Can the Fed Compete???

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I welcome the opportunity to appear today before the bankers of the nation assembled in convention, but I do so with some trepidation, knowing that the Federal Reserve has been accused, by some, of being unresponsive in its service policies to the banks that it serves. In fact, I will admit that there is an element of validity to that observation. The Fed has, in many cases, been satisfied to provide its own version of a "no frills" service. One of your colleagues--paraphrasing Henry Ford--described the Fed's attitude as follows: "You can have any color you want, as long as it's black." In defense of the Fed, though, I'd like to note that our basic black was a pretty reliable product and that basic black was able to blend into a number of different color schemes.

But, the Fed is changing--indeed, it has to change. It is in the midst of a major reassessment of its service policies and attitudes. That reassessment is a natural outgrowth of the legislatively imposed mandate that we price our services. But, from my personal vantage point, that fundamental reassessment must go beyond--considerably beyond--the narrow questions of how we determine our prices, how we respond to shifts in patterns of demand for our services, and how we adapt our operations to this new environment. In that light, I would like to use the time provided for my prepared remarks to share with you some of my tentative impressions about some of these broader implications of Fed pricing.

As you are well aware, the new program of Fed pricing is quite different from past practices. Under the present program, the Fed's services are, for the most part, available only to members, and at no explicit charge--but the services, of course, are not free. The implicit price of these services is the amount of income member banks have foregone by virtue of the maintenance of nonearning Fed reserves. And, as you know better than I, many bankers had concluded that the implicit price of the services was

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greater than the value of the services--hence, one critical element of the so-called Fed membership problem.

Under the new program of pricing, the Fed's services will be available to all depository institutions on the same basis and will be explicitly priced. The Fed will set a fee for each of the services it offers, so that it recovers its costs--including the so-called private sector markup--as if it were a private firm. At the same time, essentially all institutions will be subject to reserve requirements. Thus, there still will be a cost associated with reserves, but that cost will no longer give one depository institution a comparative advantage over another. Members and nonmembers alike will have to play the game by the same rules!

However, the underlying rationale for Fed pricing and, indeed, the congressional intent regarding Fed pricing goes beyond the creation of the so-called "level playing field." At its root, the move toward Fed pricing reflects a desire--one shared by the Fed--to ensure that payments services are provided in the most efficient manner.

As I see it, the market for payments services that is unfolding is fully compatible with that objective, in that it will produce a more efficient payments mechanism, if by efficient we mean that it produces the desired amounts of goods or services at the least cost. Compare the Fed's present approach to the new approach. Currently, the Fed really doesn't have a good way to make decisions about the quantity and quality of the services it provides. How fast should checks be cleared? How often should coin and currency be delivered? It can't answer such questions clearly, because it cannot readily determine if the benefits of improved service are worth the additional costs. So the Fed generally makes its production decisions--educated guesses--and then proceeds to minimize its costs.

Under the new competitive approach, in contrast, the Fed will have an unambiguous way of knowing if its production decisions are yielding benefits commensurate with their costs: the bottom line. The change is that it will know for sure which

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services are really wanted at what price. If the Fed's price is too high, the demand for its services will shift to those with lower prices--those that are presumably more efficient--and the objective of overall efficiency will be served. In those circumstances the Fed will be faced with the need to match those efficiencies or get out of the particular line of service in question. The reverse is also true if the business shifts to the Fed. But in either case, the market--not the ambiguities associated with a particular regulatory structure--will make the decision.

What I have just described is a rather straightforward textbook description of how things should work in a competitive environment. In fact, you and I both recognize that markets and institutions seldom conform to the simplicities of the textbook model. The case in point is no exception. There are characteristics associated with the market for payment services and characteristics associated with the players in that market that are not readily captured in my synopsis as to how things should work. Those characteristics will, however, have an important bearing on how things will work.

For example, one of the textbook prerequisites for a market is that there be perfect knowledge about prices on the part of all market participants. This will hardly be the case in the market for payments services. Fed prices and our costs must be laid out in detail for scrutiny--if not nit-picking--by competitors and customers and the Congress itself. Our competitors--the large correspondent banks--do not have that constraint. Similarly, they do not have to publish their prices and possibly even some price changes for public comment! The resulting advantage, I suspect, is not inconsequental, since I, at least, am not so naive to believe that practices such as "loss leader" pricing do not or will not exist in the market for payments services.

