For release on delivery
8:30 p.m. E.D.T.

THE EVOLUTION OF OUR MONETARY SYSTEM:

Adaptation in a Changing Environment

Remarks by

G. William Miller

Chairman

Board of Governors of the Federal Reserve System

before the

Annual Dinner

Graduate School of Business

Columbia University

New York, New York

May 7, 1979

For any American it would be a privilege to receive this W. Averell Harriman award. For me, it is a particular honor. As have Americans and people from throughout the world, I have long admired Governor Harriman as a giant in his own time. His contributions have spanned the public and private sectors and stand as a unique model for the total concept of service. Many shall try, but few will be able to match his achievements.

Tonight, in recognizing the Harriman tradition, I would like to discuss with you an issue that is crucial to the continued success and growth of our economic system. It is an issue that has been brewing for some years, but is now becoming ripe for decision. How we resolve this issue will determine whether our financial system will continue to support the American economic aspirations or whether it will stagnate and give way to some undefined and ineffective substitute.

Our financial system has shown great resiliency over the past 200 years. It has adapted successfully to changing economic conditions. Our nation has already faced a series of watershed decisions in our financial history. We now face another: the challenge of up-dating our financial system to adjust to the technological, social and market changes that have occurred in the financial world over the last 30 years.

Simply put, the issues involve modernizing the nation's central bank and its relationships to all our financial intermediaries, establishing competitive equality among financial institutions, and assuring more effective tools for the conduct of monetary policy.

Like watershed decisions that were made in the past, the choice today is between reconciling ourselves to new realities and needs, or allowing the financial system to flounder in the status quo.

Let me recall briefly four episodes in the evolution of our monetary system when the choices that our nation faced were similar in magnitude to the choice we face today. In each of these cases, after major debates or minor ones, the resulting decision was for constructive change. In our democratic and diverse society, watershed decisions never come easily, and that is as true in 1979 as it was in past eras.

EARLY EXPERIMENTS

To recall those earlier milestones, we must start at the beginning of U.S. history. The issue of the proper form and substance for a monetary system was at the core of one of the very first major political controversies following the ratification of the Constitution in 1789.

Secretary of the Treasury Alexander Hamilton advocated, as necessary to the growth of American commerce, a strong central bank to manage the government's money and to regulate the country's credit. Secretary of State Thomas Jefferson was opposed, arguing that the Constitution did not specifically empower Congress to create a central bank. Hamilton responded that in order to carry out its constitutionally enumerated monetary and fiscal powers, Congress could create a central bank as "necessary and proper" to the exercise of these responsibilities.

Hamilton prevailed, and the First Bank of the United States was created in 1791. It was a nationwide bank, headquartered in Philadelphia and run by 25 directors. The First Bank performed the basic banking functions of accepting deposits and issuing bank notes, and it supplied credit needed by business and government.

But the Bank's size and power made it unpopular with those who opposed a centralized control over money. A bill to recharter the Bank in 1811 failed by the margin of only a single vote. The theme in this battle was one that would recur in banking history up to the 20th century. Rural and urban values clashed, with the result that the institutions needed for a commercial society -- a common medium of exchange and a regulator of that medium -- were frequently greeted with hostility.

Indeed, a variation of that theme repeated itself when Andrew Jackson in 1836 successfully blocked renewal of the charter for the Second Bank of the United States, which had been established after the War of 1812.

From 1836, through the next quarter century, America's banking was carried on by a myriad of State-chartered banks with no Federal regulation. In some areas of the country this system functioned well, but in others banking was unstable, producing an overall picture of difficulty for the American economy.

NATIONAL BANKING ACT OF 1863

Consequently, it should come as no surprise that a second major watershed was crossed during the War between the States. At the time, there were several thousand different bank notes circulating in different sizes, shapes, and colors. The Federal government found itself unable to market securities to finance the war.

In 1863, Congress responded by passing the National Banking Act. Basically, the legislation provided for the creation of nationally chartered banks. And, by effectively taxing the State bank notes out of existence, the legislation in reality provided that only national banks could issue bank notes, these to be backed by U.S. government securities. To the surprise of many who had opposed and many who had supported the legislation, there was a particularly noteworthy result: state-chartered banks were able to survive and to prosper because the expanding use of checks was decreasing the importance of bank notes, and demand deposits -- checking accounts -- became a source of bank funds. Indeed, under this new "dual" system of banking the number of state-chartered banks increased. Perhaps there's a lesson for us today.

