

## **SOME ISSUES ON THE HORIZON FOR RETAIL BANKING**

**Remarks by  
Darryl R. Francis, President  
Federal Reserve Bank of St. Louis  
at the  
Banclub Association Convention  
New Orleans  
March 14, 1975**

---

**Mr. Chairman, members of the Banclub Association, and guests, it is good to have this opportunity to discuss with you some issues which I believe are vital to the future of retail banking in our nation. Your firms operate in an economy that is largely competitive. Most of your activity is neither planned, controlled, nor directed by an economic czar or governmental agency.**

**You have a vital interest in maintaining a healthy, competitive, economic system. In my view such a system, where production is designed to meet consumer demands rather than Government objectives, is essential, if man is to enjoy maximum gains from his increasing knowledge and the specialization and division of labor. Maximum efficiency in the production of goods and services is realized when each person performs those tasks for which he is relatively best qualified and when output is freely exchanged among all people.**

**For example, major advantages accrue to a community as a**

result of the market provided by bankers in bringing together savers and users of capital. In a system of private financial markets the rights to use resources are transferred from savers to borrowers who are specialists in resource use. Those borrowers with superior talents increase the productivity of resources and make them more valuable. In the process savers gain because they get a greater return from resources invested by the more efficient investors. Borrowers likewise gain; otherwise they would have no incentive to borrow. Gains thus accrue to all parties in the process of saving and investing, and the public at large gains as a result of the increased productivity achieved.

### Free and Unhampered Credit Markets Most Efficient

The gains from the market system are greatest when the system is not hampered by regulations and controls. The pricing process in unhampered financial markets directs funds from savers to those producers of goods and services who best serve the wishes of consumers. If consumers desire more of a specific good, the price of the good will be bid up and producers will find it profitable to employ additional resources in its production. They will bid for funds to gain control of such resources and the resources will be bid away from areas where returns are less.

For example, if returns to labor and capital are greater in the production of energy than in the production of automobiles these resources will move from automobile to energy production. Furthermore, the firms that use resources most efficiently can bid the most for the funds to purchase resources, and the banks supplying such funds can, in turn, earn more and pay the highest rates to savers. The free market price of loanable funds (that is, interest rates) thus directs savings to those users of resources who maximize returns to the economy.

In competitive markets the most efficient firms survive and prosper, and the less efficient deteriorate and fail. The competitive price system thus assures efficient production and minimum prices for those goods and services that are demanded by consumers.

### But, Numerous Credit Market Restraints Exist

Despite the greater efficiency of free markets, our credit markets have not been completely free in recent years. Credit market restrictions include legal ceilings on interest rates charged to borrowers and on rates paid to savers by the major financial institutions. Until recent years the market rate was generally below the ceilings, and the restrictions did little damage. Since the mid-1960s, however, market rates have risen sharply and in many instances have moved above the legal ceilings. The regulations have thus become increasingly restrictive

and reduced the efficiency of retail banking in the credit allocation process.

The restrictions have affected adversely those sectors and persons whom they were designed to assist. For example, state usury laws, which date back to the early years of recorded history, were designed to help poor people by limiting the rate charged them on loans. However, instead of providing them with low cost credit, restrictive usury laws practically eliminate the credit markets for poor people. The poor have fewer assets to offer as security for loans, and when the legal limits are below market rates, the limited amount of loan funds will flow to wealthier borrowers who have more assets for assuring repayment. Loanable funds search for the highest assured rates of return. Hence, states having low legal ceilings will lose funds to those having higher ceilings. Thus, rather than fostering credit to the poor, the restrictions have actually reduced credit availability in the low ceiling states.

The limits on rates payable by banks and other financial intermediaries have likewise reduced the efficiency of retail banking and other credit markets, and added to borrowing costs. These restrictions date back about a half century. They were originally designed to reduce "destructive" competition among banks. More recently, however, they have been used to attempt to channel more funds into housing and for other purposes.

Following the great Depression of the late 1920s and early 1930s, the Federal Reserve Board was authorized to set maximum rates which banks could pay on time and savings deposits. It soon adopted Regulation Q which imposed a ceiling of 3 percent on such accounts at member banks. Ceilings were later established on time and savings accounts at nonmember banks, and more recently on savings and loan association accounts. For many years following the establishment of the ceilings on bank accounts they remained above most market rates and were not very effective in altering the flow of funds. Hence, they did little damage and were often looked upon with favor.

In recent years of high inflation, however, the restrictions have begun to hamper competition significantly, and they have rarely been raised to bring them more in line with market rates. There is little doubt that the ceilings have reduced the efficiency of regulated firms in retail credit markets. They have led to inefficiencies in channeling funds since the efficient intermediaries were often not permitted to bid the market price. The efficient intermediaries failed to grow at a rate commensurate with total credit growth and nonregulated means have been used for channeling a larger proportion of the total savings to users of funds. In addition the restrictions have discriminated against the small saver and against the housing industry. They have denied the small

saver a market rate of return on his savings. They have reduced the flow of funds through the intermediaries into the housing market. Hence, both small savers and home mortgage borrowers were injured as a result of the restrictions placed on the more efficient credit market channels.

