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THE OUTLOOK FOR THE U.S. ECONOMY AND BANKING

REMARKS OF
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MEETINGS WITH BANKERS IN
KOREA, PHILIPPINES, AND AUSTRALIA

THE OUTLOOK FOR THE U.S. ECONOMY AND BANKING

Outline of Speech

I. The U.S. Economic Outlook

- A. Our policy actions have cut the rate of inflation in half since 1981 and established the basis for a sustained and robust business recovery
 - 1. FRBSF expects real GNP growth close to $6\frac{1}{4}$ percent for 1983; $5\frac{3}{4}$ percent for 1984
 - 2. But Federal deficits are causing short-term real interest rates to remain high (4-5 percent range) and to threaten to crowd out some private borrowing needs
- B. Deficits and the Foreign Exchange: Effect of high real rates most evident in the appreciation of the U.S. dollar and the worsening of the U.S. trade balance
 - 1. real value of the dollar marked a 26 percent gain since 1980 against other major currencies
 - 2. rise in exchange value of the dollar due to high real interest rates that have attracted foreign investment
 - 3. adverse impacts: reducing competitiveness of U.S. exports, increasing U.S. trade deficit, threatening multi-lateral trade
 - 4. foreign governments protest rise in dollar import bills and reduction in their control over domestic monetary policy
- C. Course of Recovery
 - 1. first time in recent memory when fiscal policy has caused a major increase in real interest rates
 - 2. high real rates affect composition of recovery, reducing credit-sensitive demands
 - 3. Fed will provide enough money to sustain a non-inflationary recovery but a strong and balanced recovery also requires a reduction in federal deficits

II. Banking Industry Outlook

- A. Changing Federal regulatory structure
 - 1. recent deregulation (MCA and Garn-St. Germain Act) and growth in the provision of financial services by non-bank entities, such as brokerage houses and retail firms, have raised questions about a total restructuring of regulatory and supervisory authority
 - 2. but because deregulation is mapping out yet unknown courses, we should wait before undertaking an overhaul of the federal regulatory structure

3. any restructuring, however, should allow the Fed to retain sufficient authority to conduct monetary policy and to promote financial stability
 4. the Fed might have a broader role in regulation and a narrower one in supervision; it could, for example, focus only on institutions that play key roles in the financial markets
- B. Emerging Trends in the 1980s
1. technological developments will spur further deregulation
 2. Treasury's proposed "Financial Institutions Deregulation Act" will give bank and thrift holding companies new powers through their subsidiaries and will redefine a bank
 3. technological trends will change our concept of a bank whether or not regulations also change, making the 1980s the start of a new era for banking

THE OUTLOOK FOR THE U.S. ECONOMY AND BANKING

I APPRECIATE THIS OPPORTUNITY TO SHARE WITH YOU SOME VIEWS FROM THE HOMEFRONT. WE HAVE TRAVELED A LONG WAY ON A BUSY SCHEDULE, AND IN SOME SENSE, THAT DESCRIBES THE COURSE OF THE U.S. ECONOMY AS WELL. OVER THE LAST SEVERAL YEARS, WE HAVE STRUGGLED SUCCESSFULLY TO REDUCE INFLATION, BUT HAVE SUFFERED THROUGH HIGH INTEREST RATES AND SLUGGISH REAL GROWTH. DURING THE SAME PERIOD, WE'VE SEEN FAR-REACHING CHANGES IN OUR FINANCIAL STRUCTURE, AND IN THE LAWS AND REGULATIONS GOVERNING IT.

I NEED NOT TELL YOU THAT THE FEDERAL RESERVE HAS HAD A MAJOR ROLE IN EACH OF THESE AREAS. AS THE NATION'S ARCHITECT OF MONETARY POLICY, THE FEDERAL RESERVE HAS HAD THE MAJOR RESPONSIBILITY FOR WAGING THE SUCCESSFUL WAR AGAINST INFLATION. WE ARE ALSO RESPONSIBLE, ALONG WITH SEVERAL OTHER U.S. GOVERNMENT AGENCIES, FOR MAINTAINING THE SOUNDNESS OF FINANCIAL INSTITUTIONS AND FOR ENSURING THE STABILITY OF THE FINANCIAL SYSTEM AS A WHOLE. THUS, WE HAVE BEEN HEAVILY INVOLVED IN THE PROCESS OF DEREGULATION. I WOULD LIKE TO FOCUS MY REMARKS ON THE CURRENT SITUATION AND SHARE WITH YOU MY VIEWS OF WHAT THE FUTURE HAS IN STORE.

