

The Federal Reserve and the Future  
of the Financial System

I am delighted to be present this evening to share with you some of my thoughts as to what may be the future of banking and specifically what forces or events may help shape that future. It is a special privilege to share the podium with John Perkins, a distinguished banker whose thoughtful industry leadership is widely recognized and respected.

As observers of the financial scene, I am sure <sup>you</sup> ~~we~~ all realize the rapid pace of financial innovation that has taken place in recent times. Much of what we traditionally <sup>have</sup> understood about payments services and specialized financial institutions, financial instruments, investment strategies and the like has been largely swept away by a tide of <sup>Persistently high</sup> inflation, high interest rates, and technological progress. To illustrate the point, I ~~was~~ <sup>heard of</sup> recently <sup>Spoke</sup> talking with a community banker who ~~told me~~ of his recurring nightmare. It involves one of his traditional customers that goes into her neighborhood Sears store to buy a pie plate. After charging the item to her revolving credit account, she stops to deposit her paycheck into her account at Sears' savings and loan subsidiary, checks on her investment in one of Sears' consumer notes, makes a payment on her life insurance policy, <sup>renew her auto insurance</sup> adds a small sum to the money market fund marketed by <sup>the</sup> Sears' brokerage firm subsidiary, and so on. And she gets a good buy on her pie plate, too!

While this vision may be a nightmare for the traditional banker, it highlights the incredible change in our financial system over the

last 15 years or so. Moreover, this change continues unabated and is accompanied by significant uncertainty about the role and impacts on the varied participants in the <sup>financial</sup> system, as well as concern about the ~~system's~~ stability of the system itself

In view of these legitimate concerns, I want to focus my brief comments on what I see as the primary role of the Federal Reserve during this transition period. That is, the transition from the tightly regulated financial system that was legislated in the 1930's to the more competitive - market oriented financial system which is emerging in the 1980's.

I believe the Federal Reserve will be a major player in shaping the new financial system and that the Federal Reserve's primary responsibility will be to create a stable economic environment within which orderly change can take place.

As the central bank, I believe ~~our~~ <sup>the</sup> focus ~~will~~ <sup>should</sup> be twofold. First to promote financial stability by pursuing an effective anti-inflationary monetary policy and, second, to provide or encourage a regulatory framework that will permit orderly change during the transition period and <sup>one</sup> in which all participants have an equal opportunity to compete. This, of course, suggests that more freedom should be granted to the regulated participants and that some restraint <sup>should</sup> ~~would~~ be placed on the unregulated participants.

The importance of the role of monetary policy can be <sup>best</sup> illustrated by looking at the <sup>Reasons for the</sup> accelerating pace of financial change ~~in~~ <sup>an economy marked by presently high</sup> inflation and high interest rates which provide new incentives for competition and rewards for financial innovators. It is my view that the Federal Reserve's current firm anti-inflationary policy

course is an absolutely essential ingredient for both the short-  
and long-run stability of <sup>our</sup> financial institutions and the whole finan-  
cial system. Moreover, I am convinced that the goals of long-term  
noninflationary economic growth are <sup>complete</sup> in harmony with goals emphasizing  
the stability of our financial structure. I say this because I am  
certain that the best way to achieve stability of our financial  
institutions is to bring down the level and variability of interest  
rates--and that means bringing inflationary forces under control  
while building a base for noninflationary growth.

The Federal Reserve's ability to adhere to a monetary policy  
of restraint in pursuit of future stability is complicated by public  
pressures for action to bolster the near-term stability of certain  
financial institutions. Some call for the Federal Reserve to  
rapidly ease its restrictive policy so that an increased flow of  
credit can work to bring down interest rates, permitting hard-pressed  
thrift institutions to adjust more rapidly to the imbalance between  
their high-cost funds and their low-yield portfolios.

