Some Stubborn Problems For Central Bank Policy*

By ALFRED HAYES
President, Federal Reserve Bank of New York

It is again a pleasant experience for me to meet with this group. I particularly look forward to these sessions as an opportunity to review developments and exchange ideas relating to our mutual concern with banking and the general well-being of our economy. When I considered possible topics for these remarks, a number of timely subjects came to mind, each deserving of thorough exploration. Rather than concentrate on any one of these to the exclusion of the others, however, I propose to address myself briefly to several stubborn questions which have been with us for some years and do not seem amenable to easy or quick solution.

Some of these problems are in the area of banking organization—relating to the development of an ever more efficient and healthy banking system in keeping with our developing economy. Some others are concerned with how best to apply our instruments of general monetary policy, through the existing banking structure, to foster the kind of sustained economic growth and viable system of world payments that we all want to achieve. The common strand that I believe we must keep in mind in approaching all these problems is that we are living in a world of change, calling for continual reappraisal of institutional arrangements and techniques of monetary control.

BANKING STRUCTURE

My first comments, then, concern banking structure. We might note that in the Second Federal Reserve District alone, during the past year, we have processed forty applications for merger or holding company acquisitions. This is clear evidence, I think, of existing strong pressures to adjust our banking structure to new requirements and conditions. In the face of these pressures, I have been troubled, as I know you have, by the absence of clear guideposts pointing out the direction in which the nation's banking structure might be expected to develop. We are all aware of the vast changes that have occurred over several decades in the nation's organization for the production and distribution of goods and services to the consumer. In these developments we have seen a clear tendency toward larger, more flexible, and more efficient enterprises operating in extended market areas which seldom respect "banking district" or even state lines. Against this background there has been an understandable feeling on the part of commercial bankers that they, too, must adjust to long-range trends of this kind and must be prepared to offer the most complete and efficient banking services possible to these larger industrial and commercial units as well as to the public at large.

Indeed, before the recently increased concern at the Federal level with regard to banking concentration, natural economic forces had already resulted in a considerable consolidation of banking resources and organizations, where legislation made this possible—especially in areas of rapid economic growth. Many of the mergers and holding company acquisitions which took place almost unnoticed ten or fifteen years ago would probably be seriously questioned or even denied today. And yet there is little or no evidence that these past consolidations have had any adverse effect on the public interest or, in any meaningful sense, diminished competition. Instead, great gains have been made in the variety and extent of banking services, and competition is still very keen not only among commercial banks but between banks and a wide array of other savings and lending institutions.

Admittedly, we need to know a great deal more about the actual and specific effect of consolidation of banks on the scope and quality of banking services, if only to allay the fears of those who view it as a vague evil. It may even be the case that the geographical limitations on banking expansion have produced more actual concentration in certain areas than is either necessary or desirable. Perhaps one hopeful line of approach to the problem of banking

* An address before the thirty-fifth annual midwinter meeting of the New York State Bankers Association, New York City, January 21, 1963.

structure would be to emphasize the "trading area" as an appropriate field of banking operation.

A similar regional concept was recognized at the time of the organization of the Federal Reserve System, with its twelve districts cutting across state lines. Specifically, I think a good case might be made for allowing any bank considerable freedom to operate branches (or affiliates if it were to prefer a holding company setup) throughout the economic area in which its head office is located—ultimately, perhaps, throughout its Federal Reserve District.

Of course, even if this were accepted as a valid longer term goal, progress toward it would necessarily be gradual and would have to take careful account of the views of the state authorities concerned in each case. It is important, however, for purposes of discussion and study to have some clear objectives in mind. And I suspect that, if a measure of agreement on broad objectives could be reached among banking authorities, banks, legislators, and the public they all serve, we would make some progress toward clarifying the present extremely muddy situation.

DECENTRALIZING SUPERVISION

I am wondering, too, whether the current uncertainty and confusion resulting from so much divided authority on bank supervisory matters might not be reduced through a greater degree of decentralization, whether or not accompanied by a concentration of authority in a single organization at the Federal level, as has been suggested. I would hope that, whatever the ultimate solution at a national level, perhaps a way might be found to place with a regional authority the initial responsibility for ruling on all questions of mergers, new branches, holding company acquisitions, and bank charters in a given area. There is a rough analogy, at least, for this kind of decentralization in our Federal court system, where only the most important issues involving matters of principle are carried to Washington for decision.