I. THE U.S. ECONOMIC OUTLOOK

THE U. S. ECONOMY HAS PASSED THROUGH SOME PRETTY WRENCHING TIMES IN THE PAST SEVERAL YEARS. BUT WE'VE ACCOMPLISHED A GREAT DEAL LATELY IN CLEARING THE ECONOMIC LANDSCAPE OF ONE OF OUR MOST SERIOUS PROBLEMS -- INFLATION. SPECIFICALLY, OUR POLICY ACTIONS HAVE CUT THE RATE OF INFLATION IN HALF SINCE 1981, AND IN THE

PROCESS, ESTABLISHED THE BASIS FOR A SUSTAINED AND ROBUST BUSINESS RECOVERY.

THE PROGRESS AGAINST INFLATION IS ESPECIALLY IMPRESSIVE IN LIGHT OF THE SEEMINGLY UNSTOPPABLE PRICE SPIRAL THAT BADLY UNDERMINED OUR ECONOMY THROUGHOUT THE PAST DECADE. LAST YEAR, FOR EXAMPLE, THE CONSUMER PRICE INDEX AND THE WHOLESALE PRICE INDEX FOR FINISHED GOODS ROSE BY ABOUT 4 PERCENT AND 3.5 PERCENT, RESPECTIVELY. THESE PERCENTAGES ARE LESS THAN ONE-THIRD THEIR RATES OF INCREASE IN 1980. DURING THE FIRST SIX MONTHS OF THIS YEAR, THE CONSUMER PRICE INDEX ROSE AT APPROXIMATELY A THREE PERCENT ANNUAL RATE, WHILE THE WHOLESALE PRICE INDEX HAS ACTUALLY FALLEN AT AN ANNUAL RATE OF NEARLY ONE PERCENT FROM DECEMBER TO JUNE.

NOW, AS THE INFLATION NUMBERS CONTINUE TO BRING GOOD NEWS, WE ARE FOCUSING MORE ON THE ECONOMY'S ABILITY TO PULL OUT OF THE SEVERE RECESSION WE SUFFERED LAST YEAR. THE INDEX OF LEADING ECONOMIC INDICATORS HAS BEEN MOVING UPWARD STEADILY SINCE LAST SEPTEMBER AND CONTINUES TO PORTEND GOOD THINGS. OVER THE FIVE MONTHS SINCE JANUARY, IT HAS SCORED A VERY IMPRESSIVE GAIN OF 7.4 PERCENT. BUTTRESSING THAT EVIDENCE, REAL GNP GROWTH AT 9.2 PERCENT IN THE SECOND QUARTER OF THIS YEAR IS THE STRONGEST SINCE THE SECOND QUARTER OF 1978. ALSO, THE UNEMPLOYMENT RATE HAS FINALLY DROPPED OUT OF DOUBLE-DIGIT TERRITORY TO 9.5 PERCENT IN JULY AS EMPLOYMENT INCREASED BY ALMOST 2 MILLION BETWEEN MAY AND JULY. THIS REDUCTION IN THE UNEMPLOYMENT RATE IS EVEN MORE

IMPRESSIVE BECAUSE THE LABOR FORCE POSTED THE LARGEST JUNE INCREASE EVER RECORDED.

