



LET'S GET OFF THE ROLLER COASTER

**Address by
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It is both a privilege and a pleasure to be included in the program of your annual meeting. As a former commercial banker, I feel very much at home with members of your profession . . . and I must observe that you could not have chosen more delightful surroundings for this get-together.

Although the peace and beauty of this area are conducive to peaceful relaxation, I know that I need not remind you that "back home" things are not totally tranquil as far as the banking industry is concerned. Major economic changes are taking place in all phases of our society . . . changes which I know have profound implications for all bankers and especially for those of you who are engaged in commercial lending.

When I first became active in banking in the early 1950s as the CEO of a medium-size financial institution in my native city of St. Louis, banking was relatively uncomplicated. In those days, as I am sure is still the case today, we had three primary goals: to attract deposits to our bank, to arrange loans on which we could reasonably expect repayment, and to earn an appropriate return on stockholders' equity.

Under economic conditions prevailing at that time, all three of those goals were relatively easy to achieve. As incredible as it may seem by today's standards, we were able to attract substantial savings deposits by paying as little as 1% on passbook accounts. The maximum maturity on automobile loans was 24 months, and occasionally . . . in exceptional situations . . . we extended mortgage credit up to 60% of the value of the property rather than our standard 50%. We did not purchase Fed funds because we had no reason to, and we scarcely knew the meaning of liability management. Under those circumstances, needless to say, we were able to earn a pretty good return for our stockholders.

Alas! Those were the good old days!

Today, commercial banking, and especially commercial lending, are a great deal more complicated. Much of this increased complexity can be attributed to persistent and

accelerating inflation, which is the subject of my remarks this afternoon. Specifically, I would like to discuss the impact of inflation on commercial banking, the causes of the inflation we are experiencing, and how sound monetary policy could gradually reduce inflation without causing a recession.

There is little doubt that inflation has had an adverse impact on the business of banking. It has affected the ability of banks to attract and retain deposits, it has complicated the making and collecting of loans, and it has had an adverse effect on bank profits.

Prior to the onset of relentless inflation, banks were able to attract deposits through relatively inexpensive means. Some were successful in securing funds by marketing their "friendly banker" image . . . others relied on free toasters, alarm clocks or similar premiums . . . some were able to build savings merely by offering nominal rates of interest. Before the advent of serious inflation, the cost of attracting and retaining loanable funds was significantly less than it is now.

Inflation has changed all this. With market-determined interest rates now hovering near the 10% mark, bankers are forced to pay significantly more for funds . . . or face a loss of deposits. Savers are no longer content with modest rates of return on their savings. They are shopping for the highest available interest and are moving from the passbook to higher yielding instruments in order to maximize their income. Money market certificates and Treasury bills are increasingly in demand by savers whose sophistication of choice has been enhanced by the pressures of inflation. Large corporations are resorting to corporate certificates of deposit and are more aggressively entering the commercial paper markets, thus depriving banks of some of their lower-cost loanable funds.

Demand deposits are also becoming more expensive, as the pressures of inflation have led to the emergence of the automatic transfer account, money market fund checkable accounts, repurchase agreements and other inflation-inspired arrangements.

Larger banks have been forced to resort to the Euro-dollar market and the purchase of Fed funds in order to generate the necessary resources to support their loan demand. The net result is that today, as a result of inflation, bankers find themselves having to pay substantially more than formerly for the funds they lend.

Similarly, inflation has complicated the lending function. In earlier times when price levels were relatively stable, lending officers based their credit decisions on an analysis of such fundamental factors as the borrower's net worth, the profit-making potential of a company in the case of a commercial credit and the character of the applicant. Today, because of inflation, it's another story. While the traditional fundamentals must still be considered, lenders are now faced with unpredictable variables which are the direct result of the uneven acceleration of inflation. Will the borrower's real income, after inflation, be the same in the future as it is at present, or will inflation-impacted revenue and depreciation-at-cost put him in a higher tax bracket which will reduce his income? What effect will increased inflation have on future labor costs? Would a sudden reduction in inflation make the borrower's inflation-adjusted interest payments untenable?

Ongoing inflation follows an erratic course. Its rate is unpredictable and, thus, it can have an unpredictable effect on business or individual borrowers in spite of a good product, good management or good intentions. In short, inflation has created a whole series of variables that make the already-difficult judgments involved in lending even more precarious.

Finally, in addition to increasing the costs of acquiring deposits and complicating the commitment and collection of credits, inflation tends to erode profit margins of commercial banks. In the good old days, if I may again refer to them as such, a banker could predict the cost of loanable funds, add a few percentage points to yield a desired rate of return, and be fairly certain of his ultimate bottom line. Inflation has made such profit projections much more difficult. The cost of funds is in a constant state of flux. Renegotiation of interest rates has become a prevailing practice. Even if you succeed in maintaining a desired spread between costs and returns, you know that your real profit margin will be narrowed by taxes

and inflation. It is no secret that inflation has caused an erosion of bank earnings in real terms, and the reduced prices of bank stocks on today's markets reflect the disenchantment of investors with long-term earnings potential of the banking industry in an inflationary economy.