The kind of regional grouping I have in mind might include representatives of state banking authorities as well as of national authorities, and it might be possible to reach solutions that would be satisfactory to most of the major interests within the area. If these solutions differed in one or another respect from those reached under similar circumstances in another part of the country, there is no reason to assume that this would necessarily be damaging to the national economy. In fact, it would be quite in keeping with the long tradition under which each state has an important voice in the way banking facilities are expected to develop in its territory. State-wide branching, for example, need not be wrong for California just because Illinois permits no branching at all. The consistency we should seek first should be with respect to the decisions that affect banks and other financial institutions which compete directly with each other.

RESERVE REQUIREMENTS

The consistency of rules applying to competing institutions is also involved in the question of Federal Reserve membership, with the somewhat more burdensome obligations of members to maintain reserves against demand and time deposits than are generally required of nonmember banks. I am heartily in sympathy with the view that the proper levels of reserves required for member banks should be under constant scrutiny and that changes should be made when necessary for reasons of equity as well as monetary policy. I hope, however, that commercial bankers will never lose sight of the primary purpose of reserve requirements—namely, to provide a convenient lever whereby the monetary authorities can influence the availability of bank credit. Were it not for the effectiveness of this highly impersonal and general mechanism, the authorities would have to fall back on a far more detailed and bureaucratic system of scrutinizing and regulating various classes of assets or liabilities, or even of individual transactions. This sort of control would be as objectionable to me as I know it would be to you.

I would hope, too, that sight not be lost of the fact that, if a reserve requirement system of this kind is to have any meaning, it must embrace a very large proportion of the nation's bank deposits, and no important bank should expect to be excluded from its coverage. I would hasten to add my hope that such banks will always find the obligations of membership substantially offset by its advantages and therefore in their own best interest; but in improving our services to emphasize these advantages, we must be careful not to interfere unduly with established bank-to-bank correspondent relationships as well as be mindful of the fact that our funds must be used only for purposes that clearly promote the public interest.

Recently there has been some particularly lively discussion about the Federal Reserve System's reserve requirements against time deposits. It has been pointed out, quite rightly, that many institutions which are in direct competition with the banks for such deposits are entirely exempt from reserve requirements. Recognition of this fact was one of the reasons lying behind the Board of Governors' recent reduction in time deposit reserve requirements from 5 per cent to 4 per cent. Perhaps more should be done eventually along these lines for the same reason. We must, nevertheless, keep in mind that the

relative size of the demand deposit component in the country's aggregate bank deposit structure has been shrinking and may continue to do so in the light of the growing tendency for all types of depositors to hold working balances to a practicable minimum in order to take advantage of interest-earning opportunities.

RATES ON TIME DEPOSITS

A closely related subject is that of official regulation of the maximum rates of interest that may be paid on time deposits of various maturities. The origin of these regulations lay, of course, in the fear of abuses, but I believe that with our improved bank examination procedures we need no longer rely on this method of combating whatever tendency may exist in some few banks to seek higher returns by sacrificing quality standards. Moreover, I am a little concerned with what seems to be a tendency for maximum rates to become the actually prevalent rates. I should think that a reasonable goal would be elimination of mandatory ceilings on time deposit interest rates, although there is a good deal to be said for having the Federal Reserve System and Federal Deposit Insurance Corporation retain the right to impose such ceilings if unusual circumstances might seem to call for it.

Turning from these more or less regulatory and administrative matters to some problems of current monetary policy, let me say first that I regard the Federal Reserve System's credit policies over the past year—and in fact over the past two and a half years—as being easy. The System has provided reserves liberally to support solid expansion in the reserve base, although it has avoided pushing out funds much faster than the economy could use them. Member bank free reserves, which can be taken as a rough clue to the current climate of reserve availability, have been maintained in a substantial positive position, necessitating only minimal use of the "discount window" by member banks. The total reserves of member banks, after adjusting for the effect of the reduction in reserve requirement ratio against time deposits, increased about 3 per cent from December 1961 to December 1962. Over the same period, the earning assets of all commercial banks increased nearly 9 per cent and by the largest dollar amount since World War II. The wide divergence between the rapid growth rate of total bank credit and the more moderate growth in total reserves can be explained largely by the very rapid expansion of time deposits which followed the changes in Regulation Q, since time deposits of course require a much lower ratio of reserves in back of them.