AT THE FEDERAL RESERVE BANK OF SAN FRANCISCO, WE EXPECT REAL GNP FOR THE U.S. TO GROW CLOSE TO $6\frac{1}{4}$ PERCENT THIS YEAR. FOR 1984, WE EXPECT CLOSE TO $5\frac{3}{4}$ PERCENT REAL GROWTH. IN THIS RECOVERY, WE EXPECT CONSUMER SPENDING TO MAKE THE GREATEST CONTRIBUTION. CONSUMER REAL INCOMES LOOK MUCH STRONGER NOW THAN LAST YEAR, REFLECTING A SUBSTANTIAL SLOWING OF INFLATION, IMPROVEMENT IN EMPLOYMENT, AND CUTS IN PERSONAL TAXES. PLANT AND EQUIPMENT SPENDING ARE LIKELY TO REMAIN WEAK BECAUSE OF HIGH REAL INTEREST RATES EVEN THOUGH RECENT SURVEYS OF BUSINESS PLANS AND THE CURRENT RISE IN FACTORY OPERATING RATES SUGGEST SOME IMPROVEMENT FROM THE RECENT PAST. WE EXPECT NET EXPORTS, HOWEVER, TO DECLINE SOMEWHAT BECAUSE OF THE STRONG FOREIGN EXCHANGE VALUE OF THE DOLLAR.

THUS, IT SEEMS CLEAR THAT AN ECONOMIC UPTURN IS UNDERWAY. THE IMPORTANT QUESTION AT THIS POINT IS WHETHER WE CAN SUSTAIN THE RECOVERY. IN MY VIEW, INTEREST RATES WILL PLAY A KEY ROLE. UNDER NORMAL CIRCUMSTANCES, THE LEVEL OF REAL SHORT-TERM INTEREST RATES (AS MEASURED BY THE 3-MONTH TREASURY BILL RATE) WOULD HAVE RETURNED TO THE 1-2 PERCENT LEVEL EXPERIENCED IN THE 1950s AND 1960s ONCE THE EFFECT OF MONETARY DECELERATION ON INFLATION HAD FULLY WORKED ITSELF OUT. IN FACT, REAL SHORT-TERM INTEREST RATES REMAIN IN THE 4-5 PERCENT RANGE.

FEDERAL DEFICITS AND HIGH REAL INTEREST RATES

THE SOURCE OF THIS APPARENT CONTRADICTION IS THE FEDERAL GOVERNMENT'S MASSIVE CREDIT DEMANDS. THE FEDERAL GOVERNMENT SHOULD BE MOVING TOWARD A SURPLUS IN ITS ACCOUNTS AS THE RECOVERY PROCEEDS IN ORDER TO MAKE ROOM FOR INCREASED PRIVATE CREDIT DEMANDS IN THE FINANCIAL MARKETS. BUT INSTEAD, IT WILL BE POSTING A SERIES OF RECORD DEFICITS. THE PROJECTED UNIFIED BUDGET DEFICITS ARE ENORMOUS: AN ESTIMATED \$210 BILLION IN FISCAL 1983 AND \$180 BILLION IN FISCAL 1984. THE 1983 DEFICIT COULD AMOUNT TO AS MUCH AS 85 PERCENT OF AVAILABLE NET SAVINGS FROM THE PRIVATE SECTOR AND THE SURPLUSES OF STATE AND LOCAL GOVERNMENTS, AND THUS LEAVE LITTLE ROOM FOR THE FINANCING OF NET PRIVATE INVESTMENT.

IN OTHER WORDS, THE BORROWING NEEDS OF THE FEDERAL GOVERNMENT THREATEN TO CROWD OUT THOSE OF THE PRIVATE ECONOMY. BECAUSE IT IS NOT SUBJECT TO THE CONSTRAINTS OF A PROFIT/LOSS STATEMENT, THE FEDERAL GOVERNMENT WILL ALWAYS GET WHATEVER IT NEEDS SIMPLY BY OUTBIDDING PRIVATE BORROWERS FOR THE AVAILABLE SUPPLY OF FUNDS. WITH A DEMAND FOR CREDIT THAT EXCEEDS THE AVAILABLE SUPPLY, INTEREST RATES WILL BE BID UP AS THE MARKET'S WAY OF ALLOCATING CREDIT.

