

# CHANGING INFLUENCES ON BANKING

REMARKS BY

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It is indeed a pleasure to be with you today in this magnificent natural setting, especially since this is the first opportunity I have had of attending a convention of the Nevada Bankers Association. At the very outset, I would like to pay tribute to your contribution over the years in assisting the rapid growth of the state's economy, as witnessed by a rate of income growth half again as large as the national average. I also note with admiration that Nevada has ranked first among the states in bank-deposit growth throughout the last decade or so, and that your annual rate of deposit growth in the last five years (12 percent) was double the national average.

It is the general theme of change that I would like to discuss today. In particular, I would like to review with you some of the long-term changes that might affect your industry's fortunes in the last quarter of the twentieth century. But first, I believe I

should mention some of the major influences affecting banking in mid-1973, as well as the policy measures taken to counter the excesses generated by the current boom. In 1971, we were worried about inadequate recovery from recession, along with a paradoxical inflation; in the spring of 1973, we are worried about an overpowering boom, but again inflation. The nature of the policy response has also varied. In 1971, the prescription called for easy monetary and fiscal policies to stimulate the economy, along with wage-price controls to keep cost increases from leapfrogging each other. Recently, the prescription has called for tighter monetary and fiscal policies, to curb the widespread upsurge in demand and the price increases developing from the resultant scramble for resources.

### **Rapid Rise of Output and Prices**

Recent business statistics give a good picture of the headlong pace of business activity. The first-quarter expansion in GNP was one of the largest on record—\$43 billion, or over 15 percent on an annual rate basis. In real terms—that is, after allowance for price increases—the rate of gain was 8 percent, which is almost double the rate which economists believe is sustainable over the long run. Then, in April, industrial production scored one of the largest monthly gains of this entire boom period, while personal income also rose sharply, supported by a strong gain in employment and by a rise in the factory workweek to the highest level of the past six years. While the unemployment rate remained at 5.0 percent in May, that rate was almost one full percentage point below the level prevailing last spring.

The bad news—the very big cloud on the silver lining—was the rapid rise in prices which accompanied the early-1973 upsurge

in business activity. The GNP price index rose at a 6.6-percent annual rate of increase in the first quarter—more than twice last year's rate—while consumer prices rose at a 9-percent rate through the January-April period, largely because of the phenomenal jump in food prices that we have all heard so much about. Equally worrisome was the rapid rise in industrial commodity prices, which make up three-fourths of the wholesale price index. Those prices have increased at a 15-percent annual rate since the inception of Phase III in January, with the rise in April and May being the largest since the panic-buying days of the Korean War period.

The upsurge in incomes and prices has brought about a sharp improvement in Federal revenues. Last winter, the Treasury had forecast budget deficits of \$25 billion for fiscal 1973 and \$13 billion for fiscal 1974. Despite the commendable efforts of the Administration to hold down the level of Federal expenditures, Secretary Shultz recently estimated that the deficit will approximate \$18 billion in the current fiscal year and perhaps \$3 billion next year. This is an improvement, but it is not nearly good enough; running a huge deficit in a boom period like today compounds the problem by overstimulating the economy and contributing to the dangerous rate of inflation. Thus, to a large extent, the burden of combatting inflation has fallen largely on monetary policy, leading to the increasing use of monetary weapons as the year has progressed.

Unless or until some device is adopted to eliminate budget deficits and preferably produce budget surpluses in periods of boom and inflation, we will continue to be faced with this problem. There have been many proposals over the years to remedy

the situation, ranging from discretionary authority delegated by the Congress to the President to change income tax rates or the investment tax credit, within certain limits, to "automatic" tax surcharges to be triggered by a certain rise in the price level. But unfortunately, none have been adopted. In my view, the time has arrived when the country can no longer afford not to do so.

### **Monetary Countermeasures**

Disturbed already by the rapid pace of activity in the closing quarter of 1972, the Federal Reserve adopted a policy stance designed to slow the growth in bank reserves and the monetary aggregates, thereby fostering financial conditions conducive to a sustainable rate of growth of income and output. Consequently, the money supply grew at a substantially reduced rate during the first four months of 1973. Also, the Fed raised the discount rate in a series of steps, from 4½ percent in January to 6½ percent in June.

