



"MONETARY POLICY AND BANK MANAGEMENT"

Address by
Theodore H. Roberts
President
Federal Reserve Bank of St. Louis

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I am very pleased to have this opportunity to return to Chicago and visit with so many of my good banking friends.

Although I am now associated with a somewhat different kind of bank a few hundred miles south of here, the miles can't separate me from many pleasant memories of almost 30 years of close association with Illinois bankers.

Over the years, I have been privileged to speak to your bank management conferences on several occasions. This summer when I moved to St. Louis, I found a file of my old speeches, including one that I made to this group in Champaign about 20 years ago. Fortunately, it contained few predictions, and none about interest rates. But as you know, the bright glare of hindsight can be quite humbling. I certainly would not have anticipated the enormous changes in financial markets and banking which have occurred since that time.

Curiously, however, that speech in 1964 did contain considerable comment about monetary policy. (Perhaps I was predestined to be a member of the FOMC!) Seriously though, I have always had a strong interest in monetary policy since my days as a student at the University of Chicago's Graduate School of Business. So, here I am again, talking about monetary policy and this time about its relationship to bank management.

Although monetary policy may have seemed to be a rather academic subject to bankers in 1964, it wouldn't have been if they could have foreseen the future. Behind them at that time were 15 years of limited money supply growth, and moderate inflation--a little over 2 percent a year of each on average. Ahead of them, however, were 15 years of much more rapid

money growth and sharply higher prices--more than 6 percent a year on average. Understandably, interest rates rose dramatically in the latter period.

As you well know, by the end of 1979, inflation in this country had reached 10 percent and we were beginning to hear references to our being no better than some of the "banana republics" in our ability to control prices. Interest rates soared to levels never before experienced in our modern history. These extraordinary interest rates reflected investor concern about the rapid depreciation in value of their money. When lenders expect inflation to rise, they try to protect their purchasing power by demanding higher nominal interest rates. And borrowers, under the same circumstances, willingly pay the higher rates.

I was in New Orleans attending the A.B.A. convention with some of you in October, 1979, when the Fed announced that it would change from a policy of interest rate management to a policy of controlling the money supply. By 1982, this new approach had stopped inflation cold, even in the face of a massive Federal deficit. But this was not without considerable pain and misery in the form of sky-high interest rates, unemployment reminiscent of the thirties, and substantial idle productive resources throughout the economy.

The relevance to you of all this talk about monetary policy is that high inflation and high interest rates produced fundamental and permanent changes in your business. As rates rose along with inflation, depositors abandoned banks in droves for the higher returns available in marketable securities and money market mutual funds, forcing a relaxation of bank interest rate controls. The market value of your investment portfolios

declined substantially below book value, wiping out a large portion of your real capital. With a mismatch between the duration of assets and liabilities, liability funding costs increased faster than return on assets, squeezing net interest margins. Your operating expenses rose rapidly (particularly employee compensation), producing overhead levels which were much too high for a new market sensitive, technologically oriented environment. The credit condition of many of your borrowers deteriorated, particularly those in interest sensitive areas such as real estate. Finally, a lot of folks outside banking were attracted to the business and are now selling traditional banking services, including transaction accounts. The financial services industry began to consolidate.

Of course, most of you have moved aggressively to counter these forces. Improved strategic planning and marketing, tighter control of operating expenses, reduction of unnecessary overhead, greater use of computers, communications technology, and ATM's, increased fees for services, elimination of unprofitable lines of business, better management and hedging of duration mismatches, brokering of loans, and more variable rate loans are all examples.

In the final analysis, I think you would agree that we would all be better off with an assured lower level of inflation and interest rates. The question is how we can best accomplish this objective.

