

LOOKING INTO THE FED'S CRYSTAL BALL

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Usually, the characteristic associated with crystal balls is cloudiness. As one who has some responsibility to take frequent looks at ours for purposes of current monetary policy, I can vouch for the fact that the Fed's crystal ball shares that attribute with many others. Another characteristic of crystal balls, however, is that they tend to show what you're looking for. This will be the case this evening. I want to look some years into the future to see what the Federal Reserve will be like, and what I see is to a considerable extent what I'd like to see.* The picture will also be tempered, however, by what seems to be reasonably possible.

The Environment

First, let's look briefly at the environment in which the Fed will be operating. It seems to me clear that there will be two kinds of changes in this environment, one quantitative, the other qualitative. The magnitudes with which the Fed will be dealing in future years will be much greater than now. Qualitative changes pose even greater challenges. Our society today is more complex and varied than it was, say, 25 years ago. By the end of the century it will be infinitely more so.

These observations apply to three phases of the environment in which the Federal Reserve will be operating: the economy, the payments system, and the financial system.

* Although these views are essentially mine, they are influenced by a long-range planning project in which the Philadelphia and Cleveland Reserve Banks are cooperating with the help of the Busch Center at the University of Pennsylvania.

The economy has been growing in the past 25 years at an annual rate of 6.8 percent (measured by GNP in current dollars). By the year 2000 this could mean a GNP of \$8 trillion. The typical (median) family could well have an income of nearly \$50,000 as compared with \$11,000 today. Just projecting past rates of growth suggests the Fed could be dealing with a money supply of \$1.5 trillion.

Simply projecting past growth could cause us to overshoot, especially if the current view of at least some thinkers that our society is too growth conscious comes to be shared by many others. But I'm skeptical, for many reasons which I don't have time to go into here.* The best bet is that the Fed will be dealing in economic magnitudes that could make today's look like small potatoes.

Yet it is true, I think, that increasing emphasis will be placed on the quality of life. Ours is already a rich and varied society and seems likely to become much more so. People's wants are insatiable. As desires for more quantity become better fulfilled, wants will be increasingly directed toward more variety. If you think life is complex now, those of us still around by the end of the century may look back on these as fairly simple times.

Above all, in terms of both quantity and quality, the Fed will be operating in an environment which is much more demanding than now. People today demand more of their public servants than in the past. But their expectations rise at an increasing rate, and at a rate faster than the ability of public institutions to perform. I

* See Business Review of Federal Reserve Bank of Philadelphia, "Social Man and the New Stationary State", May 1971.

feel sure the Fed will be doing a much better job in managing the economy than it is now, but the public still will not be satisfied, and this is as it should be. Dissatisfaction will be made known increasingly, I believe, through the political process.

The payments system needed to handle the vastly increased volume and complexity of transactions will be vastly different from today's. The present load of check clearing is already staggering. Around 26 billion checks are currently being written in a year and the Fed processes about a third of these. In Philadelphia we are now handling about 2¼ million checks a day. If you project our current annual growth rate of 5-7 percent, you can readily see that we will be pressing hard on the manpower, machinery, and space available to take care of the volume. Before too many years we should be well into the conversion from a paper to an electronic payments system.

At the same time, the financial system will be handling enormously greater business to service a much larger economy. Even more significant, however, will be major changes in the institutions performing these services. We are already seeing pressures to diversify functions, to overlap traditional jurisdictions. Through holding companies, commercial banks are getting into fields that formerly were reserved for insurance companies, investment companies and nonbanking corporations. Savings banks and savings and loans are experimenting with check-type NOW accounts. Geographical restrictions are breaking down. The trend seems to me irreversible. By the end of the century we may scarcely recognize the institutional structure we now have.

Implications for functions of the Fed

What do these changes in the environment mean for the Fed? In approaching an answer, I want to make very clear a value judgment that influences everything I see in the crystal ball. I believe that the kinds of changes in the environment I have described require an attitude on the part of policy makers--including the Fed--that gives maximum scope to the free play of competitive market forces and individual choice. If I'm wrong in this assumption, my crystal ball will be wrong; and the picture will be less favorable than I paint here.

As far as the Fed's role in the economy is concerned, this assumption means that monetary policy will occupy a strategic position. It is, after all, a way of influencing the economy in a manner that interferes only indirectly and impersonally with individual decisions.