*The revival of the housing industry is the presumed result of such policy easing*  
To those pressures I would respond that the Federal Reserve is  
the nation's central bank. <sup>Therefore</sup> Its policies must be tailored to accomplish  
the economic goals of the nation as a whole--and to promote the  
efficiency of our entire financial system. The Federal Reserve should  
<sup>in my judgment</sup> not ~~and must not~~ alter its course to alleviate the temporary problems  
of some particular segments of the economy.

I would also point out that the rapid monetary growth which  
would be needed to bring interest rates down sharply might well have  
that effect--but only for a short time. With rapid monetary easing,  
financial markets would anticipate the traditional by-product of

too-rapid money growth--inflation--and interest rates would quickly incorporate an even larger inflationary premium. The net result, of course, would be just the reverse of what was intended.

Some observers may be tempted to believe that the recent reduction in the Federal Reserve's discount rate is a signal of ease, or worse, abandonment of the firm anti-inflationary course <sup>that have been</sup> we ~~are~~ pursuing. However, because credit demands have moderated as a result of slower economic growth, <sup>the</sup> ~~the~~ recent reduction may more accurately be characterized as <sup>only</sup> a reflection of developments in money markets and in discount window borrowing. In such a context, the action was not inconsistent with a pattern of continued restraint of growth in money and credit.

Public understanding of ~~and~~ support for the Federal Reserve's anti-inflationary policies have suffered because of vocal criticism from some observers who disagree with the method used to conduct monetary policy. Particularly troublesome have been demands from some very prominent economists that the Federal Reserve <sup>should</sup> announce <sup>its</sup> ~~its~~ monetary targets and stick to them regardless of what else may be happening in the economy. Some even suggest that the particular monetary aggregates targeted by the Federal Reserve are of no particular significance.

In my view, a policy based on rigid adherence to a fixed growth rate ~~target for~~ a particular measure of the money stock would be irresponsible. In fact, in the current environment of rapid economic and financial change, holding to a fixed monetary growth ~~rate~~ could actually induce instability. Those of you who are "Fed-watchers" I'm sure recognize the inadvisability of inflexible growth targets for monetary aggregates that do not adequately capture the effects

of recent financial innovation and structural change. For example, in setting long-run target ranges for monetary growth for 1981 at the beginning of the year, the FOMC was aware that NOW accounts would have a large but unpredictable impact on the growth of transactions <sup>balances included in the measure of money</sup> ~~measures of money like~~ M1-B. Rather than pretending that we could foretell precisely the effects of NOW accounts and other changes on the composition of the public <sup>desire to hold</sup> ~~transactions~~ balances, the Federal Reserve cautioned that these targets might need to be adjusted as warranted by incoming information.

As evidence accumulated during the year, it became apparent that the impact of NOW accounts and the growth of other innovations such as retail repurchase agreements, money market mutual funds, and cash-sweep accounts for corporations was greater than initially anticipated. As a result, the FOMC at its midyear policy review decided to aim for M1-B growth near the lower limit of its long-run range. Had the Federal Reserve been ~~previously~~ committed to M1-B growth precisely at a rate near the midpoint of its long-run range, more reserves would have been pumped into the banking system to stimulate more rapid growth of traditional transactions deposits. The resulting flood of liquidity would almost certainly have ruled out the steady progress that has been made this year against inflation -- and, perhaps more importantly, the public's expectations of future inflation.

The distorting impact of financial innovations has not been limited to the narrow ~~transaction~~ <sup>the</sup> measures of money, though. It is now apparent that the growth of <sup>the</sup> broader monetary aggregates such as M2 have also been affected considerably by the tidal wave of financial changes. For example, money market mutual funds account

for nearly half of the total growth in M2 over the last year. Although money market funds have certain characteristics that make them potentially close substitutes for transactions balances, they also have characteristics that make them attractive substitutes for longer-term investments like stocks and bonds. By remaining flexible, the Federal Reserve has, in my view, avoided the pitfalls that could have destabilized the economy and the financial system. Commitment to constant growth of a particular monetary aggregate in an environment of rapid change, though alluringly simple, could have caused irreparable damage to our prospects for achieving both *our* short-term and long-term objectives.