PERSISTENT PROBLEMS

The National Banking Act strengthened the banking system and created a national currency, but it did not provide the essentials of central banking. It did not provide a mechanism for regulating the flow of money and credit nor for assuring the security of the nation's financial system.

During ensuing years, America's finances were strained by two severe problems. First, the currency was inelastic. The national bank notes grew or contracted in response not to the needs of American enterprise but fluctuated according to the value of bonds held by national banks. With such inelasticity in the currency, the economy swung wildly between boom and bust.

The second problem was immobile reserves, resulting from the structure established under the National Banking Act. There was no easy way to expand reserves and reserves could not be shifted easily to areas of the country where they were needed.

These weaknesses in the national banking system became increasingly critical as the 20th century approached and America's industrial economy grew and became more urbanized, while the banking system stood still. The booms and busts increased in amplitude. In 1893, a massive depression rocked the economy; money panics ensued, and by 1908 it was only too clear that the banking system was out of date and in need of major reforms. For 120 years, America had been taking slow steps toward the creation of a central monetary authority, but at each prior opportunity it had ultimately backed away from the decision.

THE FEDERAL RESERVE ACT OF 1913

A third great milestone -- a watershed decision -- was creation of the Federal Reserve in 1913.

The period of debate over the Federal Reserve Act is historically enlightening. It illustrates a classic textbook case of the fruits of skillful negotiation and compromise. The basic questions were: how much monetary control, by whom, under what kind of structure? Resolution among competing concepts required legislative, administration and financial leaders of great stature, good will and determination. And such leadership prevailed.

One issue that was not compromised was the principle of an independent monetary authority. That principle was recognized by Nelson Aldrich, Chairman of the preparatory National Monetary Commission; Carter Glass, who steered the legislation as Chairman of the House Banking and Currency Committee; and President Woodrow Wilson. They were aware of the need for integrity in the conduct of the nation's finances, as well as the case for insulating the central bank from political abuse. They knew the lessons of history and responded wisely and well.

Essentially, the structure and the responsibilities of the monetary authority -- the nation's central bank -- as we know it today were established in 1913. America was at last on the right path toward a reasonably stable financial system, with many of the problems of earlier periods resolved by this monumental reform. America had at last begun to guide the inevitable evolution of its financial system.

Before moving to our next historic watershed, let me call attention to a few of the catchwords that are associated with the

Federal Reserve Act and those benefits that bankers and the nation came to appreciate: safety and soundness; liquidity or mobility of reserves; monetary control. These concepts should be kept in mind; these are the very principles that are in danger unless we adapt to today's financial world.

THE GREAT DEPRESSION

Another great watershed for the U.S. monetary system came during the Great Depression.

Congressional reaction to the cataclysmic events of 1929 and the early 1930's largely set in place the financial system that we have today. The first priority of the Roosevelt Administration was to ensure the integrity of the dollar. Therefore, the Banking Acts of 1933 and 1935 contained measures to halt the rash of bank failures and prevent their recurrence. Federal deposit insurance was established. The Federal bank regulators were granted authority to impose interest rate ceilings on time deposits. Payment of interest on demand deposits was prohibited in order to prevent the destructive interest rate competition that was widely believed to have led to bank failures. A central credit facility for home financing institutions was established with the Federal Home Loan Bank Act of 1932. A system of Federally chartered and supervised savings and loan associations was created in 1933, with Federal insurance provided the next year.

Finally, the effectiveness and independence of the Federal Reserve was improved. Many believed the decentralized policymaking structure of the Federal Reserve System had hampered its ability to deal with the financial crisis and the Great Depression. Hence, legislation was enacted centralizing policymaking in an independent Board of Governors. Independence of the Federal Reserve from the executive branch was strengthened at the insistence of Senator Carter Glass, who successfully urged that both the Secretary of the Treasury and the Comptroller of the Currency be dropped as members of the Board.

These landmark reforms of the 1930's -- deposit insurance, interest rate regulation, specialized housing lenders, the Federal Open Market Committee, and an independent Federal Reserve Board -- are the dominant features of the financial landscape today.

