

OUTLINE

for

COMMENTS ON BANKING AND THE FEDERAL RESERVE SYSTEM

presented by

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to

MBA STUDENTS

THE UNIVERSITY OF ROCHESTER

3:30 p.m.

MONDAY, DECEMBER 7, 1992

SETTING FOR THIS SPEECH

This talk is to MBA students at the University of Rochester.

We don't know how many students to expect.

My presumption is that Jerry Jordan is the only speaker.

My presumption is that Charles Plosser will introduce Jerry.

Jerry will talk for about 15 or 20 minutes, and then do Q. and A for the remainder of the period.

The first several pages of the outline are about the role of the Fed in creating prosperity.

The final three pages of the outline are about derivatives and industry risk analysis.

I. Introductory Comments

- A. Acknowledge introduction.
- B. Greet students and any other speakers.
- C. Introduce the topic.

The nation has reached an important juncture. The election showed quite clearly that voters were dissatisfied with the nation's economic situation.

There is no doubt that the economy has not performed well in recent years, but we also need to recognize the progress that's been made towards laying a solid foundation for growth in the coming years. Inflation has been considerably reduced, and, with the Cold War behind us, resources are being redirected towards peacetime activities.

Clearly, however, serious problems remain unresolved -- in education, health care, and government services, to name just a few areas. In addressing these, it is important not to repeat mistakes of the past. One that is of particular concern to me is the belief that the Federal Reserve somehow has the power to create prosperity just by opening the money spigot.

This is, I believe, a widespread perception, but it is incorrect. What I would like to discuss today is the Fed's true role in restoring and sustaining the nation's prosperity.

II. Plan of the Speech.

- A. To understand the Fed's role in national and state prosperity, one must understand:
 - 1. The organization and functions of the Fed.
 - 2. What the Fed cannot do.
 - 3. What the Fed can do in three basic arenas that are important for national prosperity. Those three arenas are: monetary policy, regulation and supervision of commercial banks, and the payments mechanism.
- B. I want to talk about those things, and then make some comments on a couple of current banking issues.

III. A Quick Overview of the Organization and Functions of the Federal Reserve System.

- A. For those of you who are not very familiar with the Federal Reserve System, let me give you a much-simplified overview of how we are organized to perform the functions that are the main subjects of my remarks today.
- B. The Federal Reserve System is comprised of twelve Congressionally-chartered corporations, called Federal Reserve Banks, located in major cities, and the Board of Governors located in Washington D.C. The Federal Reserve Bank of Cleveland is one of the twelve Reserve Banks. Reserve Banks have outside Boards of Directors, our employees are not civil service, and we are not subject to appropriations by Congress. Our expenses are only about 10 percent of our annual earnings, we pay a statutory 6 percent dividend to our stockholders -- the member commercial banks -- and turn our surplus earnings over to the U. S. Treasury.
- C. **Monetary Policy.** Monetary policy is formulated by the Federal Open Market Committee, which is comprised of the 7 members of the Board of Governors, the president of the Federal Reserve Bank of New York, and a rotating group of 4 other Reserve Bank presidents. I am currently a member of that Committee.
- D. **Supervision and Regulation.** The Board of Governors writes regulations governing the operations of commercial banks, to implement laws enacted by Congress. Federal Reserve Banks supervise (examine) commercial banks (state-chartered member banks, and bank holding companies) to assure that they are following the Board of Governors' regulations. (We are not the only banking supervisor; some others are the U.S. Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the various state Superintendents of Banks.)
- E. **Payments Mechanism.** The Reserve Banks and their Branches perform the Fed's functions in the payments mechanism. The Federal Reserve Bank of Cleveland has offices in Cleveland, Columbus, Cincinnati, and Pittsburgh that perform important work for the payments mechanism. Later in my remarks I'll explain what the payments mechanism is.

IV. What the Fed Cannot Do.

- A. The pace of the current economic recovery has been slower than previous recoveries.

1. Structural imbalances have proven to be large and persistent.
 - a. Unrealistic expectations of rising incomes and asset prices led to:
 - (1) Historically high usage rates of debt by business and consumers.
 - (2) Excessive commercial real estate construction.
 - b. The result has been that:
 - (1) Borrowers have cut spending and investment.
 - (2) Lenders have become more cautious.
 2. Cutbacks in defense spending involve lags and structural adjustments that affect individuals, firms, and communities.
 3. Budget problems of state and local governments are resulting in tax increases, layoffs, and cutbacks in transfer payments.
 4. Contraction of the savings and loan industry has disrupted many long-standing lending relationships.
 5. Mandated increases in commercial bank capital-to-asset ratios have induced banks to restrain the growth of their loan portfolios by setting higher standards of credit-worthiness.
- B. Structural imbalances such as these cannot be corrected with easier monetary policy.
1. Monetary stimulus cannot reduce the time it takes to accomplish these structural adjustments.
 2. Recessions and the current slow recovery are like hangovers -- excesses cause hangovers. Monetary stimulus, like more drinking, can delay an economic recession or hangover, but cannot avoid it, and indeed, the more one is postponed, the worse it is likely to be.
- C. Expansion of the money supply cannot:
1. Produce real goods and services.

