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Address by

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It is indeed a pleasure for me to participate in this conference today. The program certainly is an impressive one and I know that a great deal of planning and effort has gone into organizing it.

I must say that the timing of this meeting is extraordinary. Not only is Congress in the middle of heated debate over the appropriate structure of the financial system, but also AEI has managed to order up a little financial turbulence to add to our excitement.

This luncheon speech also seems appropriate. I'm sandwiched between your morning session dealing with "Maintaining Financial Stability" and just before your afternoon session on central banking, monetary policy, and financial deregulation.

The severe financial strains of the last few weeks bring to mind two very important issues relating to the Federal Reserve and to both your morning and afternoon sessions. The first issue involves the financial system's liquidity needs associated with events like the stock market crash last month.

In such circumstances, what exactly is the central bank's role in maintaining stability?

A second important issue relates to the structure of the financial system. Specifically, what structure is most conducive to preserving financial stability in the face of large shocks?

This afternoon, in the brief time that I have, I want to talk about both of these issues.

The Importance of Liquidity Availability for Financial Stability

It is generally believed that the net wealth loss associated with this stock market decline together with its psychological effects will have significant adverse effects on both consumption and investment.

Coincident with this decline in stock values, both long and short-term interest rates fell substantially. This event is in part a manifestation of a shift in risk preferences; that is, a desire to shift out of risky assets into safe or more liquid, monetary assets. This is evident not only in an increased demand for Treasury securities, but in greater demands for currency and insured demand and checkable deposits. Increased demands for excess reserves by banks and other financial institutions also became noticeable. And a widening of spreads between rates on Treasury securities and other riskier financial instruments were observed.

Historically such sharp preference shifts involving increased demands for liquidity have been associated with financial crises--as in the 1930s--and in some loss of confidence in the stability of the financial system. In an age when liquidity was inelastic and deposits were not insured, disintermediation and runs on banks sometimes occurred and confidence in fractional reserve banking systems came into question.

Fortunately, such severe circumstances have not occurred in the current episode.

I believe that part of the reason these more severe conditions have not developed is due to the Federal Reserve's pursuit of it's liquidity responsibilities in such circumstances. The guaranteed provision of such liquidity was an original purpose for the creation of central banks. This responsibility was spelled out by several early writers, the most famous being Walter Bagehot in his book, Lombard Street.

Given existing institutional arrangements, monetary systems are sometimes vulnerable to sharp increases in the demand for the safest, most liquid assets. All other things equal, these increased demands are equivalent to a sharp monetary contraction and if these demands are not quickly accommodated, sharp contractionary forces may develop and become contagious. In such circumstances it is the responsibility of the central bank to quickly make funds available to the market in order to maintain stability.

In terms of October's stock market crash, it appears that to date, the Fed has been able to accommodate the strong liquidity demands that have developed. Available data suggests that confidence in the financial system is improving. Commodity and gold prices have remained stable. Quality spreads have narrowed over the last two weeks. Banks and thrifts have attracted deposits and stock prices of these institutions, in general, have not deteriorated relative to the total market.

It is important to note that the Fed's elastic liquidity provision role is fully compatible with the pursuit of price stability. By preventing systemic financial contraction that could lead to deflation, this strategy works to ensure that the mistakes of the 1930s are not repeated, and, in so doing, helps to promote longer-term price stability.

Financial Stability and the Bank Regulatory Structure

In addition to issues regarding liquidity, the financial turbulence of the last few weeks highlights the primary question posed by this conference. What type of structure, given the basic safety net, enables the financial system to best absorb shocks like this recent experience and at the same time promotes the flexibility and innovative capacity necessary to maintain competitiveness in today's fast changing, integrated world financial environment?

Regarding this question, it is well-known that diversification reduces risk and hence promotes stability and resiliency. Additional product diversification and geographic diversification would likely enable financial institutions to better withstand shocks to specific classes of assets or specific regions of the country.

But those of us who favor additional powers for banking organizations and other financial firms must be wary that product deregulation in conjunction with public deposit insurance and other safety net arrangements potentially can lead to major problems. It is well-known that deposit insurance itself may lead to riskier portfolio selection because of moral hazard arguments. And, even if one argues that banks are not special regarding their financial intermediation role, the point remains that regulation of banking exists to protect deposits and the insurance fund. Therefore, if product deregulation allows exploitation of insured deposits in a way that leads to the adoption of risky activities, public (taxpayer) underwriting of such activities is certainly a possible and very undesirable outcome.

One extreme example of this relates to the situation in which a number of thrift institutions have been allowed to remain open, even though their capital is exhausted. These firms have been permitted to raise funds through insured deposits and to invest in risky real estate ventures. This activity, in which the owners of these thrifts are betting not their own capital but that of the FSLIC in the hope of resurrecting themselves, constitutes an extreme and obvious form of moral hazard.

One approach to this problem is to allow product and service deregulation through a holding company structure so that (insured) bank activities could be conducted in a subsidiary insulated from its (uninsured) nonbank activities. Variants of this approach have been proposed by several experts.

In skeletal form, such a formulation contains the following elements:

(1) It assumes and is based on the view that a "fire wall" can be established that would fully and effectively insulate the insured depository from the

activities and possible problems of its affiliates.

(2) Under this arrangement, depository subsidiaries of holding companies would continue to be treated as special, therefore requiring (a) deposit insurance; (b) access to the Fed's discount window; and (c) supervision by federal banking authorities.

(3) The proposal allows other units of the holding company to engage in any activity, no matter how risky, including commercial activities. It also allows for banks to be owned by commercial firms.

The approach provides a framework for significantly expanding powers while, at the same time, limiting the scope of the safety net and governmental supervision and regulation. In other words, it enables bank holding companies to assume broader diversification and profit-making opportunities without endangering the health or safety of the depository affiliate or the payments system. And it does not extend the safety net designed for depositories to nondepository financial firms and commercial activities. It seeks to foster a significant role for free market forces in determining the viability of various new, nonbanking powers.

Of course, there is wide disagreement as to whether such insulation can, in fact, be effectively carried out. Some argue that such a "fire wall" can be implemented by strictly enforcing laws and regulations designed to restrict transactions between banks and their nonbank affiliates. Others argue that in practice, it is not feasible. Still others argue that while it is possible, the creation of such insulation removes the benefits and synergies of affiliation of depository institutions with nonbank firms.

Full reconciliation of these alternative views has not yet occurred. Nevertheless, it should be noted that this approach does enable policymakers to create a safe financial structure able to withstand financial shocks while still promoting product and geographic deregulation. And it both limits governmental intervention and guarantees while fostering competitive forces that in the long-run should maintain the necessary health and resilience of our financial system. At a minimum, such proposals or their variants merit extended consideration and discussion. Hopefully, some of this discussion will take place today and tomorrow at this conference.

Conclusions

In summary, we have all witnessed considerable financial turbulence in recent weeks. I believe the Federal Reserve has responded in an expeditious and dependable manner in carrying out its liquidity provision responsibilities. In so doing, I believe our actions have worked to promote financial stability.

While the stock market shock was substantial, there is little reason to believe that we need to slow down the deregulatory initiatives currently under consideration. At least with regard to the question of security powers, it can be argued that doing nothing actually entails greater risk to the financial system than moving ahead.

Further restructuring of the financial environment certainly needs to be considered in order to create the type of financial system able to absorb shocks and maintain stability while promoting flexibility and competitiveness.

Thank you.