THE SHAPE OF FINANCIAL MARKETS INTO THE 1980's:

SURVIVAL AMID CHANGE

by

David P. Eastburn, President

Federal Reserve Bank of Philadelphia

before the

1972 Annual Conference

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

The Regency Hyatt House - Atlanta, Georgia

May 16, 1972

THE SHAPE OF FINANCIAL MARKETS INTO THE 1980's: SURVIVAL AMID CHANGE

by David P. Eastburn

I have been asked to tackle a most imaginative topic--at least it took a great deal of imagination on someone's part to think that anything very specific could be said about the shape of financial markets ten to fifteen years from now. Nevertheless, if we are to plan effectively, we all need at times to stretch our imaginations and take the long view. The price for doing so is that we can be only very speculative and impressionistic.

Let me begin this long view, therefore, by reminding you that this year marks the 70 millionth anniversary (roughly speaking) of the death of Tyrannosaurus rex, one of the most ferocious creatures ever to roam the earth. It marks the 10 thousandth anniversary (give or take a couple of thousand years) of the death of Mastodon Americanus, one of the largest mammals to make its home in the territory of the United States. And it marks the 156th anniversary of the birth of the first mutual savings bank, a unique institution established--appropriately enough--in Philadelphia.

Reasons for creating the savings bank are fairly clear, but the exact causes of extinction of many animals are debated by authorities. In the past 11,000 years, more than twenty-four species of mammals are said to have disappeared because of dramatic changes in climate. Others have fallen victim to predators, including Man.

Extinction of species has accelerated in our time. Since 1600 A.D., when there were over 4,000 species of living mammals in the world, thirty-six have become extinct; of the more than 8,000 living species of birds, ninety-four have disappeared. Direct killing by man for the sport of it is blamed for the Great Auk and the Passenger pigeon. In many other cases, extinction has come from changes man brought about in the environment, such as destroying habitats by draining swamps and felling forests or by introducing foreign predators or diseases.

Those of you who are optimistic at heart can take all this as suggesting that savings banks, mere infants in the time dimensions I have been speaking of, can look ahead to long and healthy lives. Others may find reason to worry that forces similar to those which have brought an end to certain biological organisms also threaten certain financial organisms.

These forces, of course, come with change and the accelerated pace of change. Until recently, change has been welcomed without much question by the American people. Today's concerns about some of the undesirable by-products of change are well-based and long overdue, but I believe they will not and should not lead us to a status quo society.

Too many benefits flow from an environment of growth and from the competitive market system that produces growth for us to abandon it completely. Redirect it, yes, but not abandon it. People and institutions, therefore, must look forward to more change and still faster change. They must be exploring the opportunities and risks of change.

There are many risks, but most of them fall into two categories. The first is that change may make an individual or an institution unneeded. It is popular these days to speak about the fickleness of consumers' tastes and the wastefulness of "creative obsolescence." Perhaps the future will bring greater stability in tastes and needs, but I wouldn't count on it. Chances are good, in fact, that our society will seek more and more diversity as it gets more and more affluent. Alvin Toffler makes a strong point of this in Future Shock. People are likely to change their minds frequently about what they want to consume and what they want to do. These shifting demands could create a great deal of uncertainty on the part of those who try to anticipate and supply people's wants. Even now thousands of engineers are paying in a very personal way the price of specialization in a profession which for the time being, at least, has become less needed. Too many other examples of unneeded people and unneeded institutions can be called to mind to overlook this risk of change.

A second and closely related risk, one that spelled the doom of so many species of animals, comes from an unfriendly environment. It is hazardous, as I've said, to try to predict the kind of environment in which we will be living in the future; but it can be fatal not to. I see an environment in which needs not only will be shifting but in which they will be competing fiercely for limited resources. Consider the energy crisis, pollution, housing for a bulging population of young adults, health and welfare needs for the poor and elderly, education for the disadvantaged, rehabilitation of the cities--and on and on. These competing needs could put severe strains on real resources, pushing up prices.

I say this with some awareness that those in the past who have predicted chronic inflation or chronic stagnation have invariably been proved wrong. It is too simple to extrapolate indefinitely into the future the kind of environment we are currently living in. Nevertheless, it does seem to me that the mood of people has changed in recent years in a very fundamental way. The various groups in it--consumers, minorities, the disadvantaged, developing countries--have become more demanding and less patient about getting what they want. I fail to see anything coming along that will make them either more content or less vociferous, or any more alert to the limitations of resources available to satisfy all their desires. So inflation seems to me a more reasonable hypothesis than either stability or stagnation.

Pressures on real resources would be paralleled by pressures on financial resources. One consequence could be that interest rates would be at historically high levels. Unless the present attitude toward interest rates on the part of many politicians and parts of the public were to change markedly, however, it seems likely that efforts would be made to hold interest rates down. I hope that these efforts would not go so far as to hinder the flexible use of monetary policy. But even if not, they could lead to many kinds of nonprice rationing of funds and attempts to direct funds into certain areas (like real estate) by various means other than interest rates. Although a realistic view compels me to think that we should be exploring the best ways of allocating funds*, I would hope that steps could be taken to make financial markets work more flexibly and efficiently through interest rates and competition.

