Recent Developments in Banking Structure and Monetary Policy*

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Since I last spoke at this annual luncheon, monetary policy and banking structure have undergone a number of important changes, and many further changes have been proposed. Significant banking changes have been taking place here in New Jersey, for much has been happening to New Jersey banking law. I should like to take a few minutes to say briefly how my associates and I in the Federal Reserve Bank of New York look upon some of the opportunities—and some of the pitfalls—with which you New Jersey bankers are faced as you adjust to these sharply altered rules of the game.

The 1969 revisions in New Jersey's banking law have provided an excellent opportunity for banks to grow through branching and through mergers and acquisitions. As you know, the revised law permits branching and merging across county lines within three banking districts and allows, for the first time, the formation of statewide bank holding companies. Many banks have already taken advantage of these new powers. About two hundred new branches, representing about one fifth of the number of offices in existence at the end of 1968, have been approved by state and Federal regulatory authorities since last July. Most of these new offices could not have been opened under the old branching laws. In addition, about thirty mergers have been announced or consummated during this period and about a half dozen banks have formed or announced their intentions to form multidistrict holding companies.

The prospective benefits to the people of the state of increased competition, improved services, and more efficient flows of funds could be quickly lost if a few banks were allowed to dominate the state's major banking markets. Both New Jersey bankers and the bank supervisory authorities have an important responsibility to see that the structure of banking evolves in a way that will produce the maximum benefits to businesses and residents of the state.

The public interest in the field of banking is best served by well-managed, diversified banking organizations, provided there are sufficient banking alternatives in each market to assure effective competition among banks within those markets. In our view, every proposed combination of banks in New Jersey should be judged within the framework of maintaining or improving, if possible, the competitive environment and performance in each of the state's banking markets.

On a statewide basis, concentration of bank deposits in New Jersey is not excessive. The ten largest banks hold about 35 percent of the state's total deposits—a proportion which is much lower than in most states. However, statewide data for New Jersey are quite misleading. Most individual banking markets are fairly concentrated and are dominated by relatively few banks.

New Jersey bankers contemplating taking advantage of the new leeway provided by the revised branching, merging, and holding company laws would be well advised to consider the antitrust decisions of the courts, the opinions of the Justice Department, and the rulings of the Federal Reserve Board with respect to bank mergers and holding company formations and acquisitions. I do not agree with all these conclusions. However, I think you will recognize that they provide some realistic guidance in formulating expansion plans.

From these decisions, it appears that any bank which is regarded as a significant competitor within a market would be limited in the size of other banks it could acquire within that market. The determination of the likely anti-

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competitive effects resulting from a merger between two banks in the same market would depend upon the absolute size and market shares of the banks involved, the number of other competitors, the degree of deposit concentration, and the possibility for *de novo* branching. The chances for a New Jersey bank to acquire a bank outside its own markets would seem to be much greater. This would be particularly so in the case of "out-of-district" acquisitions by bank holding companies.

There are perhaps a dozen or so large banks in the state that appear to have the management and financial resources to form statewide holding company systems. They are experienced in all areas of commercial banking and provide correspondent services to other banks in the state. These leading banks should be the nucleus from which competitive forces are transmitted throughout the state. Just how many will ultimately strive to market their services throughout the state is, of course, unknown. One thing does seem fairly certain, however—at this juncture affiliation or merger of any of these institutions with each other, whether in the same or a different market, is likely to meet regulatory resistance.

To date, New Jersey bankers have by and large acted prudently with their newly won powers to branch, merge, and form holding companies. Branching and merging activity beyond county lines and into previously protected communities has permitted greater geographic diversification of banking in the state and has often introduced more competition, with its benefits of more and better services.

Perhaps the best advice I could offer to bankers contemplating expansion is to come into the Reserve Banks and discuss their plans with officers close to the New Jersey situation. While none of us can give any kind of formal or informal commitment about decisions to be reached by the Federal Reserve, we can certainly give you some feel for the competitive issues involved in specific proposals and offer guidance in the development of your expansion plans.

Let me turn now to a subject which I believe is very much on the minds of most bankers, as it is on the minds of all of us in the Federal Reserve System, namely, the role of monetary policy in the economy. Early in the year I delivered an address entitled "Inflation: A Test of Stabilization Policy", in which I expressed my view that fiscal policy and monetary policy would be up against a very severe testing in the year 1970. The test would determine whether these generalized impersonal policies would succeed in coping with inflation, or whether this nation would have to fall back on other—and to my mind less desirable—remedies to meet the situation.

Four months later it seems to me that the answer is still up in the air. Certainly, aggregate spending has slowed markedly, and there has been a pronounced business slowdown. These developments should set the stage for the moderation of inflationary pressures. So far, however, despite a few encouraging signs, it is difficult to find any conclusive indications of a slackening in price advances. It is encouraging that excess demand has been practically eliminated, but cost-push is still a problem. And it is certainly not correct to conclude, as some have, that entirely different methods are now required to cure inflation. Prime reliance must still be placed on the traditional tools of fiscal and monetary policy. Even if we were prepared to go over to direct wage and price controls, and I am not, these alone would be altogether useless, unless the traditional tools were used in an appropriate manner. The rejection of direct wage and price controls does not mean, however, that the Government should refrain from supplementing fiscal and monetary policy with the help that might be obtained by focusing public attention on the basic relationships of wages, productivity, and prices and on glaring deviations from sound observance of these relationships. I might add that I feel much sympathy with Chairman Burns' comments the other day on this general subject.

