Important Issues for Bankers and the Central Bank

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I want to express my pleasure at being able to meet with you in Atlantic City today to speak on matters of mutual concern. These gatherings have always provided me with a welcome opportunity to see many old friends among New Jersey bankers and to meet others of you for the first time.

Many important changes have taken place in our national economy and in New Jersey's banking structure since I addressed this group in May 1970. On the national scene, the worst upsurge of inflation we have seen in many years has presented exceptionally difficult problems for policy makers. Before turning to these problems and the role of monetary policy in meeting them, I would like to take the opportunity to discuss some developments in banking structure in New Jersey that have been occurring as a result of the changes enacted in the state's banking statutes in recent years. I would like first to comment briefly on the opportunities this new legislation has given bankers to expand, compete, and diversify their operations. I would also like to call your attention to the added responsibilities these changes have placed on bankers and regulators alike.

Since 1969, we have witnessed in New Jersey the launching of multibank holding companies, the removal of barriers to statewide branching, and the phasing-out of nearly all of the branch-office and home-office protection features of the law. These legislative changes now provide banks and bank holding companies in New Jersey with broader opportunities than they have ever had before to expand into the state's most attractive banking markets. You are also aware, I'm sure, that these new laws allow banking organizations in the state to take advantage of the opportunities provided by the Bank Holding Company Act Amendments of 1970.

I would also like to emphasize strongly that bank regulators must consider each proposal by a banking organization to acquire a bank or nonbank firm in terms of its impact on the competitive structure and performance of the markets concerned. This appraisal must include an evaluation of the scope and substance of the benefits the proposed merger or acquisition would yield the public. My associates and I at the Federal Reserve are keenly aware that the prospective benefits from increased competition, better services, and more efficient flows of financial resources would be quickly lost if only a few large banking organizations were allowed to dominate the state's major banking markets. Both bankers and regulators alike have an obligation to contribute to a structure of banking in the state that will result in the greatest possible benefit to the public.

From the point of view of formulating your own plans, I think you may be interested in how the Federal Reserve Bank of New York evaluates each of the many proposals submitted to it by banking organizations. Each proposal undergoes a searching analysis from three distinct viewpoints.

Our economists undertake to determine whether the proposal would result in any loss of competition or, on the contrary, would contribute to an improvement in market performance. Our financial analysts study the terms of the transaction, the financial condition and management capabilities of the participants, and the ability of the combined organization to meet its future capital needs, particularly those of its bank affiliates. Our lawyers review each proposal to determine whether it is in full compliance with Federal banking and antitrust legislation, and whether all other legal requirements of the application have been met.

All three staff groups evaluate the benefits the proposal would offer the public either directly or indirectly in the form of improved services, lower charges, or more conveniently located facilities. I should point out that much of this evaluation takes place during the early stages of the application process, when we provide every opportunity for the applying organization to supply additional information.

Once our staff completes its analysis, it makes a recommendation of either approval or denial to a committee of senior officers at our Bank. A recommendation of approval must reflect the solid finding that the proposal would not seriously damage the competitive structure of the market, particularly where the institutions to be combined are represented in the same market, and would not result in unsound banking practices. We would not look with favor on any proposals that would consolidate competing firms with relatively large market shares, or eliminate a significant amount of future competition, or unduly diminish the possibilities for entry by outside firms. We would also discourage proposals that would tend to strain the financial or management capacity of the acquiring company or inhibit the capital growth of affiliated banks, and we would be particularly skeptical of proposals that held little or no prospects of benefit to the public interest. These are matters that also weigh heavily in the decisions of the Board of Governors, which has final authority over all holding company proposals and certain merger applications.

Within the framework of the process I have just described, many changes have occurred in the structure of banking in New Jersey since I spoke here four years ago. Branching and merging into previously protected territories, coupled with the growth of multibank organizations, have resulted in considerable geographic diversification of banking in New Jersey. Between mid-1969 and the end of last year, about 350 new branches of commercial banks were established. These new branches resulted in almost a 40 percent increase over the number of offices of commercial banks in existence during 1969. About two thirds of these new branches could not have been opened under the laws in existence prior to 1969.