When I look at the Federal Reserve Banks relative to their potential competitors under this regime. I am also inclined to believe that certain "nonprice" considerations will weigh very heavily in the manner in which the demand for payments services is ultimately met. For example, the full array of services offered by large

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correspondent banks to their prospective customers--computer services, loan sharing agreements, investment advice, not to mention splendid receptions at bankers conventions--is far wider than the services provided by the Fed. In short, the large correspondent banks are, in fact, supermarkets for banking services, while the Fed is something more akin to the corner delicatessen. Given our society's preference for convenience shopping, here too, I suspect that the Fed banks are at a real disadvantage, even if its charges for--say--processing a check are close to or even below charges available in the private sector.

I don't want to leave you with the impression that the Fed is without some comparative advantages of its own in these areas. We have considerable expertise; we have considerable capital, both human and physical; and we have a solid, if not spectacular, reputation for the delivery of services. There may also be areas in which the Fed has an inherent advantage in providing services, if for no other reason than the fact that customer relationships are not divulged to prospective competitors for loans and deposits. And, as with the Fed wire or net settlement services, there may be some areas in which the Fed has its own nonprice competitive advantage. But, even if I make some generous allowances as to the significance of those factors in a competitive environment, I am inclined to the view that we in the Fed will not be able to fully match the scope and types of competition we will face in the new environment.

All of this raises the question as to how the Fed should go about the business of being a market competitor--stated differently, just how vigorously should the Fed compete? Should the Fed advertise? And if so, how and how much? Should it draw the line at informative mailings, at a billboard campaign, or at hiring Bob Hope to be its national spokesman? Should it hire a public relations firm to change its image? Should it sponsor a television show like "Dialing For Dollars"?

Or consider the gifts or premiums that private firms give away to customers. Should the Fed imitate these firms? Should it give football tickets to institutions that buy

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a lot of services? Should it give toasters or teddy bears to institutions that open clearing accounts at the Fed?

Although these examples may be a little farfetched, offering demand deposit accounting services to depository institutions--if priced to cover our costs--may not be so farfetched. And, in such less exotic areas, it doesn't seem to me that offering a fuller range of services, if priced appropriately, would be incompatible with the intent of the Congress that the Fed compete. I am not predicting any such result, but I do think we in the Fed must consider the question of how we will compete within a framework in which we realistically appraise the nature of the competition we face.

In fact, we in the Fed cannot answer the question of our competitive posture in the same ways that a private sector firm would. We have, it is clear to me, underlying public and statutory responsibilities relating to the payments and banking systems that transcend our role as a competitor in the market for payments services. These public responsibilities may, at some point, come into conflict with the mandate to compete or, at least, the mandate to compete in the more traditional ways that private institutions might compete. In a word, we could encounter situations that from the perception of the public interest might pose serious dilemmas. Let me give an example or two:

- Is it possible--looking down the road a few years--that economies of scale are, or will be, such that the clearing and correspondent business for the nation as a whole will end up concentrated in a handful of electronically interdependent large banks, and if so, is that result in the public interest?
- Is it possible that the current Fed share of the market for check clearing will be "cherry picked" to the point where the Fed is serving only the most remote of locations with the result that prices of such services in those locations will be many times in excess of prices available in other locations--that is, the post office problem--and, if so, will that result be acceptable?

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- Finally, is there any real risk--however remote--that, in the name of competition, operational practices or credit risk insensitivities which are contrary to the public interest could crop into the payments mechanism? We in this country are fortunate indeed to have a highly efficient, reliable, and flexible payments mechanism--a payments mechanism that ultimately rests on the confidence we all have in the payments we make and receive. That confidence is central to the functioning of our banking system and our economy at large. Whatever we in the Fed and you in the banking system do in response to this new environment, we must preserve that confidence!

I don't know the answers to these questions, and I don't know if events will unfold in a manner that will require that we answer these questions. But, I do know that from my personal vantage point as a central banker it would be as inappropriate to ignore them as it is devilishly intricate to answer them.

If I've raised more questions than I've answered today, it's because I have more questions than answers. That's an indication of where I, at least, stand today. To get at the answers--indeed, to be sure we know all the questions--will take time and some careful thinking. But, in spite of all the unanswered questions, I do believe that the move to Fed pricing is the right move. Pricing is more efficient--it should provide services in the desired amounts at the lowest cost. Pricing is more equitable--it makes the institutions that use the Fed's services pay for them and pay for them in proportion to use. And pricing is perhaps what the Fed needs to further improve its services. In a few years--who knows?--the Fed may offer not just the standard black, but a whole rainbow of choices.

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