### Additional Restraints Have Been Proposed

In addition to the interest rate restrictions, other proposals have recently been made which would further reduce the efficiency of credit markets in terms of their contribution to total economic product. If implemented by legislation, these proposals may prove to be even more injurious to agencies in retail credit markets and the economic well-being of the nation than the usury laws and Regulation Q.

The proposals provide for the allocation of credit through legislative action to such "socially desirable" functions as housing and small business. As stated by one legislator, "We want to exercise judgment on where funds should go."<sup>1/</sup> The assumed need for legislative action is based on the assumption that much credit is extended for nonproductive purposes.<sup>2/</sup> Hence, it is argued that if "nonproductive" credit could be diverted to such socially desirable objectives as housing and small business, the well-being of the nation's population would be increased. I believe that each of us should be vitally

---

<sup>1/</sup> American Banker, January 29, 1975, p. 4.

<sup>2/</sup> See p. 3, Washington Banktrends, February 17, 1975.

concerned with these proposals for several reasons.

The suggested means for implementing these proposals would reduce the efficiency of banks and other financial intermediaries in channeling credit from savers to users of funds. The proponents of the proposals have suggested two methods for channeling more funds into housing and small business -- namely, reduced income taxes on interest from such loans and lower reserve requirements. Each of these methods would discriminate against other borrowers. Those who are discriminated against would, in turn, find other ways of tapping credit markets. Unless total credit controls are enacted they can offer their own commercial paper to savers or borrow from unregulated loan companies. If total controls are enacted Governmental decision making would largely replace private decision making regarding resource use.

The elimination of income tax liabilities on a portion of the interest derived from home mortgages and small business loans would no doubt increase the volume of such loans. However, I have serious reservations as to the influence of such loans on the volume of housing construction or on the total stock of housing. Credit is highly fungible and dollars are difficult to trace. Homeowners would be encouraged to borrow for home building or repairs, and to use their incomes and savings for other purposes. Hence, the additional real estate mortgage credit, instead of resulting in more building activity or more housing, may only mean an increase in borrowing on home mortgages and a decrease in

other types of credit.

On the other hand, if the proposals are implemented and more credit is used for home construction, the additional housing will be at the expense of other products and/or services. The total quantity of goods and services, and of savings will not be increased. Hence, fewer goods and services will be produced in the credit-starved areas.

My greatest concern with the proposals, however, is that they are likely to reduce the total product of the nation from what it would have been under free markets and thereby reduce the well-being of the people. If people wanted more credit for housing and less for other purposes, in the absence of impediments to credit flows, the demand for home mortgage loans would increase. In turn, home mortgage rates would rise, additional credit would become available to housing, and a smaller quantity would be available for other uses. Credit flows do not require legislative allocations in a free market since the appropriate amount of credit already flows to each use on the basis of consumer demands.

Hence, when a legislative body proposes to channel additional credit into home building or any other activity, the objective is an attempt to compel individuals to adjust their conduct to what the legislature thinks is desirable, rather than what individuals prefer in



a free market. Through such legislation government defines what economic activity is desirable and what is not rather than leaving such decisions up to each individual.

I much prefer the interpersonal free market exchange system where owners are free to choose the use of their goods and resources on the basis of consumer demands. I would recommend, therefore, that the answer is less legislation, including the removal of most existing restrictions.

Furthermore, in my view there is no such thing as wasteful or nonproductive credit in free credit markets. Corporations, farmers, large individual businesses, and purchasers of common stock all use credit productively. All such credit serves a useful purpose. It satisfies individual desires, independent of any intervention by third parties. It either enhances the volume of capital goods or the volume of goods and services flowing to consumers. Hence, it makes just as much economic sense to provide for additional flows of credit to the non-housing activities as it does to housing.

There is no reason to believe that a political decision to allocate resources enhances overall well-being from that attained under free markets. By substituting the subjective values of the legislators for those of the population as a whole we run the risk of creating excesses and waste in housing. For example, if we could reduce the size of homes

by channeling less credit into the housing industry, we would save on energy consumption and reduce pollution. Homes are a major factor in the nation's demands for energy and as a result they are a major source of air pollution. Although I do not favor this route to energy conservation or clean air, it makes just as much economic sense as the proposals to channel additional credit to housing or those to reduce energy consumption in automobiles by any means except through the free market system.

Consequently, it seems reasonable to me that we should let the market system solve the entire problem of credit and energy allocation. It provides each person the opportunity to spend his funds for those purposes that lead to his maximum individual well-being. In contrast, it is my belief that instead of contributing to well-being, the credit allocation proposals and most other economic judgments made through legislative action, if effective, actually reduce the well-being of the people.

### Summation

In conclusion, we have already experienced too much government regulation in financial markets. Both state usury laws and Regulation Q have hampered the efficiency of credit markets, and impeded the growth and profitability of banks and other financial firms.

Proposals for additional credit controls are now before the nation. Those proposals provide for channeling additional funds into specific sectors of the economy. In my view, like the restrictions on interest rates, they would be damaging to existing financial markets and the nation's well-being.

Instead of permitting the market system to channel credit to its most productive uses as determined by yields on borrowed funds, credit flows into specific sectors of the economy would be determined by legislation. Legislators would substitute their judgment for each individual's judgment with respect to credit use. In contrast to such a system, it is my view that a system where economic actions are based predominantly on individual decision making in the marketplace provides greater well-being and is more compatible with a free and open society.