Through April of this year, the increase in bank lending was financed by a liquidation of securities and by the marketing of large-denomination CD's at high cost and with short maturities. In fact, CD's of all types accounted for virtually all of the net increase in commercial-bank deposits in the January-April period. Last month the rate on short-term large CD's reached 7½ percent—up from 5 percent in January—and the concentration of deposit growth in such high-cost funds thus contributed to the succession of increases in the prime business-loan rate, from 6 percent in December to 7½ percent in early June.

By mid-May further tightening measures seemed required, and the System directed its attention to commercial-bank reliance on money-market sources of funds, such as

CD's and Eurodollars. Steps were taken to dampen the excessive expansion of bank credit, especially to business. To begin with, the Board of Governors imposed an 8-percent marginal requirement—the regular 5 percent plus a supplemental 3 percent—on further increases in funds obtained through the issuance of large CD's or through an affiliate's issuance of commercial paper. The Board also proposed including finance bills as part of the total obligations subject to this requirement. In addition, the Board reduced the reserve requirement on Eurodollars from 20 to 8 percent, thus affording roughly parallel treatment with the marginal reserve requirement on the other types of obligations.

While on the subject of marginal reserve requirements, I would like to make a few comments about Chairman Burns' request to some 190 large nonmember banks to voluntarily comply with the new marginal reserve requirements imposed upon member banks. This request included a provision that any such reserves held by nonmember banks be deposited with a member bank, which would then redeposit these balances with the Federal Reserve. The purpose of this redeposit proposal was not to attack the existence of the dual banking system, as has been the belief in some quarters.

The redeposit proposal is based on an important technical point: namely, that unless the new marginal reserves held by nonmember banks with their correspondent member banks are redeposited with a Federal Reserve Bank, these reserves will not be sterilized. Instead, they would be available for credit expansion, and all that would have occurred would have been a shift of lending capacity from nonmember

banks to member banks. It was on this basis that the request was made for redeposit of such voluntarily-held marginal reserves with the Federal Reserve System.

At the same time, the Board suspended interest-rate ceilings on large CD's with maturities of 90 days or more—the area which had practically been precluded from use because of the rise in market rates above existing ceilings on longer-dated CD's. The suspension of ceilings thus enabled banks to compete in all maturity sectors, and thereby to establish a balanced structure of deposits. As a result, the marketplace is now playing an increasingly important role in governing banks' dealings with large firms—first, in regard to the rates charged big corporations for loans, and secondly, in regard to the rates they pay corporate treasurers for the use of funds. It should be remembered, however, that prevention of substantial escalation in interest costs to households and small businesses remains a policy goal, with the rates charged such borrowers kept “under special restraint,” and with the rates paid for consumer-type deposits kept under rate ceilings as well.

Altogether, the cyclical changes we have undergone since August 1971 have now generated a countercyclical response by monetary policy, designed to bring the economy back to a sustainable growth path and to reduce the unacceptable rate of inflation which now besets us. At this stage, you may be thinking, “Here we go again,” remembering the distortions which marred the banking scene so badly in 1966 and again in 1969. However, a “credit crunch” is not inevitable. The Federal Reserve, having supported the recovery from the earlier recession, stands ready to support an ongoing expansion in line with the long-

term growth trend of the national economy. To do so, however, it needs the cooperation of all members of the banking community, in line with Chairman Burns' recent request that the rate of bank-credit extension be "appropriately disciplined." The boom now going on in the economy, especially in the capital-goods area, is adding substantially to inflationary pressures. Therefore, some sense of restraint by the banking industry in financing this capital-goods boom would make an important contribution to the anti-inflation effort.