So there are, indeed, complications for the Federal Reserve in achieving its ~~stated~~ goals. Given the inevitable strains in a financial system in transition, what can be done to promote progress and to hasten accomplishment of the objectives we have discussed? In my judgement, there are three major cornerstones for *such* progress:

(1) One is continued commitment to an orderly, steady course of deregulation and adjustment.

(2) Another is additional legislative or regulatory changes during the transition period which will promote equity among financial institutions, address the temporary earnings and liquidity problems of some institutions, and improve the potential for effective monetary policy.

(3) The third is the continued high-profile commitment of public economic policies -- both monetary and fiscal -- to the goal of reduced inflation, despite the disagreeable near-term side effects *that*

that course entails.

The first element -- commitment to orderly transition -- appears to be largely in place insofar as <sup>the traditional</sup> depository institutions are concerned. The landmark legislation, <sup>contained</sup> in the Monetary Control Act sets a timetable for interest rate deregulation, gives depository institutions more of a market-oriented framework in which to make asset and liability decisions, and ultimately spreads the direct burden of monetary policy among <sup>traditional</sup> all depository institutions through the phase-in of uniform reserve requirements.

However, neither the severity of the problems of transition nor the accelerated pace of financial innovation were fully anticipated by the Monetary Control Act. As a result, earnings shortfalls, liquidity pressures, and inequities in opportunity -- geographic and otherwise -- among firms offering financial services have been magnified. These situations suggest <sup>that</sup> the second element -- legislative or regulatory actions -- may be needed to improve or ease the transition process.

As you know, Congress is now considering legislation which would liberalize further the powers of financial institutions. In my view, much of the fundamental change being suggested, such as permitting thrift ~~institutions~~ to have full banking powers, would more appropriately be considered later in the transition period, when earnings pressures on thrifts are eased and when the distortion in financial markets caused by inflation and high interest rates have smoothed out.

In the short term, however, I would encourage consideration of actions such as simplified, accelerated accommodation of mergers of depository institutions -- particularly when the public interest would be served by the continued operation of the institution. As

you may know, the Federal Reserve supports legislation allowing interregional or interindustry mergers in such situations.

In order to improve monetary control, I would favor imposition of reserve requirements on that portion of money market funds which function as transaction balances. Such reserve requirements -- which should be extended to transaction-type balances wherever they are housed -- would improve the Federal Reserve's <sup>ability</sup> ~~capability~~ to measure and control monetary growth more accurately. Furthermore, such requirements would help bridge the competitive gap between depository institutions and those financial and nonfinancial firms who do not share the costly burden of regulation.

The third and most important cornerstone for building the successful transition period is, of course, the continued commitment of public economic policies to bringing down the rate of inflation. No transition scheme I can imagine will be successful without the consistent monetary and fiscal discipline which leads to lower inflation, lower interest rates, and moderate sustainable economic growth. In my view, reducing inflation is the only way to facilitate <sup>an</sup> orderly transition to the financial structure of the future, and permanently reduced inflation is a necessary pre-condition for the efficient, distortion-free functioning of that structure.

Now that the Federal Reserve's commitment to the necessary adjustment process is <sup>hopefully</sup> shared by fiscal policymakers, it is possible at last to foresee steady progress toward the ultimate <sup>goals</sup> ~~transition~~. However, should either monetary or fiscal policy waver because of short-term pressures to ease the pain of transition--or because of outside shocks or even political expediency--I have no doubt that

the pace of financial change will accelerate. If that happens, the abilities of our political and financial institutions will be strained further, and our capacity to manage this process would be severely weakened. However, at the moment, I am encouraged with what I see happening on the fiscal side but I believe that additional evidence of fiscal restraint--whether further budget cuts, or perhaps rescheduled tax cuts--will contribute importantly to building the long-run anti-inflationary bias so necessary if the nation is to achieve its economic goals.