I have continued to feel that the current slowdown is unlikely to accelerate and become a full-fledged recession. For a time early this year there were rather widespread fears of recession; then, for a while, these tended to fade in view of the stronger business outlook. Very recently a shadow has been cast by rising unemployment, stock market declines, developments in Indochina, and sharply diminished liquidity in some sectors of the economy. On balance, however, it seems to me that the outlook is for a modest increase in economic activity over the rest of the year. Inflation, even if somewhat diminished in force later in the year, will continue to be an extremely serious problem.

It is a problem not only in terms of the domestic economy. Our inflation has tended to worsen the competitive position of the dollar and the United States balance of payments. Success in the fight against inflation is vital to the development of international flows of trade and payments that will improve our serious balance-of-payments situation. Given the weight of the United States economy in the world, our success is important, not only to us, but to others as well. This is especially true today, when the battle against inflation is common to virtually all the major industrial countries.

Monetary policy has shifted moderately since the beginning of this year and is no longer highly restrictive as it was through most of 1969. In my view, recent fiscal policy has not been restrictive enough. As I have said before, I believe we would be far better off if the 10 percent income tax surcharge had been left untouched. It is true that those in charge of the budget are making strenuous efforts to preserve its restrictive character, and I wish them every success.

Meanwhile the burden on monetary policy is greater than it should be, thus making it difficult to avoid inflationary pressures and excessive strains in money and capital markets. In this connection, a good case could be made for retaining the 5 percent income tax surcharge. Moreover, the rise in Federal agency spending, which has in recent years been removed from the budget, and in private spending for urgent social purposes, such as housing, education, antipollution, and urban renewal, means that additional financing will be required. I would therefore strongly endorse the view that large budget surpluses may be necessary in the seventies to help generate the savings required to meet pressing social and economic needs. And I urge you to support tax and spending decisions that would serve this objective.

During the past year or so we have seen some interesting developments in both the theory and the practice of monetary policy. There has been increased emphasis on the growth rates of major monetary aggregates, such as the money supply and bank credit. This change of emphasis found official expression in the Federal Open Market Committee's policy actions in early 1970. I would like to point out, however, that the change was evolutionary and not revolutionary. For years the FOMC directive had included a proviso requiring the Manager to modify his operations if specified aggregates moved in ways substantially different from those foreseen at the FOMC meeting in question. Long before that, and in fact throughout the System's history of open market operations, developments with respect to the growth of money and credit had been watched closely, along with other factors bearing on policy decisions. No doubt the recent formal change reflected to some extent, however, a widespread feeling in the System that the aggregates had not received enough attention by comparison with the traditional measures of money market conditions.

This sense of dissatisfaction received a strong boost after the experience in the second half of 1968, when fairly tight money market conditions were accompanied by what was, at least in retrospect, a clearly excessive expansion of money and credit. I might add that many of those who complained after the fact about the excessive monetary expansion of late 1968 were, nonetheless, so fearful of "overkill" at the time that they were quite unwilling to countenance the firmer money market conditions that would have been needed to slow this expansion.

More recent experience has reinforced the view that the aggregates deserved more attention. In the second half of 1969, tight money market conditions were accompanied by a virtual stagnation of the major aggregates. Slow, or even no, growth in the aggregates was acceptable enough for a time, particularly in the light of the strong performance earlier and the continued rapid advance in prices. However, the persistence of this sluggishness became increasingly disturbing.

I believe we have moved in the right direction in placing greater stress on the aggregates. But I confess I have been troubled by the tendency of journalists and persons operating in the money market to overplay the extent of this modification in techniques. Of course by its nature it implies some greater willingness of the authorities to see interest rates and other money market indicators swing a bit more widely than before if this is necessary to come closer to the intermediate goal in terms of money and credit growth. But it certainly does not mean that henceforth the System is going to ignore everything as a policy criterion except these aggregate growth rates. We are not nearly sure enough of the relationships of the aggregates to the real economy, which is our ultimate concern. We know that the statistics themselves are subject to random movements, particularly in the short run. I can assure you that the System still cares about the condition of the money and capital markets and about interest rate movements. We are not "abandoning" the markets, as some seem to have feared in recent weeks; nor have we lost interest in the principle of avoiding actions at the time of a major Treasury financing operation that could prove to be destabilizing to the market by constituting or suggesting a significant change in monetary policy.

Another point I would like to make in connection with this change of emphasis is that it is entirely possible to place greater stress on the money and credit aggregates without becoming a "monetarist". I am applying that term to those who believe in a virtually assured mechanical relationship of a causal character between the money supply and economic activity, and who therefore tend to favor a very steady increase in the money supply and a minimum resort to discretionary policy by the central bank. I fail to see any convincing evidence of this reliable mechanical relationship, and I see every likelihood that varying growth rates for money and credit should be deliberately sought by the System from time to time in the light of a host of other factors affecting the course of real growth, prices, and wages, etc.