Thus, in many respects the persistent inflation of the past decade and a half has adversely affected the banking industry and has created a situation which must be reversed for the benefit, not only of bankers, but of the vast public which depends so much upon the existence of a sound and profitable commercial banking industry.

So, we have two choices. We can accept inflation and try to adapt to it; or, and I prefer this latter course, we can work to reduce inflation to where it no longer poses a serious threat to our economy, our society and our political system.

Which brings us to the question: what can we do to reduce inflation without in the process precipitating an intolerable recession?

To cure a disease, it is helpful to know its causes, and in the case of inflation, there is no shortage of alleged causes. In fact, there are so many imagined causes that I sometimes think that they tend to divert our attention from the true culprit. Some pundits attribute inflation to high interest rates, others to excessive wage settlements. Politicians like to point an accusing finger at greedy businessmen.

In reality, inflation is not caused by evil unions, greedy businessmen, or self-serving farmers, dentists and doctors. Contrary to what some people think, it is not caused by high interest rates. Inflation occurs only when the supply of money available for spending increases faster than the supply of goods and services available for consumption. Whenever the supply of money is increased, and people have more money in their pockets to spend, spending on goods and services increases. When spending out-distances the available supply of goods and services, prices are bid up, and inflation results. Wages and interest rates are affected by, but are not in themselves the causes of, inflation.

Since 1960, money supply narrowly defined, has skyrocketed 130% while real GNP has risen less than 80%. Over the past 5 years growth of the money stock has averaged more than 6% annually. In the past 2 years it has averaged 8% annually. For every dollar the Fed pumps into the economy 2-1/2 new spendable dollars are created . . . which pleases politicians especially just before election time. Unfortunately, within 18 - 24 months, those extra dollars cause an acceleration in the rate of inflation commensurate with the injection of the new money into the economy.

Conversely, if the money supply is abruptly contracted from a high level of growth to a significantly lower rate of growth, and if that contraction persists for any length of time, the result is usually a recession. The recessions of 1961 and 1970 are examples of the consequences of abrupt reductions in money supply.

It is thus fair to ask why, if control of money supply growth is so important, doesn't the Fed simply expand or contract the money supply as necessary to stabilize the economy.

First, let me assure you that no one at the policymaking level wants to perpetuate inflation, and no one wants to cause a recession. I can also assure you that no responsible policymaker welcomes cyclical swings in the economy regardless of the direction they might take.

I rather believe that excessive money supply growth as well as excessive money supply contractions are the direct results of a traditional practice of trying to "fine-tune" the economy through the stabilization of interest rates instead of directly controlling the growth of the money supply. The fault lies in the process of monetary policymaking rather than the intent of policymakers.

Let me explain how the process works. As you know, the Federal Open Market Committee meets monthly and gives the trading desk at the New York Fed two primary targets to achieve. These are a Federal funds interest rate range and a growth range for the monetary aggregates (known as M-1 and M-2). If market demand for credit threatens to move the

Federal funds rate above the upper limit of its prescribed range, the desk, in order to curb the rise in the Fed funds rate, buys securities and thereby supplies additional reserves to the banking system. On the other hand, if the monetary aggregates reach the upper limits of their ranges, the desk withdraws reserves by selling securities, thereby limiting money supply expansion and causing an upward pressure on the Fed funds rate. These open market operations have two simultaneous effects: they change the total amount of reserves available to the banking system, and they temporarily alter the level of short-term interest rates.

Thus, monetary policymakers can either supply reserves at a rate they deem consistent with some desired growth rate of money and the general economy, or they can try to affect the Federal funds rate in a manner consistent with these same goals.

Which path have we tended to follow?

A review of the published history of interest-rate and monetary-aggregate behavior in the period since long-term monetary aggregate growth ranges were first announced gives us the answer. In the 46 periods since short-term ranges have been set, the Federal funds interest rate fell outside of its target ranges only five times; in the same periods, M-1 growth fell outside of its ranges on 22 occasions, or nearly 50% of the time. M-1 tended to exceed its targets during periods of rising Federal funds rates, to fall short of its targets during periods of falling Federal funds rates, and to usually remain within its targets in periods of stable Fed funds rates.

One conclusion can be drawn from these facts . . . in periods of incompatibility, the Fed funds target predominates. In my opinion, it is this, more than any other factor, which can lead to inflation in times of strong credit demand and to recession in times of weakening credit demand.

Suppose the economy is booming, and credit demand is strong. These conditions would normally, in themselves, cause the Fed funds rate to rise. But if stabilization of the Fed funds rate is the principal objective of policy, as we contend that it often is, then the monetary

authority must counter the rise in rates by buying government securities in the open market, thereby expanding the supply of dollars available for lending. This results in a booming economy being fueled even more, and inflationary pressures are reinforced as more money is supplied than is consistent with the economy's average growth. That is how short-run stabilization of interest rates in times of increasing credit demand causes inflation. It has the same result as stepping on the accelerator of a car after you discover the brakes have failed.

