

TOWARD A MORE EFFICIENT FINANCIAL SYSTEM

Remarks by

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Introduction

I am delighted to be in Montana again. This is my third trip here in two months since I became president of the Federal Reserve Bank of Minneapolis. That should give you some idea of how important I think Montana, her people and institutions are.

My visits here have helped me to understand why you are all so proud of your state. The scenery is fantastic, and the people are equally delightful. Everyone has been very friendly and gracious to me, and considering some of the things that have been attributed to me in the press, your kindness has been all the more impressive and welcome.

Even though I was born and raised in Utah, since I have spent the last 18 years in New York and Pennsylvania, people tend to assume that I have a rather jaundiced view of the West, and particularly of agriculture. Perhaps that is why every time I say something about the farm sector of our economy, there is a tendency to misread my statements and my intentions.

Consequently, probably the safest thing for me to do today is to refrain from saying anything about agriculture. I am very concerned, however, that you should understand that I am deeply interested in, and sympathetic toward, the plight of the farmer or rancher. In addition, I think there is an important issue involved that has implications for the relationship between the Federal Reserve and banks. So I would like to make a few brief comments about agriculture.

Let me begin by referring to an article that appeared earlier this month in a Montana newspaper that had the following headline: "Farmers not hurting, says Minneapolis Fed chief." A number of people were understandably upset when they saw that headline. And so was I, for it did not accurately reflect what I had said nor, for that matter, what was contained in the article that followed. What the article did say, and what I had said, was that:

1. Montana farmers and ranchers are in better shape than they had been earlier in the year (because of the "miracle" of rain).
2. Relatively few farmers or ranchers are having critical difficulty financing their operations, and most banks have reported to us they are able to accommodate the financial needs of farmers and ranchers without too much strain.

Neither of these statements was intended to imply that I don't think farmers and ranchers in Montana and elsewhere face a very difficult situation. In the face of rising costs, lower prices and drought, there is no question that many in agriculture must really struggle. To say that some rain and accommodating bankers make the struggle a little less severe in no way implies that the struggle is not very hard. I doubt very much that I could survive under these conditions as a farmer or a rancher. I have great admiration for those who strive so hard to do so. But I hope

to do more than stand on the side and admire. I would very much like to see our Bank play a more constructive role in helping farmers and ranchers find lasting, long-run solutions to their problems.

More Dialogue with Banks

One of the lessons I learned from my recent experiences in Montana is that I personally must do a better — a more complete — job of communicating my thoughts and intentions to others. It also occurs to me — and this is the main point I want to make today — that we in the Federal Reserve System need to do a better job of communicating our ideas and intentions to bankers — and we in turn might profit from more open and continuous communication from you.

For example, I have been told that actions taken by the Fed often appear to be very abrupt and arbitrary. That is unfortunate, because I really think it is fair to say that a great deal of careful thought and analysis goes into our decisions. Yet I'm afraid that once a decision is made, we sometimes fail to explain it to those who are affected in such a way that they can understand and even support what we are doing.

At the Minneapolis Fed, we are going to try very hard to improve in this area — to communicate with you clearly, completely, and early so that you can have a full understanding of what we are doing — so you can impact on our decisions where that is appropriate — and so you can have the maximum possible lead time to prepare for changes that we must all make in a dynamic world.

The Future World of Fed Services

In that spirit, I would like to spend a few minutes today taking a look into the future at some possible changes in the service relationship between the Federal Reserve and banks. The things I discuss may never take place the way I outline them, but I want to explore with you some things that could have a significant impact on how you conduct some parts of your business, especially in your relationship to us. I do this now so you can have maximum opportunity to impact on the decisions that are ultimately made and to plan your own adjustments to changes that could take place.

It's no surprise to you when I state that banking has become an increasingly dynamic and competitive business. Here in Montana, as elsewhere in the nation, other financial intermediaries including credit unions are aggressively chipping away at the markets and profits of commercial banks. And commercial banks themselves are engaging in more fierce competition among themselves. For example, during my visit to Montana two weeks ago, I learned of the effort of a bank in California to handle some financial services for a Montana retailer that are currently being handled by a Montana bank.

This kind of competition, coupled with the tremendous amount of experimentation and innovation currently taking place in the development of electronic and other kinds of banking services, is all very good for those consumers and businesses that must buy banking services. But it makes life difficult indeed for commercial bankers.

The question, then, is how can banks and the Fed best work together to best meet the needs of both bank customers and the banks themselves?

To explore that question, let me lay out several assumptions or principles about which I hope we can all agree.

First, it is in the public interest to have a highly competitive banking system. That is true because we can rely on the forces of competition to help insure that bank customers have access to the widest possible set of services at the lowest possible cost.

Second, therefore, we want to create a banking environment where competition among banks and between banks and other financial institutions is keen and widespread.

But third, we don't want competition to significantly impair the soundness or safety of our financial structure. People have very emotional feelings about their financial accounts, and severe disruption to the financial sector can cause unfortunate economic consequences on a widespread basis.

Fourth, we must depend on the banking system to play a significant role in the provision of payments, savings and other services in addition to helping finance economic activity and growth. Therefore, banks must be able to earn sufficient profits so that they can perform their services effectively.

Finally, fifth, we should ensure that all participants in the financial arena operate under sets of rules that are fair and equitable, so that no one group has an unfair competitive advantage at the expense of another.

As I said, I think we could find broad agreement on these assumptions or principles. And it is important to spell them out, because I think they can help guide us through some difficult decisions that will have to be made in the days ahead.