MONEY SUPPLY AND LIQUIDITY

Now, I recall that when I joined the Federal Reserve System I was intrigued and puzzled by the differing views of economists as to just what should be included in the term "money supply" and as to the economic significance of changes in the money supply, however defined. It is true that in recent years we have added a good deal to our general knowledge and statistical coverage in this field, yet I am almost as puzzled as ever as to the precise relationship between changes in money supply, or in total liquid assets, and in economic activity. For example, the money supply proper—that is, currency plus demand deposits—has risen only very moderately during the past two years. On the other hand, the picture is quite different if we add time deposits at commercial banks, or more generally all savings deposits as well; and the expansion is also very substantial if we measure the total of liquid assets, including short-term Government securities, held by the nonbank public. In fact, if we use the total of such liquid assets in relation to the gross national product as a measure of overall liquidity, we find that the country's total liquidity has been much better sustained in this expansion period than in any of the comparable postwar periods. This would seem to fit in with the common-sense view, which I share, that the general experience of bankers, businessmen, and the public at large suggests no dearth of available credit and in fact points to a very ample degree of liquidity.

Thus, while we cannot measure precisely to what extent our operations affecting money supply, total liquid assets, and general credit conditions are bringing results in increased consumer and investor spending, I do believe we have contributed to a financial climate that is generally encouraging to the economy. There are those who argue that our monetary policy has been unnecessarily restrictive and therefore harmful to the growth of the economy; but I can find no persuasive evidence to support this contention, and I suspect that, if money had been even easier, it would not have had any appreciable beneficial effect on business activity and might have encouraged undesirable speculative excesses in some directions. These conclusions seem to me valid, entirely apart from the obvious drawbacks of an easier policy from the standpoint of our international responsibilities, on which I shall have more to say later.

While I think we are justified in feeling that monetary policy has been making a significant contribution, I must also say that the total performance of the economy has not been so robust as this nation should be able to achieve with its ample resources and growth potential. In particular, I find it disappointing that our sluggish business

expansion of the past year has made no more appreciable dent in unemployment. The unemployment rate was down to about 6 per cent at the end of 1961, and it has hovered in a narrow range around 5½ per cent during the past year. It is also disappointing that we have seen thus far no stronger pickup in capital expenditures by businesses, although I believe that the tax credit plan enacted last year and the important revision of depreciation rules for tax purposes are already providing stronger incentives in that area.

TAX CUTS AND DEFICITS

Beyond these useful tax revisions which are already in effect, I believe that it would be extremely helpful, and indeed imperative for our economy, to have some significant tax reductions to stimulate both consumer and business spending. The Administration's current proposals for tax reductions, and the recent similar suggestions of various business and labor groups, reflect a growing awareness that, if economic growth and employment are to be stimulated by additional governmental measures, it is fiscal policy rather than monetary policy that should be looked to at this point. Let me emphasize, however, that in supporting a more stimulative fiscal policy I am not thinking in terms of higher Federal expenditures; any substantial tax reduction should be accompanied by strenuous efforts to restrain increases in Federal spending and to achieve material reductions wherever possible.

An effective stimulus to the economy as a result of tax reduction, I believe, would significantly ease the difficult problem faced by the Federal Reserve System in trying to meet its international and domestic responsibilities. With fiscal policy playing a more positive role in the domestic economy, the System would have greater scope as needed for actions conducive to a better international balance, while at the same time avoiding the excesses that may arise—and that in the past have arisen—when monetary ease is pushed too far.