### **Changing Financial Payments System**

Now that I have mentioned some of the cyclical influences affecting your near-term future, let me turn to a long-range development which is certain to have widespread impact upon your financial markets for some time to come. I refer specifically to the massive changes expected in the financial payments system, including expanded participation by thrift institutions in such a system. These changes will be nationwide in scope, of course, but I find it worthwhile to mention them here because Nevada banking represents a microcosm of the national banking scene. Two of your eight banks are subsidiaries of a multi-bank holding company, while another is owned by a one-bank holding company; some are branch-banking systems while others are unit banks; some are national and some state-chartered; some are Federal Reserve members and some nonmembers; and finally, deposit size varies widely, ranging from \$12 million to over \$700 million.

What sort of payments system are you likely to encounter over the next several decades? Most likely, there will be a single, integrated, nationwide mechanism for the transfer of funds, covering the widest possible gamut of transactions—from the auto-

matic deposit of wages and salaries and other receipts, to the preauthorized debiting of regularly recurring payments along with current transactions. We can visualize a comprehensive series of computer-directed communications networks, involving both commercial banks and other financial institutions as well, which will be linked to point-of-sale terminals in retail establishments, to computers in business firms, and quite possibly to terminal devices in homes. Through the use of a card to activate transactions, transfers of funds may be effected in a manner which will credit the creditor's account at the same time a charge or debit is made to the payor's account.

Local networks probably will be linked to regional, national, and even international networks, making possible the expeditious transfer of funds and significant reductions in the volume of paper-oriented transactions. The Federal Reserve most likely will maintain the interface—the basic link—among financial institutions. In fact, the newly established regional check-processing centers and automated clearing-house arrangements may become the nuclei of the interconnecting regional networks for handling electronic transfers.

You may ask, why the need for greater reliance on electronic transfer of funds? Well, last year alone, nearly 500 million items a week had to be processed as some 25 billion checks were drawn upon the 94 million accounts maintained by consumers, businesses and government agencies. Within five years, money transfers of one type or another may increase about 1½ times above last year's level. Yet we have just about reached our maximum efficiency in the handling of paper checks, and thus will have to devise more sophisticated systems to avoid being submerged under a flood of paper.

### **Innovations Now Being Undertaken**

You are undoubtedly familiar with some of the innovations already being undertaken in this field. There is first of all the 150-bank California Automated Clearinghouse Association, now known under the acronym of CACHA but formerly known as SCOPE. This system involves credit entries to checking accounts in the form of payroll depositing, as well as debits in the form of regular monthly payments such as utility bills and mortgage loans. There is also the rather similar COPE project underway in Atlanta; this system plans to offer so-called "bill checks," or machine-processible documents on which the payor endorses a bill and stipulates the amount and date on which his bank is to debit his account and effect payment to the account of his creditor.

To date, we have witnessed relatively slow progress in the implementation of pre-authorized debits, partly because of the banks' failure to overcome the traditional customer reluctance to "surrender control," as they may view it, over their timing of payments. However, the two major bank credit-card systems may soon speed up this trend. They have announced plans to activate electronic networks which will provide for the authorization and verification of credit-card purchases on a nationwide, 24-hour daily basis. In addition, more and more retail stores are installing credit-authorization terminals, thus linking the consumer, the merchant and the banks at the very point which probably offers the most leverage in terms of selling the consumer on the advantages of a full electronic-payments system. But because point-of-sale authorization entails the use of some sort of card, it should give some impetus to the wider use of the credit card and thus increase the volume of card-related transactions, which itself is essential if we are to

realize the economies of scale which should result from a heavy investment in an electronic payments system.

In any event, I believe that you can understand the opportunities which an electronic payments system presents for expanding the volume and variety of your services. The developments I have outlined may take a decade or more to effectuate, but there is little doubt in my mind that commercial banks—and their competitors—will eventually be in a position to accommodate a very wide range of bill-paying and accounting functions, as well as ancillary services, for consumers, business firms and government agencies.

### **Role of Nonbank Financial Institutions**

This brings us to the crucial question—what role shall the nonbank financial institutions play in these new developments? Despite the relatively slow progress made by CACHA and COPE in marketing pre-authorized debits, the S&L's and mutual savings banks realize that the electronic payments system represents the wave of the future—on the crest of which they believe they must ride.