Nationwide NOWs

Let me cite a current example of how I believe a clear recognition of the above principles can help us all decide what actions should be taken. There is much debate at the moment about whether or not Congress should authorize nationwide NOW accounts. Many banks are having a difficult time deciding where they come out on that issue. And yet, given the principles outlined above, the basic decision is really quite simple. First of all, more and more financial institutions are already offering NOW-like accounts. They may not be called NOW accounts and they may not operate exactly like NOW accounts, but they are very similar in intent and effect. I'm referring, of course, to the numerous telephone transfer and share-draft type payments that are sprouting up all over the country. In essence, they allow individuals to make payments (directly or indirectly) from interest-bearing accounts. Given this fact, two of the principles outlined above — those having to do with promoting competition and equity of treatment among financial institutions — make it clear that some form of national NOW account legislation should be passed. Such legislation would allow more institutions to compete directly with each other in providing that kind of service. That is clearly to the advantage of the consumer. The legislation would also allow all institutions to compete on an equal, or at

least substantially equal, basis. And that is clearly to the advantage of commercial banks, for otherwise, the business will simply be taken away by other financial institutions which are already authorized or which would likely be authorized to provide that type of service. So for commercial banks, it is not a question of whether such services will be available to the public. Instead, it is simply a question of whether or not banks will be able to provide the service under conditions or terms similar to those faced by other financial institutions.

Now of course these terms are critical, for they will not only determine the competitive balance among financial institutions, but they will also determine the ability of banks to make a fair profit, thereby ensuring their soundness and vitality which are required by the other principles I outlined. So, I would hope that all commercial bankers would actively work to shape and promote some form of national NOW account legislation so that they can help ensure that the interests of consumers and the banks are both protected.

Access and Pricing

There are other examples of how adherence to the principles outlined above could help us see our way through difficult issues. The one I would like to focus on for the remainder of my talk is that complex set of questions concerning what services and upon what terms we in the Federal Reserve should supply services to banks and other financial institutions. With nonmember banks and thrifts clamoring to get into our ACHs, and

with some member banks clamoring to get out of the Federal Reserve System, the question of Fed services has taken on some very critical dimensions.

Harking back to the basic principles I outlined earlier, however, certain things seem to fall into line.

For example, if all financial institutions should be allowed to operate under essentially the same ground rules, then all financial institutions should probably have access to services provided by the Federal Reserve. But, and I want to emphasize this very strongly, access should be on the same terms and conditions for everyone. No institution should have to pay more than any other institution for the same service.

There may well be some alternatives that I have not thought of — perhaps someone here will write and let me know — but after a great deal of thought and study, I can really only see one way to ensure that all institutions are treated fairly in terms of access to our services, and that is for us to pay interest on whatever required reserve balances are held with us, and then charge on a use basis for the services we provide.

The payment of interest on required reserves is absolutely essential in my view, if we are to eliminate the current inequity between member and nonmember banks. That inequity has gone on for too long and is one reason why I am so pleased that the administration has now introduced a bill that would allow us to begin in a substantial way to rectify that problem. Since that provision will not harm nonmember banks and

will appropriately reduce an undesirable position for member banks, I would hope that all bankers would work hard for its passage.

The issue of pricing Federal Reserve services is more complicated and more controversial than the payment of interest on reserves. And yet, according to the principles we have been using in our discussion today, it is equally important. If we were to appropriately price our services, two things would happen.

First, banks and other financial institutions would only use as much of our services as they really need. We might well find that some of our services are in greater demand than others. Consequently, we would expand our provision of services which are most needed and contract our provision of services where the demand is small. This would improve the allocation of resources to the advantage of both the financial sector and the general public.

Some might ask why we don't just make those kinds of changes in services now. The answer is that without charging a specific price for a given service, we can't really tell how much of that service is really needed (as evidenced by the fact that someone will pay for it) and how much is just used because it is available.

The second thing that might happen, if we were to charge for services, is that we might find that the private sector can provide some services at a lower price than we can. Should that happen, you would buy those services from other banks or other institutions, and we would then drop out of that line of business.

I'm not sure that such an occurrence is very likely. We are really quite efficient producers of services and are getting better all the time. For example, output per man-hour in the Fed's measurable functions increased by almost 12% in 1976, following an increase of 6% in 1975. Those numbers are considerably better than what was accomplished on average by private industry during those two years. The Fed is pursuing operations improvement with great vigor, for we feel we have a responsibility to provide our services in the most effective and efficient way.

But, if it should turn out that someone else can do things with the same quality at lower cost, then it is in your interest and the public's for others to supply the service. That way you get the service at less cost, which would obviously be to your benefit and that of your customers. Under a pricing system, you would have the flexibility to choose the best possible source for what you need, and competition would work to keep the cost as low as possible.

Summary

What I have tried to say today can be summed up as follows:

1. Montana has a lot of member banks. We want an open line of communication with you. You are important to us. We want to keep you better informed and have you share your ideas with us.

2. With the way the world is changing, we seem to be moving rapidly into an era when financial arrangements need to be more explicit and equitable. Equity among financial institutions is required because it is right. Explicitness — e.g., explicit payment of interest on reserves and explicit charging for services — is required in order to achieve equity and in order to give all financial institutions the maximum freedom of choice.

The road ahead is going to be challenging and even a little choppy for bankers and the Fed. If we both face the challenge squarely, however, I'm convinced we can end up with a financial world that is not only different but better than the one we have today. And who knows, with your help, I may even be able to get back into the good graces of farmers.