Tax reduction would not only stimulate private spending and credit formation, but would also temporarily enlarge the Federal deficit. Both of these developments would tend to have some firming effect on interest rates, which would be helpful in checking capital outflows. The extent of this firming effect would depend, among other factors, on the degree to which a temporarily enlarged deficit would be financed within or outside the banking system. This is a matter on which I would not want to offer any hard and fast rules, particularly since so much depends on the volume of savings that may be channeled through commercial banks, but some rough limits can be noted. Certainly, it is clear that, if the Federal Reserve System automatically provided the banks with all the reserves they needed to take up any Federal deficit, this process would not only vitiate the firming effect on the money market of increased Treasury borrowing, but—more important—could set in motion a highly inflationary chain of events. At the other extreme, to force a financing of the entire deficit outside the banking system might produce too great an offset to the stimulative effect of tax reductions—although of course the beneficial impact of tax rate reductions on incentives to spend and invest would still remain. In the final analysis, the appropriate extent of bank financing of a given deficit can be determined only in the context of what is happening to total bank credit and total liquidity, to the degree of slack in the economy in terms of unused manpower and capacity, to prices, and to the balance of international payments; but in all probability a large proportion of the budget deficit will have to be financed out of current savings.

Before leaving this question of tax cuts and deficits, let me underscore the point that I do not envisage here an unending stream of large Treasury deficits; this would be a disturbing prospect indeed. On the contrary, I would expect that rising national income would gradually produce a greater volume of revenues to make up for lower tax rates.

BALANCE OF PAYMENTS

Whatever merit a more aggressively easy credit policy might have for our domestic economy—and as indicated earlier I am doubtful that net gains would accrue even on that side in the present circumstances—I am convinced that such a policy would be highly injurious to our balance of payments. In viewing the United States balance-of-payments deficits of the last few years it is easy to reach conclusions that are either too optimistic or too pessimistic, depending on which elements are emphasized. I believe that we have made some progress toward solving the problem, but not nearly enough progress—and in some directions practically none at all. While we have come a long way from the time when few businessmen or even Government officials thought of the balance of payments as a subject entitled to high priority consideration, there is still a dangerous tendency in this country to feel that we can afford to orient our economic and financial policies almost entirely to domestic conditions with only perfunctory acknowledgement of the international risks that may be involved.

The full record for 1962 is still being compiled, but we do know that our total payments deficit last year—in the neighborhood of $2 billion—was not so far below the $2.5

billion level of 1961 as was hoped earlier, although it was substantially below the $3¾ billion average of 1958-60. It is particularly disappointing that the deficit did not shrink further in the light of certain special transactions, such as the early repayment of long-term debts by some of our allies, which worked to reduce the deficit through means that cannot be counted on to continue year after year. Clearly, there is still a major job to be done.

In some respects the past year's results have been heartening. I find encouragement, for example, in the notable degree of cost and price stability achieved in this country in the past year or so, at a time when unit labor costs have been advancing rapidly in the principal countries of Europe. Yet it would be a mistake to rely on these trends, important as they are, to bring about as large an increase as is needed in our favorable trade balance. For one thing, there are limits—and they may not be very distant—beyond which some of the other industrial nations may be unwilling to go in permitting cost-price inflation in their economics. There is already a good deal of evidence of concern on this score on the part of the monetary and other governmental authorities in a number of European countries, and if these cost trends persist we can doubtless expect credit restriction or other measures to be used to counter them. Also, with stronger demand at home, it is not clear to what extent our business and labor leaders would adhere to a conservative policy with respect to wage settlements and pricing policies; yet the need for cost stability will be as great or even greater as domestic demand strengthens, given the typical stimulating effects on imports of an acceleration in business activity. In this connection it is sobering to note that United States imports increased by more than 10 per cent last year while our exports rose not much more than 2 per cent.

Turning to another major component of our payments problem, a laudable degree of progress has been made in reducing the heavy burden of our net Government outlays overseas, especially in the military segment. However, much remains to be done in this field, as well as in the area of a better sharing of economic aid burdens by the major industrial nations—a number of which have now achieved strong balance-of-payments positions. Larger contributions to the common cause by our allies are all the more essential in light of the new demands for aid that are constantly arising and that must be given sympathetic consideration.

CAPITAL FLOWS

While the two areas I have mentioned, i.e., the trade balance and Government outlays, are of unquestioned importance with respect to our long-run balance-of-payments prospects, it would be a great mistake to neglect the contribution of private capital flows to the current deficit problem. Of course the outward flow of long-term investment funds carries with it the building of an ever stronger asset and income-earning position abroad; and it would be short-sighted indeed to ignore this useful aspect of our foreign investments, particularly where capital is flowing into productive investment channels. On the other hand, there is no denying that capital outflows, whether short-term or long-term, are adding importantly to the size of our deficit right now; nor can we deny that some of these flows are sensitive to relative levels of interest rates and credit availability, as well as to the comparative climates for profitable business investment. Since it would be wholly contrary to our basic economic goals to place any direct obstacles in the way of a free international flow of capital, we must give consideration to those factors that can be expected to influence the flow through normal market forces.