These new offices have resulted in the introduction of competitive forces in many communities that long had been shielded from outside competition. Many of the acquisitions and mergers concluded by New Jersey's banking organizations since 1969 have involved entry into new markets, contributing to an improvement in the competitive environment in those markets. We have good reason to believe that the expanded competition in banking in New Jersey has increased the quality and quantity of financial services available to individuals and businesses in the state. We think that many more communities will benefit from an improved competitive atmosphere as home- and branch-office protection laws are further relaxed through 1977.

Statewide branching became effective only in August of last year when further revisions in New Jersey's banking statutes included the removal of the three banking districts within which branching and merging by banks in New Jersey had been confined until that time. By then, however, the development of statewide banking was well under way through the formation and growth of multibank holding companies.

As of early May, New Jersey had ten multibank organizations in operation. Including proposed acquisitions, they accounted for about 43 percent of the state's total deposits. Seven of these companies operate banking subsidiaries in more than one of the areas that formerly constituted a banking district, and the offices of these subsidiaries span fairly wide areas of the state. In addition, there were at least ten one-bank holding companies in operation, with just over 10 percent of total deposits of the state. Several of these companies are in the process of expanding the areas they serve either by acquiring additional banks or by branching or merging.

Banking in New Jersey retains a great deal of diversity in meeting the needs of individuals and businesses for financial services. There are about 160 independent banks that play an important competitive role in the state's major banking markets, and they control a slightly larger share of the state's total deposits than do the multibank organizations.

In retrospect, we think the development of diversified banking organizations with statewide operations has been of significant benefit to the public without any adverse consequences for banking structure in the state. Many of the holding company acquisitions have involved small- or medium-sized banks seeking to broaden their resource base through affiliation with larger organizations. At present, the five largest organizations account for close to one third of the state's total deposits, a far lower concentration of deposits than in many other states throughout the nation.

In the years ahead I think New Jersey bankers will continue to find attractive opportunities to merge and branch throughout the state, and to expand and diversify their financial services through the formation and growth of bank holding companies. These opportunities offer bankers the challenge of experimentation and innovation. I would urge those of you who are contemplating expansion to discuss these plans with your Reserve Bank. While we cannot make any commitments on behalf of the Federal Reserve, our officers who are close to the situation in New Jersey will be able to offer you useful guidance concerning the regulatory implications of your proposals.

Last year, as you know, we opened Regional Check Processing Centers in Philadelphia, Pennsylvania, and Cranford, New Jersey. I am sure that you are aware that both these RCPCs have experienced more than their share of problems, which, in turn, have had a direct impact on your banks. While both Philadelphia and New York anticipated some start-up problems, the period of adjustment has taken far longer than expected. We want to assure you that the senior officers in both Philadelphia and New York have been deeply concerned about these problems.

Several steps have been taken to improve the operations at the RCPCs: staffs have been increased and strengthened with experienced personnel, training efforts have been intensified, and work flows and the organizational structures have been improved to increase both productivity and controls. We are now operating close to normal levels and continuing to strive for further improvements in quality and efficiency. We thank you for your patience, understanding, and cooperation as we work together toward our goal of a more efficient check-clearing operation.

Let me turn now to some of the major economic problems we are all facing at this time and to the appropriate role of monetary policy in helping to meet these problems. There is no need to tell you bankers that pervasive and virulent inflation dominates the setting in which economic policies must be formulated. The causes of this condition are many, they have often been set forth at length, and I shall not take time today to cover this ground again. While a combination of special factors was of crucial importance, fiscal and monetary policies were not altogether blameless. Wage and price controls made a helpful contribution in 1971-72, as long as there was considerable slack in the economy, but they became worse than useless as aggregate demand outgrew available resources in late 1972 and 1973.