Monetary policy will still have to deal with difficult questions concerning how much stimulus or restraint to apply. It seems quite possible, however, that social policies of Government will make the trade-off between inflation and unemployment less difficult. Reforms in welfare, insurance against the impacts of unemployment, better programs to train and educate the disadvantaged, should make it easier for the Fed to play its part in combating inflation without being overly obsessed with the social impacts of its restraints.

Similarly, we will have made progress in reducing the severe impacts which monetary restraint now imposes on parts of the economy which have high social priority. Instead of hitting particularly hard

the areas of housing and state and municipal services, policy will spread the load more evenly. This can be accomplished partly as various markets become better able to compete for funds and perhaps also as the Fed develops market-oriented means to induce lenders to allocate their funds in particular directions for social purposes.*

Public demands for performance will sharpen the Fed's ability to fine-tune. This is not to say the public will be satisfied; disillusionment with fine tuning may be just as great as now. But compared with current performance, the Fed should be better able to forecast, anticipate and perhaps shorten lags in effects of its policy actions, and generally execute monetary policy with greater precision.

As far as payments are concerned, the tremendous pressures to develop an efficient payments system and the assumption that competitive forces should be given maximum play combine to form clear implications for the Fed. If we were to try to do the whole job ourselves, we might find the task so great as to divert us from our primary duties of monetary policy. In addition, we could not possibly do the job as well as competitive enterprise.

This indicates the importance of defining now with great care just what the Fed's role should be in the payments system. Without attempting to be precise here, I would just state my preference for a role in which the Fed would set overall coordinated standards within which private enterprise can compete. I see the Fed providing guidelines, leadership and incentives for private participants, but being involved in a minimal way with the actual mechanics of handling transactions.

* This theme is developed in my "Federal Reserve Policy and Social Priorities," Business Review of Federal Reserve Bank of Philadelphia, November 1970.

Changes in the financial structure have similar implications for the Fed's role in supervision and regulation. If, as I have said, the financial system will be much more complex and freewheeling, it will be extremely difficult, if not impossible, for supervisors to exercise minute control. Moreover, it would be counterproductive for them to try. The natural tendency for financial institutions to be creative and innovative should be encouraged, not frustrated.

At the same time, of course, the public needs to be protected against massive failure. I see a general approach of providing sufficient insurance and other safeguards so that depositors are not forced to take risks that should be borne by stockholders. To the extent possible, policing of unwise practices would be exercised by market analysts and investors in the stock of financial institutions.

When it comes to details of how these principles might be applied, the crystal ball gets cloudy, but the general picture is clear: competition is given as much leeway as possible within general limits of public protection; the Fed is exercising less detailed supervision and regulation.

Implications for organization of the Fed

The crystal ball is fairly clear, too, about the implications for the Fed's organization. Externally, the Fed will be responsive to the public through the political process. I have already suggested that the public will be increasingly vocal about what it expects from the Fed. This will bring Federal Reserve officials into even closer relationship

to Congress and its committees. Whether this process will avoid the danger of going too far, is less clear. It will be important to preserve some insulation from narrow political pressures. The Fed will still need to be able to take the long and frequently unpopular view.

When it comes to relations between the Fed and financial institutions, it seems to me obvious that a situation in which some institutions carry while others avoid the burdens of supporting the central bank would be intolerable. The concept of membership in the System may well disappear, but all institutions exercising the same functions will carry the same responsibilities.

Internally, the kind of environment which I visualize presents at once considerable difficulties and opportunities for Federal Reserve authorities. The central bank's job will be so difficult that the Fed will find it impossible to perform it effectively through detailed centralized direction. Fortunately, the Federal Reserve System is admirably constructed to meet the kinds of demands I see ahead. Machinery is well in place to provide overall coordination and decentralized execution. I see the Fed providing a leading example of how public policy can be carried out on a consistent basis without imposing the dead hand of centralized bureaucracy on all it does.

Implications for the public

In closing, let me come back to the basic assumption that conditions my reading of the crystal ball. The assumption is that maximum reliance will be placed on competitive markets and freedom of choice.

If this assumption turns out to be accurate, I see, as I have said, an important role for monetary policy, an efficient payments system and a dynamic financial system. The Fed's role will be largely in the first area--exercising effective monetary policy--and concentrating in the other two areas on encouraging the private system to put to work its natural creative instincts.

If you make another assumption, the picture could be quite different. The economy could be put in a straitjacket of direct controls, the payments system could be highly concentrated and centralized, and the financial system could be subjected to a body of detailed regulation. This is not my vision of the future, but it is a possible one. The choice is within our grasp.

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