DEFICITS AND THE FOREIGN EXCHANGE

TO DATE, WE HAVE SEEN MOST OF THE CROWDING OUT IN THE APPRECIATION OF THE U.S. DOLLAR AND THE WORSENING OF THE U.S. TRADE BALANCE. SINCE 1980, WE HAVE WITNESSED A DRAMATIC UPSURGE IN THE STRENGTH OF THE U.S. DOLLAR IN COMPARISON WITH FOREIGN

CURRENCIES. THE DOLLAR'S AVERAGE VALUE AGAINST MAJOR CURRENCIES APPRECIATED 27 PERCENT BETWEEN 1980 AND MID-JULY 1983, AND HAS SINCE MOVED EVEN HIGHER. THE REAL VALUE OF THE DOLLAR, I.E., THE EXCHANGE RATE ADJUSTED FOR PRICE TRENDS IN THE U.S. AND ABROAD, HAS BEEN EQUALLY STRONG -- MARKING A 26 PERCENT GAIN SINCE 1980.

THE U.S. DOLLAR'S RECENT STRENGTH REFLECTS THE FACT THAT INVESTMENTS IN DOLLARS ARE VERY ATTRACTIVE COMPARED TO INVESTMENTS IN OTHER CURRENCIES. THE MAIN REASON FOR THIS IS THAT REAL INTEREST RATES PREVAILING IN THE U.S. ARE VERY HIGH COMPARED TO THOSE ABROAD. IN ADDITION, THE DOLLAR IS INCREASINGLY BEING VIEWED AS A "SAFE HAVEN" INVESTMENT CURRENCY FOR FOREIGNERS FACING DOMESTIC TURMOIL OR INCREASING GOVERNMENT ENCROACHMENT OVER THEIR PRIVATE SECTOR.

THE SHARP DROP IN NOMINAL INTEREST RATES IN THE U.S. IN THE LATTER PART OF 1982 COINCIDED WITH SUBSTANTIAL DECLINES IN FOREIGN NOMINAL INTEREST RATES. BUT THIS DROP IN NOMINAL RATES MAINLY REFLECTED A SHARP DROP IN THE MARKET'S ANTICIPATION OF FUTURE INFLATION; REAL INTEREST RATES REMAINED RELATIVELY UNCHANGED. IN PARTICULAR, THE REAL INTEREST DIFFERENTIAL BETWEEN U.S. RATES AND THOSE ABROAD DECLINED ONLY MODESTLY. IN RECENT WEEKS, THE REAL INTEREST DIFFERENTIAL BETWEEN THE U.S. DOLLAR AND OTHER CURRENCIES HAS EVEN INCREASED AS NOMINAL INTEREST RATES IN THE U.S. HAVE EDGED UP.

THE DOLLAR'S STRENGTH, THEN, IS DUE LARGELY TO THE FINANCING REQUIREMENTS OF THE FEDERAL GOVERNMENT WHICH HAVE BROUGHT HIGH REAL RATES AND SIZEABLE FOREIGN INVESTMENT IN U.S. SECURITIES.

IN THE MOST RECENT THREE QUARTERS FOR WHICH INFORMATION IS AVAILABLE, FOREIGN INVESTMENT IN TREASURY DEBT WAS \$19 BILLION. THESE FOREIGN INVESTMENT FUNDS HAVE BEEN WELCOMED BY MANY AS A DESIRABLE SUPPLEMENT TO U.S. SAVINGS, HELPING TO FINANCE U.S. BUDGET DEFICITS AND TO KEEP A LID ON FURTHER U.S. INTEREST RATE INCREASES.

BUT IN A BROADER SENSE, THE APPROPRIATENESS OF A WEALTHY INDUSTRIALIZED NATION USING A DISPROPORTIONATE SHARE OF THE WORLD'S SAVINGS TO FINANCE ITS OWN GOVERNMENT'S EXPENDITURES IS QUESTIONABLE, TO SAY THE LEAST. UNFORTUNATELY, WE WON'T BE ABLE TO REVERSE THIS TREND UNLESS THE MASSIVE BUDGET DEFICITS LOOMING OVER THE NEXT SEVERAL YEARS CAN BE SHARPLY REDUCED. ALREADY WE HAVE SEEN SOME OF THE ADVERSE IMPACTS OF A STRONG U.S. DOLLAR. IT HAS APPRECIABLY REDUCED THE COMPETITIVENESS OF U.S. EXPORTS IN WORLD MARKETS AND MADE IT EASIER FOR FOREIGN PRODUCERS TO SELL IN THE UNITED STATES. SOME ESTIMATES ATTRIBUTE UP TO TWO-FIFTHS OF THE DECLINE IN REAL GNP DURING THE 1981-82 RECESSION TO THE WEAKNESS IN THE NET EXPORT SECTOR. MOREOVER, A \$46 BILLION TRADE DEFICIT (AT AN ANNUAL RATE) WAS INCURRED DURING THE FIRST SIX MONTHS OF THIS YEAR, AND EVEN LARGER DEFICITS ARE PROJECTED FOR THE COMING MONTHS. SOME FORECASTS PUT THE 1983 DEFICIT FIGURE AT MORE THAN \$65 BILLION, AN UNPRECEDENTED AMOUNT.