---

* I have attempted to deal with this problem in "Federal Reserve Policy and Social Priorities," Business Review of Federal Reserve Bank of Philadelphia, November 1970, pp. 2-8.

If persistent pressure on real and financial resources is the likely environment of the future, the question confronting any institution is how to survive and prosper in it.

One way is to seek protection from outside. The whooping crane has barely survived against heavy odds because Government has taken steps to protect it. Many institutions have survived only because they are protected by Government against change. Since the trend has clearly been in the direction of more rather than less Government intervention in the economy, I suspect that this reaction to change will become more prevalent.

But this solution presents numerous problems, not the least of which is that it might not work. A vivid case in point is your recent experience with ceilings on interest rates. Designed originally to protect thrift institutions in the competitive race for savings, the ceilings actually helped to put them almost completely out of the running. More importantly, this solution cumulatively and ultimately protects against change by preventing it. Although protection is necessary in some cases, if carried too far it can destroy the elements of growth which, as I've said, are important to preserve for a healthy economy.

Because outside protection can be unreliable as well as socially nonproductive, it is important for institutions to prepare within themselves for change. Many aspects of this preparation go beyond the scope of our session this morning. In large measure, they involve a state of mind, a willingness to innovate and take chances, an attitude of continual self-renewal. Although you are doing a great deal to promote this state of mind in savings banking--as witness these sessions today--this is not exactly the image the public has had of you.

For purposes of our discussion, the most promising possibility for dealing with change is diversification. Diversification seems quite compatible with the kind of environment we are moving toward. Everything has become more complex. Clear lines of distinction have become blurred; for example, we no longer can put physics, biology, and chemistry or economics, sociology, and political science in watertight compartments. Many corporations span a wide diversity of fields. Despite a desire by some to go back to a more simplistic world, I don't think there is any chance of this happening.

There is nothing very complicated about the idea of diversification. The old saying about the concentration of eggs in a basket describes it adequately. If you can spread operations over wider geographical areas, you can help to stabilize income by reducing risks of local adversity. If you can buy additional assets like consumer loans, you can help to balance out fluctuations in mortgage activity. If you can be free to issue longer-term debt at competitive interest rates, you can help to smooth out your cash flow over periods of fluctuating interest rates. Diversification has many attractions, and the recommendations of the Hunt Commission bring those attractions closer to your grasp.

Without arguing against the principle of diversification, however, I should point out that diversification, like change itself, presents risks. One is cost. If the farmer has to hire expensive labor and buy elaborate machinery to separate his eggs into various basket configurations suggested by a highly paid analyst of the egg market, he may think twice about diversification. Savings banks would run large start-up costs. You would have to hire and train experts in consumer credit. You would incur higher costs in processing consumer loans and checking accounts. You would have more complex problems of management. You would have to consider whether you are big enough to incur these costs of diversification, and I suspect that some of you would decide you are not.

This raises another problem. Diversification may be so costly that only the larger institutions can afford it, but diversification might so reduce risks for these larger institutions that they would become especially efficient. The pressure would be on to seek these economies of scale through branching and merging. Then the supervisory authorities would have to wrestle with the dilemma of encouraging efficiency or discouraging a reduction in competition. You may feel now that laws and regulations make you operate with one hand tied behind your back, but diversification could bring other restraints that could prove equally frustrating.

Savings banks will have to weigh these benefits and costs of diversification. The net result should be positive--for the industry as a whole. The decision for individual banks will be much more difficult. In the fiercely competitive environment contemplated by the Hunt recommendations, some savings banks might for the first time confront the question of survival.

I don't want to overdraw the point. There are many examples to demonstrate that economies can come from specialization as well as diversification. Consumer finance companies have prospered in the face of the incursion of commercial banks into the field of consumer lending. Similarly, many savings institutions could play a continued role as specialists in thrift and mortgages if they were to go about the job imaginatively and aggressively. Moreover, small size can be an advantage in situations where flexibility and prompt adaptation to change are required. One of the troubles with the dinosaur was that he became too big for his brain.

Nondiversified savings banks would still have to live in a feast and famine environment, however. Without the advantages of diversification they would still find it difficult to compete for funds during periods of tight money. Recent experience suggests that feasts can go far to offset famines. The problem, however, could be that the future may not be nicely divided into equal periods of tight and easy money. If I am at all correct in foreseeing an environment of rather persistent pressure of needs on real and financial resources, savings banks might have to adapt to frequent and prolonged conditions of famine. The challenge to the smaller, nondiversified institutions could be great indeed. And the urge to seek protection by Government might be irresistible.

Somebody with a more acute sense of politics than mine will have to judge when the kinds of opportunities and risks I have been talking about will become reality. My intuitive sense of economics tells me that major changes are inevitable in financial markets. Sooner or later they will expose the savings industry to new competitive forces. You are welcoming this new exposure and you are wise to do so, if only because the only other course is isolation and that can mean extinction. I wish you good luck. I hope that when the next Ice Age arrives you will be well prepared.

5/15/72