Since inflation is primarily a monetary phenomenon, to assure stable prices over a long time period, we must have a policy that supplies money to the economy at a rate that matches output growth. It must be one that will not be sidetracked by desires to alleviate short-run economic problems for short-run political expediency. No monetary policy can be conceived and practiced that will eliminate all wiggles in production, in individual

prices or in employment. No monetary policy can be designed that will eliminate short-run changes in the price level or short-run fluctuations in interest rates. If we realize that these short-run variations cannot be eliminated, and that attempts to do so are futile, we can conceive of a monetary policy that will assure long-term stability in prices and, thus, stability in long-term interest rates.

The history of monetary policy produces instance after instance where policy produced long-term disaster because policymakers abandoned their view of the future to focus on the short-run considerations of the present. Time and time again, monetary growth was expanded when short-term interest rates were rising in a futile attempt to prevent them from increasing; the result, of course, was accelerated inflation and higher interest rates than would have otherwise occurred. Time and time again money growth was contracted when interest rates were falling "too fast"; the net effect, of course, was to slow economic growth and, occasionally, to bring on economic downturns. Time and time again monetary policy was used for the best of reasons: to fight increases in unemployment, lack of demand for housing, rising or falling exchange rates or crises in various industries or sectors of the economy. The full consequences of these well-intentioned actions, however, were destabilized money growth in the long run, permanently higher inflationary pressures and, at times, contractionary processes that produced costly output losses and higher unemployment.

Monetary policymakers must have tunnel vision: they must be blind to the day-to-day and year-to-year market-induced wiggles in prices, interest rates, output and employment. Policymakers must concentrate solely on producing money growth that is compatible with the long-term growth in output and with people's desires to hold money.

This does not mean that some "pre-set" monetary target must be followed blindly regardless of the consequences to the economy. It does mean, however, that money growth targets, and the actual growth of money as well, should be changed only when there is substantial evidence that output growth has changed significantly from what was expected, or that the public is using and holding money in unexpected patterns. If policymakers are unwilling to develop this "tunnel vision," we might as well be prepared for a repetition of the past 15 years and for the general economic instability and the higher risks and costs associated with it.

As managers of banks, you already have your hands and minds fully occupied with trying to survive in a new and strange environment. Certainly you neither need nor want the complications and risks that are created by high or variable inflation, by volatile interest rates or by unpredictable government actions. Yet, often, it is people just like you who, through the political process, demand short-run stabilization of variables, perhaps because they feel that short-run government actions do not entail any long-term cost. Let me assure you that they do. As we have discovered so painfully over the past 15 years, this long-term instability has consequences that vastly dwarf any losses that you may sustain due to a one-day rise or fall in the federal funds rate.

In conclusion, I believe that managing a bank will be a more challenging and exciting experience in the future than it ever was in the past. In a deregulated environment, there will be an increased premium on good management decision making. There will be more alternatives to choose from and, consequently, vastly more decisions that will have to be made. There will be greater opportunities for profits and, correspondingly, greater opportunities for losses. But if we can prevent these increased managerial

problems from being overwhelmed by inflation and interest rate risks, they will be manageable problems. In order to eliminate these inflation and interest rate risks, we must have a monetary policy with a goal of long-term price stability. And that can be achieved only if participants in financial markets realize that we should neither expect nor demand the government to solve our managerial problems for us. Such governmental attempts have generally produced the longer-run economic instability that made many of our problems seem unmanageable.

As we emerge from three years of economic stagnation and recession, it appears that the prospects are bright for a sustained and well-balanced business expansion. Although I fear that some increase in inflation is already "built in" as a result of too rapid money growth last year, continuation of the present moderate growth of the monetary aggregates should prevent a recurrence of what happened in 1981. Over time, we must gradually reduce the rate of growth of the money supply to a level near the rate of expansion of real productive capacity in the economy. If we cut back too quickly, we could precipitate another recession. If we expand too much, we will reignite inflation. In a way, it's a tight wire act which requires skill and courage and carries an alternative that is wholly unacceptable. I know we can count on your support as we attempt to cross the abyss.