2. Create employment.
 3. Permanently lower the unemployment rate.
 4. Peg, or permanently lower, the real interest rate.
- D. Furthermore, it is not true that "there's no harm in trying." If the Fed uses monetary expansion to attempt to do those things, it can harm the economy by causing inflation. The motto of a central bank should be "do no harm."
- E. The Fed cannot direct its monetary policy actions to any particular state or region. Currently, the economies of New England and the West Coast are very sluggish. The Fed is unable to target those areas for lower interest rates because the financial and capital markets of the nation are so completely integrated.
- F. The main point to remember is that it is the **private sector** of the economy that creates prosperity. The role of the Federal Reserve System is to provide a financial and monetary environment in which the private sector can do its work with the most confidence and the least distraction.

V. Monetary Policy and Price Stability.

- A. What monetary policy can do:
1. It can stabilize the aggregate price level.
 2. It can avoid being a source of economic disturbances through unexpected changes in policy.
 3. Both of these foster real economic growth.
- B. What a central bank should focus on:
1. Price level stability.
 2. Creating a climate of certainty about future price levels.
 3. The capital of a central bank is its credibility. The Fed should seek to restore and enhance the credibility of its pronouncements about its goal of price level stability. The Fed's pronouncements about its goal of price level stability lack full credibility with the public today because:

- a. The public has long experience with inflation.
- b. The public knows that even though the Fed has often espoused price stability as a goal, inflation has continued.
- c. The Fed has often cut interest rates immediately following announcements of adverse changes in employment or unemployment numbers, sending the wrong signal about its goals.

C. How a shift in focus would help the economy:

1. Confidence in price level stability would enable business people, investors, workers, and consumers to make wiser plans for consuming, saving, and investing. Plans made on the basis of inaccurate assumptions about future prices are often inefficient.
2. Price level stability would eliminate the need for people and companies to spend time and effort trying to find ways to predict inflation and to hedge against it.
3. Price level stability would eliminate the incentive for people and companies to hedge against inflation by acquiring physical assets such as houses that are larger than needed and inventories larger than needed. This would free these resources for productive uses rather than being held idle as inflation hedges.
4. The transition costs of achieving price stability are reduced when the public has confidence in the central bank, and when the public is correctly certain about the goal of monetary policy. That is why central bank credibility is so valuable.
5. Price level stability would foster stability of banks and the financial system by making it easier for bank loan officers to evaluate projects. When investments are made on the basis of price projections that prove to be wrong, the banks that lend to the investors are often hurt along with the investors.

VI. An Efficient and Reliable Payments Mechanism.

- A. The payments mechanism is the mechanism by which payments are made to carry out the everyday economic transactions of people, companies, and governments. Most of those payments are made with currency, checks, and

electronic transfers of funds.

- B. An efficient and reliable payments system is essential to the smooth functioning of any economy.
- C. Because our payments mechanism works so well, we tend to take it for granted. But a moment's thought about life **without** a reliable payments mechanism can illustrate its enormous contribution to our national prosperity. Consider these examples:
1. Suppose checks took so long to clear that merchants would accept only currency.
 2. Suppose there was no way to wire funds when swift payment was essential.
 3. Suppose all currency was so worn and dirty that vending machines wouldn't accept it and automated teller machines routinely jammed when you tried to withdraw cash.
 4. Suppose merchants would only accept coins for purchases because so much currency was counterfeit.
 5. Suppose a one-dollar bill was the highest denomination available.
 6. Suppose your automatic payroll deposit was credited to someone else's account in another bank.
 7. Suppose your automatic mortgage payment was deducted from your checking account but not credited to your mortgage.
 8. In the extreme, suppose the payments mechanism has broken down to the point where barter is the only means of making transactions.
- D. The Federal Reserve Banks work behind the scenes to avoid the problems described above:
1. The Federal Reserve transports checks via a large fleet of private couriers (cars and planes) and operates high-speed sorters around the clock to clear checks speedily.
 2. The Reserve Banks operate a wire payments system to facilitate speedy payments of large sums between banks.

3. Reserve Banks operate an automated clearinghouse to process smoothly automatic deposits and payments.
 4. Reserve Banks sort millions of pieces of currency each day to remove counterfeits and bills that are torn, worn, or dirty.
 5. Reserve Banks provide banks and the public with however much coin and currency they want, in the denominations they want.
- E. The role of the Federal Reserve Banks is to facilitate the making of payments more quickly, more reliably, and with lower transactions costs. Improvements in these areas contribute to national prosperity.