The sensitivity of these capital flows to credit market conditions is particularly acute in the case of short-term funds, but while there seems to be a growing understanding of our need to maintain rates on United States Treasury bills and other short-term market paper at reasonably attractive levels compared with rates in foreign financial centers, there is less appreciation of the point that comparative interest rates and credit availability are also important in the area of bank loans. Nor can we neglect the fact that international differentials in interest rates and degrees of market accessibility also have some relevance with respect to long-term financing. We can hardly afford to ignore these points when they are so clearly considered important by our foreign friends, and when recent experience also seems to demonstrate their validity. In time, it is hoped that the further removal of restrictions in foreign capital markets, and the further development of long-term financing mechanisms in those markets, will reduce the tendency for international financing to be concentrated in our market. This would be particularly appropriate, and welcome, in the case of financing needs that arise in the more advanced countries abroad. However, it is clear that we cannot expect this to happen fast enough to be of much help in solving our immediate problem, which is to eliminate our balance-of-payments deficit in the shortest possible time.

In setting our sights on prompt elimination of the payments deficit, it is worth remembering that we have piled up deficits totaling more than $15 billion in the past five years, of which some $9 billion has been reflected in increased foreign holdings of liquid dollar assets. This kind of build-up leaves us no choice but to assure our

foreign "depositors", as affirmatively as we can, that they do not possess a wasting asset. In particular, we cannot set aside the possibility that, if an adequate and timely solution is not forthcoming from other sources, monetary policy may be called upon to play a much more decisive role. And while it is perhaps too early to conclude that other sources will not provide the remedy, the Federal Reserve System must remain entirely flexible and ready to do its part.

INTERNATIONAL COOPERATION

In speaking to you a year ago, I reviewed some of the steps that had been taken recently by the Federal Reserve System and the Treasury, in close cooperation with our counterparts in the major European countries, to reduce the threat of excessive speculative flows and other potentially disturbing movements of funds across international boundaries. I would not like to leave you today without some further comment on these highly useful arrangements to help assure the stability of our international financial structure. It goes without saying that the dollar, firmly fixed to gold at a $35 price, is a keystone in this structure; but the stability of all of the major exchange rates is also a prime contributing element of strength, and I have been greatly encouraged to find complete unanimity among the central bankers and Government authorities of the leading industrial nations that we have a common interest in protecting this stability.

The very existence of this cooperative spirit, and its clear recognition by the world's financial community, have been of great help in enabling the international financial structure to weather, with a minimum of disturbance, such crises as the severe stock market slump last spring, the Canadian difficulties of the early summer, and the recent period of high international tension resulting from the Cuban episode. Let me add, however, that we have no illusion that these arrangements can be regarded as a substitute for more basic balance-of-payments correctives, and in no sense do they excuse any of the participating countries from doing its utmost to keep its own financial house in order.

At the same time, I believe that these arrangements have a real value apart from their current significance in checking or preventing undesired speculative flows. Both for us and for our major partners in world financial relations, they represent cautious and careful experimentation in the mutual holding of currencies, and reciprocal extension of credit facilities, under special circumstances and limitations. I see no reason to believe that we have reached the end of this road. On the contrary, it seems to me quite likely that we may progress a good deal farther along these lines during the coming years, as our balance-of-payments situation improves. This may well prove to be an effective avenue for bolstering world liquidity, which seems ample for the present but of course must grow as our international economy develops further. I would like, on behalf of all of us engaged in these efforts, to dispel the notion that we are merely fitting in the parts of a preconceived pattern. The approach is more pragmatic and tentative than any such concept of a "grand plan" would imply. Suggestions are made from many different sources in many different countries, and those that seem worthwhile are tried out, while those that work well are retained and strengthened. In the process, we are encouraging not only a fruitful interchange of ideas, but also a much improved mutual understanding of the economic problems faced in different countries. Over a period, we may succeed in building a financial structure which will be proof against all foreseeable assaults and which will make the best possible contribution to the kind of economic world we are all trying to achieve.