THE UNFAVORABLE EMPLOYMENT AND OUTPUT EFFECTS RESULTING FROM REAL DOLLAR APPRECIATION HAVE ALSO LED TO A RISING TIDE OF PROTECTIONIST SENTIMENT IN THE U.S. THAT THREATENS TO CAUSE MULTI-LATERAL TRADE RESTRICTIONS AND A REDUCTION IN WORLD TRADE.

SEVERAL FOREIGN GOVERNMENTS HAVE ADDED THEIR VOICES IN PROTEST, POINTING TO HIGHER IMPORT BILLS THAT MUST BE PAID FOR GOODS PRICED IN DOLLARS -- MOST NOTABLY, OIL.

THE HIGH U.S. DOLLAR HAS ALSO AFFECTED THE ABILITY OF SOME FOREIGN COUNTRIES (MOST NOTABLY, GERMANY, FRANCE, AND JAPAN) TO CONTROL THEIR DOMESTIC MONETARY POLICY. AUTHORITIES IN THESE COUNTRIES MIGHT WANT TO CONSIDER MONETARY EASE AND LOWER INTEREST RATES AS ONE WAY TO COUNTER DOMESTIC RECESSIONS. BUT THEY ALSO WANT TO PRESERVE THE EXTERNAL VALUE OF THEIR CURRENCY. BECAUSE MONETARY EASE PUTS DOWNWARD PRESSURE ON CURRENCY VALUES, THESE CENTRAL BANKS ARE CONFRONTED WITH A DIFFICULT TRADE-OFF.

COURSE OF RECOVERY AND U.S. MONETARY POLICY

THE PRESENT SITUATION IS UNLIKE ANY OTHER IN THE LAST TWENTY YEARS. THIS APPEARS TO BE THE FIRST TIME IN RECENT MEMORY IN WHICH FISCAL POLICY HAS CAUSED A MAJOR INCREASE IN REAL INTEREST RATES. THE STRENGTH OF THE U.S. DOLLAR IS BUT THE MOST PROMINENT SIGN OF THE CROWDING OUT THAT HAS RESULTED. OTHER SIGNS CAN BE FOUND IN THE UNUSUAL SECTORAL PATTERN OF THIS RECOVERY COMPARED TO PREVIOUS ONES. IN PARTICULAR, CREDIT-SENSITIVE SECTORS WILL NOT RECOVER AS QUICKLY OR AS VIGOROUSLY. AS I MENTIONED EARLIER, BUSINESS INVESTMENT AND NET EXPORTS ARE PROJECTED TO BE MUCH WEAKER THAN IN PREVIOUS RECOVERIES -- LARGELY BECAUSE OF THE HIGH INTEREST RATES DUE, IN LARGE PART, TO GOVERNMENT STRUCTURAL DEFICITS. THUS, WHILE WE MAY HAVE A ROBUST RECOVERY, IT CANNOT BE DESCRIBED AS A SATISFACTORY ONE FROM THE STANDPOINT OF THE LONG-TERM HEALTH OF OUR ECONOMY.

IN THIS SITUATION, THE FEDERAL RESERVE HAS BEEN HANDED THE UNENVIABLE TASK OF SQUARING THE CIRCLE. MANY CONGRESSMEN HAVE DEMANDED THAT THE FED SIMPLY IGNORE MONEY-GROWTH CONSIDERATIONS -- ALTHOUGH THAT COULD MEAN A LATER UPSURGE IN INFLATION -- AND DO WHATEVER IS NEEDED TO BRING INTEREST RATES DOWN TO LOWER LEVELS IMMEDIATELY. IN CONTRAST, MONETARIST ECONOMISTS AND MANY IN THE FINANCIAL MARKETS HAVE DEMANDED THAT THE CENTRAL BANK CONTROL MONEY MORE CLOSELY -- ALTHOUGH THAT MIGHT MEAN A WEAK OR MORE SLUGGISH RECOVERY.