The net result of all this has been profound public disillusionment with the efficacy of official anti-inflationary policies, and widespread fear that inflation will continue unabated for years to come. Of course when such expectations develop, they tend to become self-fulfilling, as those who no longer have faith in the value of money try to protect themselves by buying anything and everything that seems to offer some promise of price appreciation. No doubt this psychology accounts, in the corporate world, for much of the heavy current demand for credit to purchase inventories and capital equipment; and among individuals we find an urgent search for new avenues of investment or speculation.

I hope this nation will refuse to succumb to the siren song of those who would meet this situation by accepting inflation as a way of life and establishing escalator or indexing practices for salaries, bonds, and other vehicles of income or savings. This may be a workable substitute for proper fiscal and monetary policies in a few rapidly developing countries—although not without some very considerable social costs—but I suspect that such a course would prove very dangerous for this country. Complete indexing of all claims probably could not be achieved as a practical matter but, even if it could be achieved ultimately, the transition would be costly. At any given time, claims on a substantial fraction of the real wealth and income payments of the country are outstanding in the form of long-term contracts fixed in nominal terms. While progressive indexing of new contracts could protect the parties to them, inflation would still cause disturbing and inequitable transfers of real wealth and income, owing to the continued existence of outstanding, nonindexed long-term contracts. I question whether the transition to comprehensive indexing could be accomplished within a democratic framework of social stability and reasonable equity. Even apart from its domestic drawbacks, I fail to see any attraction in indexing for the leading country of the Western world whose currency is still necessarily regarded as a prime foundation of that world's financial system. And the most serious objection to this automatic indexing is that it would vastly weaken the country's resolve ever to bring inflation under control.

It should not be an insurmountable task to make progress toward reduced inflation, provided enough people become convinced that the fight is worth fighting. I do not mean that a quick solution is possible, but I think it is imperative that we continue to lay the base for gradual improvement. Sound fiscal policy and restraint in setting wages and prices are of critical importance. There is now a good prospect of improvement in the Federal Government's debt management affairs, as the new Federal Financing Bank prepares to begin operations that should result in more orderly financing.

Certainly the Federal Reserve is determined that monetary policy will do its part in fighting inflation, as Chairman Burns said a few weeks ago in his fine statement before the House Subcommittee on International Finance. We must of course provide for enough money and credit growth to take care of gradual expansion of the economy and to prevent unacceptable levels of unemployment, but not so much as to feed the fires of inflation. During a period such as this, we recognize that you as commercial bankers have a difficult problem in deciding where to apply restraint. We rely on your judgment to prevent excessive pressures from falling on particular sectors of the economy.

Rising levels of unemployment would intensify the pressure for more expansionary monetary and fiscal policies. Yet the experience of recent years suggests that the low levels of unemployment we all would like to see may not be attainable through monetary and fiscal stimulus alone without exacerbating inflation. Even when aggregate demand is excessive, some willing workers will be unable to find employment if they reside in depressed areas or if they lack the particular skills that are in demand. Trends in the age and sex composition of the labor force appear to have worsened the "structural" unemployment problem over the past decade or so. This does not mean that the nation must passively accept socially undesirable levels of unemployment. It does mean that vigorous efforts—both by private organizations and by government at all levels—are needed to attack structural unemployment through improved and better funded training programs, more efficient fitting of available workers to available jobs, and perhaps some relaxation of minimum wage requirements for young workers and special carefully designed public employment arrangements. Such reforms would be much more likely to achieve a permanent reduction in unemployment than would excessive monetary stimulation and its inevitable concomitant—chronic inflation. They are needed not just to improve the economic performance of the country, but to help attack the social ills stemming from the lack of employment opportunities, particularly among the young in our central cities.

As for monetary policy, its goals are, of course, much easier to state than to translate into operational applications. As has been said so often, the central banker must still use a very large portion of judgment in reaching policy conclusions. He must always take account of a wide variety of factors, including the business outlook, price and wage prospects, the international scene, Treasury financing problems, developments in measures of money and credit and in interest rates, etc. The central banker must also be alert to the danger of undue credit stringency threatening the stability of financial markets. The Federal Reserve always stands ready to fulfill its essential role as lender of last resort—not only to the member banks but, in a broader sense, to the economy at large. This does not mean that bankers and businessmen will necessarily be spared the consequences of their own misjudgment. It does mean that the continuous functioning of the credit markets can be counted on.