THE POSTWAR YEARS

Recovery from the Depression was slow, and achieved fully only with the onset of World War II. During the war years, independence of the Federal Reserve was subordinated to the war effort. Federal Reserve independence from the Executive was reasserted in 1951, however, when the Treasury-Federal Reserve Accord freed the Board from an obligation to support the government securities market at unrealistic interest rates. In contrast to the Depression, the 1940's and 1950's were years of relative financial tranquility.

However, pressures began to build in the economy at the end of the 1950's and throughout the 1960's -- pressures which now increasingly challenge the adequacy of the financial and regulatory system in a rapidly changing world.

Banks began to be faced with new competition from other types of financial institutions. Inflation accelerated. Interest rates became increasingly variable and reached new postwar highs at the peak of each interest rate cycle. Disintermediation periodically troubled financial institutions as investors chose to place funds directly into money-market instruments instead of in deposits. Regulations which for years had not constrained banks now became excessively binding.

INNOVATION IN THE FINANCIAL SYSTEM

Increasingly private financial institutions reacted to inflation, high interest rates, and increased competition in a regulated environment through innovation. Banks began switching to concentrating on liability management in addition to asset management in the late 1960's. New sources of funds were tapped by means of negotiable CDs, first offered in 1961; Federal funds; repurchase agreements; and Eurodollar borrowings. Banks began offering corporate customers "cash management" services, paying interest on funds placed overnight in instruments that were exempt from Regulation Q interest rate ceilings.

COMPETITION AND MEMBERSHIP

As banks have sought to adjust to the inflation and high interest rates of the 1970's, they have been faced with increased competition that has eroded their previously unique charter for providing transactions accounts. Innovations have allowed thrifts to offer customers third-party payments services and interest on transactions balances. These have included the NOW accounts available at depository institutions in New England and New York, "bill-payer" services and telephone transfers, credit union share drafts, and remote service units allowing withdrawals from savings accounts by electronic means.

Finding themselves in highly competitive markets with high interest rates, non-earning monetary reserve balances, and consequent pressures on earnings, many banks have reacted by withdrawing from membership in the Federal Reserve System. The resultant shrinking of deposits under central bank cognizance is of grave concern at a time when more effective monetary control is essential to combat the clear and present danger of virulent inflation. Consider the trend: in 1945, member banks held 86 per cent of banking deposits. By 1970 this had dropped to 80 per cent. Now, in eight short years, it has plummeted to just over 70 per cent.

THE PRESENT WATERSHED

These events and trends have brought our monetary system to another critical juncture. The reformed system constructed in the 1930's has served us well, but it has become increasingly outmoded by technology and market-place innovations. Not only must we respond to the changes of the 1960's and 1970's, but also we must take this opportunity to perfect a monetary framework that can serve the needs of our growing nation in the 1980's and the 1990's and into the 21st century.

OBJECTIVES OF REFORM

In moving to modernize and strengthen our financial system, there are several objectives which are of paramount importance.

First, the tools for monetary management must be improved. Our present instruments are too blunt to cope adequately with the battle against inflation which threatens our economic well-being. The continuing and accelerating decline in basic deposits subject to central bank reserve requirements has made implementation of monetary policy more uncertain and hence more difficult. It is not that we need more reserves; indeed, less reserves, properly structured, would suffice. But we do need a more certain fulcrum for our monetary lever so that applied action will have a predictable result in the growth or diminution of money and credit.

Second, there needs to be competitive equality among financial institutions. Free and fair competition is at the heart of our private enterprise system. The present structure places member banks at a competitive disadvantage because of the burdens of non-earning reserves. And there are other inequities that need to be redressed.

Third, attention should be given to improvement in the mechanism for assuring a sound payments system and appropriate financial liquidity.

THE SEARCH FOR SOLUTIONS

The underlying issue is by no means new. The Congress, the Federal Reserve, and the financial community have been wrestling with it for some years. The House Banking Committee, under the Chairmanship of Representative Reuss, has held extensive hearings. A bill was reported out of the House Banking Committee in the last Congress, and the Committee has been considering various legislative proposals for most of this year. In the Senate, the Banking Committee reported out related legislation in the 95th Congress and hearings on more extensive proposals were held late in 1978 and early this year.

In the meantime, the banking and thrift communities have devoted extensive time and effort to the subject matter, and have made valuable contributions toward focusing the issues and developing alternative solutions.