FEDERAL RESERVE CHAIRMAN VOLCKER RESPONDED TO BOTH THESE CHARGES IN HIS SEMI-ANNUAL REPORTS TO CONGRESS IN FEBRUARY AND JULY. HE SAID THAT THE FED "RECOGNIZED THE DESIRABILITY OF ACHIEVING AND MAINTAINING A LOWER LEVEL OF INTEREST RATES TO ENCOURAGE GROWTH," BUT FELT THAT "THIS COULD ONLY BE REALISTIC IN A CONTEXT OF BUILDING ON THE PROGRESS ALREADY MADE AGAINST INFLATION." HE ADDED THAT ANY EFFORT TO FORCE INTEREST RATES DOWN THROUGH EXCESSIVE LIQUIDITY CREATION COULD NOT BE SUCCESSFUL FOR LONG BECAUSE AGGRESSIVE EFFORTS TO EASE MONETARY POLICY WOULD GENERATE NEW FEARS OF FUTURE INFLATION.

I WOULD ADD THAT THERE WERE GOOD REASONS FOR THE NARROW, M1 MONEY SUPPLY -- CURRENCY PLUS CHECK-TYPE DEPOSITS -- TO GROW ABOVE TARGET LAST YEAR AND EARLY THIS YEAR. THE FED PERMITTED ABOVE-TARGET GROWTH BECAUSE OF ITS CONVICTION THAT, IN PRACTICAL TERMS, POLICY OTHERWISE WOULD HAVE BEEN APPRECIABLY MORE RESTRICTIVE THAN INTENDED WHEN THE TARGETS WERE SET IN EARLY 1982.

THE DROP IN INFLATION LED TO AN INCREASE IN THE PUBLIC'S DESIRE TO HOLD LARGER MONEY BALANCES. WITH THE SAME AMOUNT OF MONEY DOING LESS WORK THAN BEFORE, THE FEDERAL RESERVE HAD TO SUPPLY MORE THAN IT ORIGINALLY INTENDED IN ORDER TO AVOID BEING MORE RESTRICTIVE THAN WAS DESIRABLE OR NECESSARY.

SUMMARY

TO SUM UP, WE CAN BE THANKFUL FOR HAVING BROKEN BOTH THE UPWARD SPIRAL OF INFLATION AND THE DOWNWARD SPIRAL OF RECESSION IN THE PAST YEAR. BUT IT IS DIFFICULT FOR ME TO SEE HOW A STRONG AND BALANCED RECOVERY IN THE U.S. ECONOMY WILL BE POSSIBLE WITHOUT FURTHER DECLINES IN REAL INTEREST RATES. THE BOTTOM LINE SIMPLY IS THAT THE FEDERAL RESERVE'S POLICY OF PROVIDING ENOUGH MONEY TO SUSTAIN A NON-INFLATIONARY RECOVERY CAN CONTRIBUTE TO SOLVING THE PROBLEM, BUT IT CANNOT DO THE JOB ALONE.

II. BANKING INDUSTRY OUTLOOK

UP TO THIS POINT, I HAVE BEEN TALKING ABOUT THE MACROECONOMY AND EMPHASIZING ITS INTERNATIONAL ASPECT. I WOULD LIKE NOW TO TURN TO THE OUTLOOK FOR AN INDUSTRY WE ARE INTIMATELY INVOLVED WITH. I WOULD LIKE TO SHARE SOME IDEAS ABOUT THE PROSPECTS FOR CONTINUED DEREGULATION AND INSTITUTIONAL CHANGE IN THE BANKING INDUSTRY. JUST AS THE ECONOMIC DEVELOPMENTS OF THE PAST DECADE HAVE CALLED FOR NEW APPROACHES TO MONETARY AND FISCAL POLICIES, THEY HAVE ALSO CALLED FOR NEW APPROACHES TO REGULATING THE PROVISION OF FINANCIAL SERVICES.