There is no scientific way to determine exactly what percentage rate of growth in one or several money aggregates will best contribute to a given economic goal. Some of our critics would have us follow a very simplistic path with respect to growth in the quantity of money, paying little attention to the fact that velocity of money is neither constant nor dependably predictable. Money aggregates are of course important, but there are differences of view as to which of the various aggregates should get the most attention. Even our statistical measurement of them is still pretty rough; and I would again caution against reading much into sharp swings in growth rates over periods as short as a month or even a quarter. These swings could be smoothed out only at the cost of extremely violent interest rate changes; and it has never been demonstrated that short-run fluctuations in the monetary aggregates do any real harm to the economy, which seems to be affected more by longer term tendencies of money growth. Incidentally, it is worth noting that current Congressional hearings on the proposed Financial Institutions Act give promise of improvements in the structure and functioning of our financial system.

I would point out, too, that at certain times changes in credit growth may be just as important as those in money growth, or more so. I have been concerned about the very high level of aggregate credit demands this spring, which by themselves would seem to call for a cautious monetary policy. A surge in the demand for credit of this magnitude certainly requires careful attention to analysis of creditworthiness.

As you know, the Federal Reserve System has been moving toward greater reliance on market forces and less reliance on regulatory constraints in controlling credit. This trend was exemplified by the suspension of remaining Regulation Q ceilings on large-denomination certificates of deposit a year ago. I have long been an advocate of greater reliance on the market mechanism in allocating credit. This does not, however, relieve bankers of the responsibility of exercising restraint when demands for credit seem practically insatiable. If commercial and central bankers do not share this responsibility, there could well be mounting pressure on the Federal Reserve to reverse the trend toward greater reliance on interest rates in free markets for monetary and credit control. I think you will agree that self-restraint is preferable to regulation, however well intentioned.

I should like to add a word about certain international aspects of the present setting for policy. There is no doubt in my mind that overselling of the dollar in exchange markets within the past year or two contributed importantly to our domestic inflation, not only through the direct effects on import and export prices as stated in dollars, but —perhaps equally importantly—through the great psychological damage to the faith in money throughout the world, when the dollar, which did and does play such a big part in most countries' financial arrangements, seemed to be on a downward slide. The United States monetary authorities can never be indifferent to the valuation placed on the dollar by the exchange markets, and Federal Reserve intervention in those markets from time to time since last summer has been a very healthy development. Now that capital export controls are no longer in force, the possibility of large interest-induced flows of funds has been enhanced, and these too could encourage wide exchange rate swings.

Monetary policy has always had to give some consideration to international factors. This is truer than ever in a world of freer capital movements between countries, especially since vastly augmented receipts of the oil-producing countries are adding greatly to these international flows. In any event, in setting ourselves against continuing high inflation rates, we can rightly feel that we are contributing significantly to both domestic and world stability.

Let me conclude with a comment on the importance of adequate savings in the kind of world we face today. Not only energy shortages, but shortages of a great number of basic materials are seriously aggravating our inflation. Thus, investment in new capacity should be a goal of high priority—and, if this is not to exacerbate the inflation further, there must be adequate savings to finance the investment. This may well imply some sacrificing of consumption, or at least a willingness to forego as rapid gains in consumption as have been sought and achieved in recent years. But progress to this end calls for political understanding, and it also may call for fiscal and institutional changes to induce us to save a higher proportion of our national income. And there is a kind of circular process here, too, for a slower inflation rate is itself a necessary ingredient in providing an atmosphere conducive to larger savings. I think you will agree that the future we face is not an easy one; but I remain an optimist, and I believe that we can work together to make substantial progress against inflation a reality.