ELEMENTS OF A MONETARY IMPROVEMENT PROGRAM

While as yet a consensus has not emerged in favor of any specific proposal, there has been tremendous progress in narrowing divergent views. It seems to me that there is growing and widespread accord among the affected constituencies in favor of a Monetary Improvement Program that would encompass the following essential points:

1. Maintaining the concept of voluntary membership in the Federal Reserve, thus assuring a vigorous dual banking system.

2. Reducing substantially the amount of non-earning reserves required to be deposited by member banks with the Federal Reserve. Remaining reserve requirements should be uniform as to type of deposit -- rather than the present graduated system -- and should relate mainly to transactions accounts and their equivalent. This will reduce the financial burden of membership while retaining appropriate reserve levels for monetary control.

3. At the same time, providing that all financial intermediaries shall maintain reserves with the Federal Reserve with respect to their transactions accounts -- on the same basis as member banks. Such universal reserves on deposits related to the basic money supply will provide the fulcrum for effective monetary control and will assure greater competitive equality among depository institutions.

4. Instituting a policy of explicit charges for most Federal Reserve services -- rather than the present system of providing such services without any specific charges. Prices should be based on full costs and an appropriate return on employed capital, with due regard to competitive factors. This will contribute to more efficient payment and other services,

more opportunities for the private sector to provide the services, yet assure that a safe clearance system is always available.

5. Opening up access to borrowing from the Federal Reserve discount window and access to Federal Reserve services to all financial institutions subject to reserve requirements -- non-members as well as members. This will provide assurance of the liquidity necessary to keep the financial system working smoothly in time of adjustment or stress.

This is not to overlook or to underestimate the difficulties in gaining agreement on some important details. The exact reserve ratios, the specific deposits to be covered, the form and location of some part of the reserves, are some of the items to be settled. But if there is agreement on the need for modernization, the responsible leadership should be able to deal with these matters.

OTHER PENDING ISSUES

There are other critical issues facing our financial system. The present period of economic expansion, accompanied by high inflation and consequent high interest rates, has demonstrated anew the dangers of financial disintermediation when deposit flows are hampered by unrealistic interest ceiling rates, and the threat to financial institutions' viability when market rates are paid for deposits while interest rates on loans are limited by law. Moreover, consumers have properly challenged as unfair a system of limiting interest rates on savings accounts for small savers.

And, recently a Federal Court of Appeals barred certain deposit and financial services, effective next January 1, with an express suggestion that the issues be addressed by Congress.

Thus, coincident or simultaneous with considering the Monetary Improvement Program, the Congress may be dealing with two other areas:

First, what if any additional powers should be extended to thrift institutions -- savings and loan associations, mutual savings banks, and credit unions -- to offer third-party payment accounts?

As a personal observation, it would seem to me worthwhile to consider authorizing all depository institutions to offer NOW accounts -- special savings accounts subject to negotiable orders of withdrawal which are much like checks -- for individuals, provided there was a uniform interest rate ceiling and uniform reserve requirements.

Second, should the system of interest rate ceilings on savings accounts and certificates dating back to 1966, and renewed periodically since, be altered?

Again, as a personal note there would seem to be merit in considering the phasing out of such ceilings over time -- say, five to ten years -- coupled with modification or removal of usury rate ceilings on mortgage loans and possible authorization of variable rate mortgages. At the same time, it would seem appropriate to provide thrift institutions with some expanded asset powers for consumer lending.

CONCLUSION

So, at this particular watershed for our monetary and financial systems, the agenda is extensive and challenging. Such challenges often bring out the best.

The leaders who shaped the milestones of the past served our country well. As a result, our system has been second to none in its capacity to meet the needs of a growing and more complex society. It has contributed to attaining the highest standard of living for the most number of people.

Now, we again turn to the leadership -- in Congress, in the private sector, in Government -- to meet the challenge of change and to forge a watershed decision with the same wisdom, vision and devotion to the national interest that has characterized such decisions in the past.

It seems to me that the democratic process is working -- that the constituencies are responding -- that the leadership is shaping an historic decision.

It is timely. Economic issues are at the forefront. Our very security depends upon our economic strength -- on our ability to overcome inflation and to achieve our goals of full employment, price stability and a sound and stable dollar.

I am confident that we will succeed. The American people deserve nothing less.