I AM SURE THAT YOU ARE ALREADY FAMILIAR WITH THE MOST RECENT FINANCIAL REFORM LEGISLATION IN THE U.S. -- THE MONETARY CONTROL ACT OF 1980 AND THE GARN-ST. GERMAIN ACT OF LAST OCTOBER. THE MCA REPRESENTED A SIGNIFICANT STEP IN DISMANTLING THE MASSIVE LEGISLATION AND REGULATORY FRAMEWORK THAT HAS ENVELOPED U.S. BANKING, AND SOME WOULD ARGUE, LIMITED ITS ABILITY TO ADAPT TO A RAPIDLY CHANGING ECONOMIC ENVIRONMENT. THE GARN-ST. GERMAIN ACT, ON THE OTHER HAND, ADDRESSED THE COMPETITIVE DISADVANTAGE OF DEPOSITORY INSTITUTIONS IN RELATION TO UNREGULATED FINANCIAL INTERMEDIARIES SUCH AS MONEY MARKET FUNDS AND THE PROBLEM OF FAILING BANKS AND THRIFTS.

CLEARLY, THE GROWTH OF MONEY MARKET FUNDS AND THE ENCROACHMENT OF BROKERAGE HOUSES AND RETAIL FIRMS INTO ACTIVITIES SUCH AS PROVIDING LIQUID FORMS OF SAVINGS INSTRUMENTS HAVE RAISED SERIOUS QUESTIONS ABOUT THE RELEVANCE OF EXISTING PRODUCT-LINE AND INSTITUTIONAL DISTINCTIONS IMPOSED BY REGULATIONS. THE RAPID EXPANSION OF INTERSTATE ACTIVITIES THROUGH BANK AND THRIFT HOLDING COMPANIES, THE BANK-LIKE SERVICES PROVIDED BY BROKERAGE HOUSES, INSURANCE COMPANIES, RETAIL OUTLETS, AND SO-CALLED "NONBANK BANKS" ARE LEADING MANY TO RECONSIDER THE GEOGRAPHIC LIMITATIONS ON BANKING. AS A RESULT, BOTH POLICYMAKERS AND REGULATORS ARE REVIEWING THE APPROPRIATENESS OF THE EXISTING SYSTEM OF WHAT ESSENTIALLY HAS BEEN PIECEMEAL REGULATION AND DEREGULATION.

SOME EVEN CONTEMPLATE A MAJOR RESTRUCTURING OF REGULATORY AND SUPERVISORY AUTHORITY AT THIS TIME. HOWEVER, WE ARE AT A

CROSSROADS WHERE THE PRIVATE FINANCIAL SYSTEM IS CHANGING VERY RAPIDLY, AND DEREGULATION IN SOME IMPORTANT AREAS IS STILL MAPPING OUT YET-UNKNOWN COURSES.

THERE ARE A HOST OF FUNDAMENTAL PUBLIC POLICY ISSUES INVOLVED IF WE ARE TO SIGNIFICANTLY ELIMINATE THE DISTINCTIONS BETWEEN BANKS AND OTHER TYPES OF INSTITUTIONS. THESE INCLUDE NOT JUST "COMPETITION" PER SE, BUT POTENTIAL CONFLICTS OF INTEREST, CONCENTRATION OF ECONOMIC RESOURCES, AND THE POTENTIAL INCREASED EXPOSURE TO RISK AND FINANCIAL INSTABILITY OF THOSE INSTITUTIONS (NAMELY, BANKS) THAT OCCUPY A UNIQUE AND PIVOTAL POSITION IN OUR ECONOMY. CONSEQUENTLY, IN MY OPINION, IT WOULD BE BEST TO ALLOW THE EFFECTS OF THE DEREGULATION WE HAVE HAD TO UNFOLD MORE FULLY BEFORE UNDERTAKING A MAJOR RESTRUCTURING OF OUR REGULATORY AND SUPERVISORY INSTITUTIONS.