VII. An Efficient and Sound Banking System.

- A. An efficient and sound system of commercial banks can make important contributions to national prosperity.
1. A commercial bank's primary function is intermediation -- pooling funds and channeling them from savers to borrowers. Banks have developed a comparative advantage in evaluating and monitoring loans to certain categories of borrowers, especially households and small businesses. Sound and efficient banks are able to perform their intermediation function and thereby bolster national prosperity by providing credit to creditworthy borrowers for sensible projects and purchases.
 2. Checking accounts and currency services supplied by banks to firms and households are important components of the payments mechanism.
- B. The Federal Reserve System fosters a sound and efficient banking system through its regulation and supervision functions.
1. Regulations are intended to make banks sounder, and to ensure fair treatment of depositors and borrowers.
 2. One may suspect that some regulations hamper bank efficiency, profitability, and therefore bank soundness.
 3. Much regulation is a result of Congressional legislation, but the Federal Reserve System can still seek to design regulations that achieve the intent of the legislation in the least burdensome way.

4. Reserve Banks supervise commercial banks by examining them to ensure that they are following the regulations and operating in a prudent manner.
- C. Reserve Banks also foster a sound and efficient banking system by providing innovative and low-cost services to commercial banks.
1. Most important are the payments system services that I talked about earlier.
 2. Some other services are redemption of food stamps and collection of interest coupons.

VIII. Summary and Conclusions.

- A. The Federal Reserve System plays an important role in fostering national prosperity through its efforts in three arenas:
1. In the **monetary policy** arena, the Fed can foster price stability so that individuals can make sensible plans, bankers can make sensible loans, and people and companies won't use time and resources trying to forecast and hedge against inflation.
 2. In the **payments mechanism** arena, the Fed can seek to assure that payments can be made quickly, reliably, and cheaply, so that the private sector can concentrate their attention on the wisdom of transactions rather than on the mechanics of payments.
 3. In the **banking supervision and regulation** arena, the Fed can work to support an efficient and sound banking system. This will help assure that banks are available to do their jobs of facilitating payments and providing credit to creditworthy borrowers.
- B. These efforts tend to reinforce each other. For example:
1. Price stability helps banks to make better lending decisions, leading to a sounder banking system.
 2. A sound and efficient banking system is an important component of a reliable and efficient payments mechanism.
 3. An efficient and reliable payments mechanism reduces the costs of operating banks, helping to keep them profitable and sound.

- C. It is important to remember that the Federal Reserve System:
1. Can foster national prosperity in the ways that I have described today.
 2. Can not foster national prosperity through excessive monetary stimulus.

IX. A Current Banking Issue: Derivatives.

- A. Larger banks are participating in the growing markets for derivative instruments.
1. The number of derivative instruments, and the size of the derivative markets, have grown substantially over the last decade.
 2. In many cases, the size of the derivative market is greater than the size of the underlying cash market.
 3. Derivative markets often take the lead in pricing. For example, some bond traders use the Treasury futures market to price Treasury bonds.
 4. As the numbers of instruments and the sizes of the markets have grown, participation by banks in these markets has increased.
- B. From the perspective of a regulator, this trend has both advantages and disadvantages.
1. Derivatives, properly used, can reduce risk and enhance profitability.
 2. Misused, derivatives, like any financial instrument, can threaten the profitability of a bank.
 3. In some cases, a very large bank's participation in a derivative market might be so large as to present some systemic risk.
- C. Regulators are trying to address this development.
1. Regulators are surveying banks to learn the extent of their use of derivatives.
 2. Regulators are learning about derivatives and developing guidelines for examining banks that use them.

3. A committee to study the subject is being formed at the Board of Governors.
4. Federal Reserve testimony to Congress on this subject is likely in 1993.
5. One possibility is that bank capital requirements should be adjusted to take into account increases or decreases in risk to banks from these instruments.
6. Regulators should be careful to not hamstring banks so that they cannot take advantage of these new instruments. That could further reduce the competitiveness of banks compared to other providers of financial services.
7. On the other hand, as long as banks are benefiting from a government safety net, it might be appropriate to adopt regulation intended to avoid imprudent uses of derivatives.

X. A Current Banking Issue: Evaluating Industry Risk

- A. Bank lenders should evaluate the risk of industries to which they lend.
- B. Such an evaluation might include the following factors:
 1. Outlook for the national economy. Is the industry sensitive to the business cycle?
 2. Outlook for interest rates. Is the industry highly leveraged?
 3. Outlook for foreign exchange rates and foreign competition. Would an exchange rate change affect their competitiveness against foreign suppliers?
 4. The outlook for federal, state, and local government actions.
 5. Possible changes in foreign government policies. The end of the Cold War has obvious impact on defense industries.
 6. Technological innovations. The advent of personal computers and wordprocessing software hurt the typewriter industry.
 7. Legal challenges. Lawsuits against asbestos suppliers and cigarette manufacturers are examples.

8. Antitrust policy. Will the TV cable industry lose some of its monopoly protections?
9. Regulatory factors. Can spotted owls hurt the lumber industry of the Pacific Northwest?
10. Region-specific factors. Residential construction industry is dependent on general economic conditions in regional economies.
11. Hidden dependence on other industries.
 - a. Banks have traditionally tried to diversify their risks. However, a loan for an office building, a car repair shop, a catering service, and a strip shopping mall might not be truly diversified if they are all in Houston; they might all be oil-industry risks.
 - b. Nationwide branching might someday provide a solution to this problem for some banks. But for most banks, the answer has to be found in better awareness of these hidden interdependencies.