THE CREDIT RESTRAINT PROGRAM CAME INTO BEING. IT WAS DESIGNED AS AN ADJUNCT TO MONETARY POLICY—NOT A SUBSTITUTE. CREDIT EXPANSION AT BANKS WAS CONSTRAINED TO A PACE THOUGHT TO BE CONSISTENT WITH THE ANNOUNCED MONETARY TARGETS. OTHER ASPECTS INCLUDING THE CHANGE IN MARGINAL RESERVE REQUIREMENTS AND THE SPECIAL DEPOSIT REQUIREMENTS FOR MONEY MARKET FUNDS AND THE PREFERRED POSITION FOR HOUSING, AGRICULTURE AND SMALL BUSINESS WERE INCLUDED TO REDUCE THE DISTORTION OF NORMAL CREDIT FLOWS THAT HAD OCCURRED.

NONE OF US LIKE TO MOVE AWAY FROM THE FREE MARKET ALLOCATION OF CREDIT. BUT CLEARLY THERE WAS AN EMERGENCY SITUATION FOR WHICH A TEMPORARY PROGRAM COULD BE OF HELP. I STRESS, <u>OF HELP</u>, SINCE THE BASIC PROBLEM IS INFLATION GENERATED AND ONLY THE FUNDAMENTAL EFFORT OF RESTRAINING MONEY GROWTH OVER TIME CAN SOLVE THAT.

My second topic is the recent legislation dealing with deregulation and monetary control. As all of you know, this legislation will result in a significant change in the financial environment. You know its various parts as well as I and I don't have time to comment on all of them, anyway. Let me simply give you some of my views on a narrow aspect—the impact on the dual banking system.

I am well aware that there is still a great deal of concern that the legislation is distructive to the dual banking system. I don't think that it is in philosophy or that it will be in implementation.

As to philosophy, I think that it is clear from the colloquies on the floors of the House and the Senate that there was no intention to damage the dual banking system. At each point where such concerns were expressed, one or another of the supporters (whose remarks I might add are being taken by the lawyers as having significant weight in interpreting the meaning of various aspects of the legislation) clearly stated their support for the continuation of a viable dual banking system. It was argued that the legislation "does not disturb the creative tensions"—"does not replace the state chartering of banks"—"does not replace examination and supervision of state banks by state examiners and the state instructors under state control"—"the states retain authority to define the power of state-chartered banks."

You may grant that the intent to preserve the dual-banking system is there but might well question whether in practice this will or can continue to be the case. As to the "will" I have no concern about the Fed's desire to retain the dual banking system. In fact, if there were any doubts the colloquy is clear on this too "The Federal Reserve Board and the Comptroleer of the Currency cannot infringe upon the state regulatory bodies."

AS TO THE "CAN," I THINK THE LEGISLATION CAN BE IMPLEMENTED WITHOUT DESTROYING THE DUAL BANKING SYSTEM--NOT THAT THERE MIGHT NOT BE SOME DIFFICULT ISSUES TO BE RESOLVED. THE MAJOR ASPECT OF CHANGE IS, OF COURSE, THE REQUIRED RESERVES IMPOSED ON DEPOSITORY INSTITUTIONS. AS YOU KNOW, RESERVE DEPOSITS, TO THE EXTENT THAT VAULT CASH DOES NOT COVER THE ENTIRE REQUIREMENT, CAN BE HELD AT ANY DEPOSITORY INSTITUTION WITH DEPOSITS AT THE FED. THUS, IN PRINCIPLE AT LEAST THERE NEED BE NO ASSOCIATION WITH US EXCEPT THROUGH A REPORT ON DEPOSITS FROM WHICH REQUIRED RESERVES CAN BE COMPUTED. THEY NEED NOT CHANGE SUPERVISORS FOR THIS.

NONMEMBERS WILL HAVE ACCESS TO ALL SERVICES AT THE SAME PRICE AS MEMBERS. THEY NEED NOT CHANGE SUPERVISORS FOR THIS.THIS

THE MOST CRITICAL ISSUE IS WHETHER OR NOT STATE RESERVE REQUIREMENTS ARE LOWERED, WHEN NECESSARY, TO THOSE UNDER THE NEW LEGISLATION. IF THE STATE REQUIREMENTS ARE NOT, THEN THERE COULD BE A CHANGE IN SUPERVISORS.

AND I ALSO SEE THAT THERE MAY BE CASES WHERE BANKS MIGHT PREFER THE FED AS A REGULATOR BUT DID NOT MAKE THE SHIFT BECAUSE IT WAS MORE EXPENSIVE IN A RESERVE REQUIREMENT SENSE. WILL THEY SHIFT WHEN THE RESERVE REQUIREMENT COST IS EQUAL? IN MOST CASES THAT ARE THIS CLOSE, THE LOWER RETURN ON FEDERAL RESERVE STOCK MAY WELL KEEP THE BANKS IN YOUR FOLD.

I APPRECIATE THE FACT THAT THERE ARE MANY COMPLEXITIES IN THIS LEGISLATION AND THAT THERE ARE MANY IMPLEMENTATION DECISIONS TO BE MADE. I FEEL CONFIDENT, HOWEVER, THAT EVERY EFFORT WILL BE MADE ON OUR PART TO INTERPRET THE LEGISLATION WHENEVER POSSIBLE IN SUCH A WAY AS TO PRESERVE THE DUAL BANKING SYSTEM.