ANY CONSIDERATION OF ULTIMATE REFORM ALSO RAISES THE ISSUE OF THE APPROPRIATE ROLE OF THE FEDERAL RESERVE SYSTEM IN SUPERVISION AND REGULATION. BECAUSE OF ITS RELATION TO MONETARY POLICY, ANY RESTRUCTURING OF REGULATORY AUTHORITY IDEALLY WOULD RETAIN SUFFICIENT AUTHORITY IN THE FEDERAL RESERVE TO CONDUCT MONETARY POLICY AND TO PROMOTE FINANCIAL STABILITY. CHANGES IN REGULATORY AUTHORITY (THE SETTING OF FORMAL RULES AND POLICIES) PROBABLY WOULD BE BEST STRUCTURED ALONG FUNCTIONAL OR PRODUCT LINES, WHEREAS SUPERVISION (THE ENFORCEMENT OF THOSE RULES AND POLICIES) IS MOST EFFECTIVE WHEN IT HAS A SELECTIVE, INSTITUTIONAL FOCUS. THIS MIGHT IMPLY A BROADER ROLE FOR THE FEDERAL RESERVE IN REGULATION, BUT A NARROWER ROLE IN

SUPERVISION. THE FEDERAL RESERVE COULD, FOR EXAMPLE, FOCUS ONLY ON INSTITUTIONS THAT PLAY KEY ROLES IN THE FINANCIAL MARKETS. THESE INSTITUTIONS COULD BE IDENTIFIED BY THEIR HOLDING COMPANY AFFILIATION, OR BY THE EXTENT OF THEIR INTERSTATE BANKING ACTIVITY, OR SIMPLY BY THEIR SIZE AS MEASURED BY AGGREGATE ASSETS.

EMERGING TRENDS IN THE 1980s

CHANGING TECHNOLOGY IS ALSO A MAJOR FORCE PROMOTING DEREGULATION TODAY. AUTOMATIC-TELLER MACHINES AND POINT-OF-SALE TERMINALS ALREADY ARE ECONOMICALLY VIABLE, AND ARE PROVING INCREASINGLY POPULAR WITH CONSUMERS. SUCH TECHNOLOGY TOGETHER WITH CONSIDERATIONS OF COMPETITIVE EQUITY INEVITABLY WILL EXERT INCREASING PRESSURE FOR DEREGULATING BANKS' ACTIVITIES.

IN THIS CONNECTION, THE TREASURY RECENTLY SUBMITTED A REVISED "FINANCIAL INSTITUTIONS DEREGULATION ACT" THAT WOULD PERMIT BANK AND THRIFT HOLDING COMPANIES TO ENGAGE, THROUGH SUBSIDIARIES, IN A VARIETY OF FINANCIAL ACTIVITIES DEEMED BY THE FED TO BE CLOSELY RELATED TO BANKING. THESE INCLUDE THE UNDERWRITING AND SALE OF INSURANCE AND MUNICIPAL REVENUE BONDS, LIMITED DEVELOPMENT AND SALE OF REAL ESTATE, AND THE OFFERING OF MONEY MARKET FUNDS. OTHER PROVISIONS INCLUDE A RE-DEFINITION OF A "BANK" FOR THE PURPOSES OF THE BANK HOLDING COMPANY ACT. THIS NEW DEFINITION WOULD INCLUDE ANY "INSURED BANK" OR INSTITUTION ELIGIBLE TO BECOME AN INSURED BANK, AS WELL AS ANY INSTITUTION THAT OFFERS TRANSACTIONS ACCOUNTS AND WHICH MAKES COMMERCIAL LOANS.

THE TECHNOLOGICAL TRENDS TO WHICH I HAVE ALLUDED WILL OCCUR WHETHER OR NOT BANKING REGULATIONS ARE RELAXED, AND THEY WILL CONTINUALLY CHALLENGE US TO RE-DEFINE BANKS AS WE NOW KNOW THEM. IN SUCH AN ENVIRONMENT, OUR BANKING SYSTEM WILL BE MOST COMPETITIVE AND EFFICIENT IF DEREGULATION CONTINUES. THE 1980s, THEREFORE, MAY BE SAID TO MARK A NEW ERA FOR BANKING, ONE IN WHICH THE "QUIET LIFE" ASSOCIATED WITH REGULATORY PROTECTION AND ISOLATION HAS ENDED.