Looking ahead to the time when all of an individual's financial needs may be handled under a line accessed by his credit or cash card, thrift institutions are now proceeding to develop their own card, designed to interface eventually with other types of cards. In addition, they consider it essential that they participate effectively in the third-party payments business. As you know, a number of California savings and loan associations have applied for full membership in CACHA, in order to receive direct pre-authorized deposit of payroll checks to savings accounts just as they may now receive paper paychecks. Presumably,

membership in CACHA would also permit savings and loan associations to make pre-authorized charges to their customers' savings accounts in paying bills generally, if such associations obtain legal authorization for such transfers of funds. This raises vital questions of equality of competitive ground-rules for the various institutions participating in money transfers, as proposed by the Hunt Commission, for example, with regard to reserve requirements, tax treatment, and interest-rate ceilings on savings accounts.

### **Legal and Technological Implications**

With any such far-ranging change in the nation's payments arrangements, the legal problems can be both varied and complex. Speaking for the Antitrust Division of the Justice Department, Donald I. Baker recently said that thrift institutions "probably are entitled to access to automated clearing-house arrangements if they can show that they would be significantly injured by exclusion in competing for time and savings deposits"—provided that they had no reasonable alternative such as setting up their own systems. Whether "access" should be as customers of commercial banks or as full members of CACHA would depend on factual findings, said Mr. Baker, as to which approach was sufficient for competitive equality.

By extension, then, all types of financially-oriented companies might demand inclusion in such a system—data processing firms, specialized service bureaus, large retail firms, communications companies, and so on. Moreover, given a basic agreement between payee and payor, there is no reason why payments cannot be made simply by transfers of balances on the books of those concerned, without any commercial bank participation whatsoever.

In the same speech, Mr. Baker suggested that the Justice Department would not permit the cooperative use of point-of-sale terminals or cash-dispensing machines—"the branches of tomorrow"—any more than it would the establishment of branches on a joint basis by the leading banks in a community. In a later statement, he qualified this remark somewhat by pointing out that the antitrust implications of joint ownership or usage would be based on which institutions were doing the sharing of equipment; the antitrust yardstick would be the availability, to retailers and other bank customers, of alternative systems, equipment and services. Yet even when restated in this manner, the antitrust position could tend to reduce the economies of scale inherent in a full-fledged electronic payments system.

As a matter of fact, however, a number of S&L's have already applied to the Federal Home Loan Bank Board for permission to operate automated tellers and satellite facilities on a joint basis. Moreover, commercial banks and thrift institutions in several different areas have announced plans for joint operation of cash-dispensing equipment.

Facilities sharing is a proper technological solution to the problem of tying-in financial institutions electronically, but much depends upon the outcome of legal questions regarding the form competition should take. Specifically, the Justice Department and the courts must decide whether competition is to be measured by the number of competitors, including the number of offices or pieces of equipment which they employ—or by the scope, variety and pricing of services offered, at cost savings, through a joint use of facilities. The resolution of this question will be crucially important in determining the nature and

timing of development of an electronic-payments system.

### **Summary and Conclusions**

To sum up, I have indicated some of the cyclical influences affecting the financial scene in 1973, as well as some of the long-term changes likely to affect banking behavior over coming decades because of the development of an electronic-payments system. The cyclical influences are rather clear-cut. An unsustainable boom with an unacceptable rate of inflation has necessitated strong countermeasures. The tightening of monetary policy, along with the beginning of a shift in fiscal policy, should lay the ground work for a milder yet sustainable expansion. The banking community should also play its part, however, by keeping the credit expansion within bounds in coming months.

The long-term impact of changes in the payments system is more difficult to predict, although I have set forth a number of the implications for your banking future. As an integrated nationwide system develops, presumably a number of long-standing barriers will be broken down—between different geographic areas, and between different types of financial institutions. This development may provide you with serious challenges over the years ahead, but at the same time, it should present you with the opportunity for expanding the volume and variety of your financial services.