On the other side of the coin, when the economy is contracting and credit demands are softening, stabilization of the Fed funds rate tends to produce a contraction of credit. If the purpose of policy is to artificially curb a natural decline in interest rates under such circumstances, bank reserves and money stock must be reduced, and this action, in turn, further contracts the economy. Such an abrupt reduction in money supply growth can contribute importantly to causing a recession. In this case, the result is like suddenly slamming on your brakes at a stop sign instead of gradually decelerating.

Historical evidence tends to confirm the suspicion that a policy of interest rate stabilization has usually led to money being fed into the economy in times of expansion and withdrawn in times of contraction. For example, between February and June of 1976, the Fed funds rate went up from 4.8% to 5.5%, signalling an expanding demand for credit, and simultaneously, the monetary base growth increased from 8% to 10%. From June, 1976 through January, 1977, the Fed funds rate fell from 5.5% to 4.6% . . . and the monetary base growth followed suit, slipping from 10% to 7.5%. Again, during 1977 and 1978, the Fed funds rate leaped from 4.6% to 9.8%, and the money base growth increased from 7.5% to 9.1%. In all, during 12 charted periods of upward or downward movement in the Fed funds rate, the behavior of the monetary base tended to parallel the direction of the movement of short-term interest rates.

The net result has been a roller-coaster effect, with expansionary peaks usually exceeding in magnitude the contractionary valleys. The reason for this bias toward inflation is that stimulative actions in times of recession have generally been more pronounced than actions of

restraint in times of inflation. Thus, it is no wonder that stabilization of interest rates, whether explicitly desired or not, has been a major factor contributing to our present serious inflation.

I have touched upon how interest rate stabilization in periods of economic contraction can produce a recession. During the past few months the growth of the money stock has experienced a significant decline . . . down from the 8% level which had prevailed for two years to less than 4% recently. If such a slowdown were to persist for another quarter or two and if history repeats itself, recessionary pressures could be expected to develop.

In order to enhance our ability to resist excessive inflation in times of strong credit demand and to avoid the recessionary consequences of abrupt reductions in the money supply growth, I propose the following changes in the process by which we conduct monetary policy:

1. We should abandon Federal funds targeting and the stabilization of interest rates as the primary goal of monetary policy and move gradually toward a freely-fluctuating Federal funds market.
2. Monetary policy should be conducted with a view toward providing reserves and money consistent with long-range economic goals, irrespective of temporary fluctuations in short-term interest rates.
3. We should gradually cut the rate of growth of reserves and money until inflation has been brought under control, while at the same time, avoiding any abrupt decline in the money supply.

The likely results of such a policy would be to:

- . reduce the level of interest rates,
- . reduce inflationary expectations, a major component in the chain of economic events that determines interest rates, particularly long-term rates, and restrains the economy from automatically backing away from an inflationary trend ,
- . help bolster the international value of the dollar,
- . diminish risks of a recession, assuming money growth reduction is accomplished

gradually,

. . . permit bankers to provide their traditional services with vastly improved efficiency, and

. . . provide a stable monetary environment within which free markets could operate without unnecessary risks.

As I noted at the outset, commercial banking has changed a great deal, particularly in recent years, and some of the changes have not been beneficial to either you, your banks, or your customers. But I am confident that this trend can be reversed. We have the means to curb inflation as well as to avoid a damaging recession.

The task will not be easy. It will require acts of wisdom and determination. It will require the understanding and support of the American public. And it will require unwavering adherence to a courageous, independently conceived monetary policy.

In closing, let me stress the importance of maintaining the independence of the Federal Reserve System. I would be one of the first to admit that the Fed's track record in conducting monetary policy is by no means perfect. I know of very few organizations that earn straight A's in all situations. However, I do believe that, on balance, the Fed has performed its assigned duties in a relatively capable manner.

I know that there are those among us who for philosophical or political reasons would challenge the independence of the Fed. These are individuals who sincerely believe that the best means of assuring full employment and economic prosperity is through deficit spending and easy money. They believe that the Federal Reserve should be made to accommodate such goals if called upon to do so by Congress or the President. They feel that inflation is a small price to pay for immediate and usually short-lived prosperity.

If I have learned anything in the short three years I have been in my present job it is that political domination of monetary policy would be disastrous. In almost every case where independent central banks have been placed under the control of politically-motivated forces,

short-term considerations have taken priority over the longer-term national interest and responsible monetary policy has given way to inflation-generating expediency.

If we are to avoid this happening here, each of us must take part in the struggle to preserve sound monetary policy. We can best do this by supporting the full independence of the Federal Reserve System and, in turn, making certain that the Fed acts flexibly, responsibly and steadfastly in the conduct of our Nation's monetary policy.