Another question concerning monetary policy has been getting increased attention in the last few months: Should the Federal Reserve explore new techniques with the avowed purpose of exercising more direct influence on the channeling of credit to specific sectors of the economy? Now there is no denying that there is some logical basis for at least raising the question. A restrictive monetary policy does have an uneven impact (as does an easy policy as well), but let's not forget that the major task of monetary and fiscal policy—and a task difficult enough to absorb the bulk of our effort—is to keep aggregate demand within a reasonable range in relation to available resources. When total demand is excessive, someone and some activity should be forced out of the demand side of the equation. If the elected representatives of the people in the Congress feel that the result of broad impersonal policy moves is an undue upsetting of social and economic priorities, remedies are at hand in the form of legislation with respect to taxes, subsidies, and other measures to channel funds into areas of the greatest need. This appears to me greatly preferable to asking the central bank to compound its difficulties by trying to exercise this social judgment. Personally I am not attracted to recent suggestions that a new technique of differential reserve requirements against various types of bank assets be developed to enable the Federal Reserve to play just such a role. I would also stress that this has been a suggestion of a few individuals and that no official position has been taken on the issue by the Federal Reserve System.

By the same token I have never been attracted to the thesis that Regulation Q, as applied to large certificates of deposit, has been a useful method of putting special pressure on borrowing and spending by large corporations, by making it harder for the larger banks to raise funds to finance such corporations. This would seem to me contrary to a desirable Federal Reserve goal of concentrating on aggregate demand. Moreover, the futility of attempting such selective pressure has been pretty well demonstrated during the past year or two, when the larger banks succeeded in developing many alternative sources of funds and when most major corporations were able, through issuance of commercial paper, through resort to the capital markets or, by other means, to obtain whatever funds they needed from nonbank sources when bank funds became scarce.

While recognizing that cautious business lending by the large banks may not necessarily curtail decisively the funds available to our leading corporations, there is nevertheless much to be said for a more prudent policy on the part of the banks with respect to entering into future commitments to business, as Chairman Burns pointed out in his recent speech to the Reserve City Bankers Association. During the present period of tight credit conditions, the banks have been very uncomfortable at times because of heavy commitments, entered into when money was easier, at rates having little relation to the current cost of acquiring funds to lend. The resulting tighter liquidity positions of our leading banks have not created the most favorable atmosphere for preserving market confidence in a time of great economic uncertainty.

As for the justification of Regulation Q (and related interest rate ceilings) as a way to protect the thrift institutions from disastrous losses of funds, it seems to me only a stopgap, involving a real handicap to monetary policy. A much better approach to this problem would be, I believe, to give thrift institutions a somewhat wider range of lending and borrowing powers, provided other changes are made to provide equitable treatment for all financial institutions. Consideration might also be given to making mortgages a more flexible credit instrument. Such changes should make the thrift institutions much less vulnerable to swings in interest rates, but it is obvious that they cannot be accomplished overnight. Finally, I even doubt the validity of the argument that active use of Regulation Q tended to produce a lower general level of interest rates than would otherwise have prevailed. All in all, the time is close when it would be well for the System to start moving away from the imposition of interest rate ceilings on deposits and related liabilities. I would hope that the role of interest rate limitations in relation to financial structure might be a major subject for review by the newly organized Presidential commission on financial structure and regulation.

The appointment of this commission seems to me highly appropriate, in view of the many changes that have occurred in banking practices and structure since the last full-scale review of this kind. The efforts of leading banks through one-bank holding companies to seek relief from the complex network of regulations have brought to the forefront the activities of banks and other financial institutions and what their role should be in the decades ahead. I trust that the scope of the study would encompass the entire range of issues pertinent to the role of banks and other financial institutions within the economy and the problem of Federal and state supervision.

As for the specific question of one-bank holding companies, it would appear that the matter may—and, in my judgment, should—be acted upon by the Congress before the commission completes its study. Of the many proposals discussed before the Congress, I favor legislation that would permit banks to offer a broad range of financially related services, with the services to be defined under administrative regulations rather than in a "laundry list" frozen into a Federal statute. In general, the services would be of the type referred to in Chairman Burns' recent testimony before the Senate Banking and Currency Committee. I also agree with the views expressed by Chairman Burns that the regulatory responsibility for bank holding companies should be assigned to a single Federal agency, and that the agency should be the Federal Reserve, which already has regulatory responsibility for multibank holding companies.

In its study, the commission would presumably consider questions of structure, competition, services, investment powers, reserve requirements, interest rate limitations, supervision, and examination, all as they relate not only to banks but to other financial institutions as well. I think you will all agree that these are important matters requiring penetrating analysis. Although the study will not be concerned with monetary policy *per se*, it is obvious that some of the matters covered—such as interest rate limitations and reserve requirements—have a direct bearing on the effectiveness of monetary policy.

Let me thank you for giving me this opportunity to talk to you. These are extremely difficult times, and my associates and I look forward to working closely with the banking community in trying to reach reasonable solutions to these many perplexing issues.