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Statement by

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before the

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We in the Federal Reserve welcome your initiative in undertaking these hearings to review, from a broad perspective, developments in markets for banking and other "financial services," laying the groundwork for future legislative initiatives. There can be no doubt that a reexamination of the existing legislative framework has become urgent. Our financial system has been evolving rapidly in recent years. Much of the change is a constructive response to technological or market pressures and the opportunities made possible by deregulation. But it is also clear that the process has been rushing forward with little conscious sense of some of the broad public interests at stake -- the need to maintain a safe and stable financial system, to assure equitable and competitive access to services by businesses and consumers, and to preserve an effective mechanism for transmitting the influence of monetary, credit and other policies to the economy.

Many of the laws intended to guide and shape the development of the financial system were enacted under far different circumstances. They may or may not serve today's purposes, and in some instances may themselves be a source of distortion, competitive imbalance, and weakness. For all these reasons, I appreciate the opportunity to set forth some general considerations that we in the Federal Reserve feel are relevant in assessing particular legislative proposals. At a later time, we would, of course, be prepared to set forth more specific suggestions.

The Current Situation

The accelerated pace of change in the structure of our financial system in recent years has reflected both irreversible technological as well as market forces. The low cost and speed of data transmission, communication, and personal transportation have vastly enlarged the market reach of banking and financial institutions. The technical capabilities of providing a variety of essentially computerized financial services are broadly available. At the same time, the number and wealth of potential customers have multiplied, and with them a demand for a greater array of financial services and more sophistication in seeking out maximum returns. Diversification of investments beyond traditional deposit accounts, ready access to sources of borrowing power, and the flexibility to change financial strategies rapidly and inexpensively have become increasingly important.

Several other factors affecting the financial environment have also provided impetus for change. Experience with inflation, and with sharply higher and fluctuating interest rates, has seemed to put a premium on financial manipulation, shifting funds rapidly to take advantage of changing yield relationships or perceived changes in the outlook. Institutions with embedded costs or fixed returns inherited from investment decisions made earlier have often been disadvantaged relative to newer market interests. In the new environment, regulatory restraints adding to costs (such as reserve requirements on the established depository institutions) or impairing quick responses to perceived opportunities (such as interest rate ceilings) have chafed more strongly, and distorted competitive positions. At the same time, the decades that have passed since any serious weaknesses in the financial system had been evident, a sense of security among depositors rooted in part in the knowledge of a strong governmental "safety net" protecting the financial system, and expectations of a persisting inflationary trend have all seemed to encourage less caution and a willingness -- deliberately or not -- for managers of financial institutions to undertake greater leverage and risk in the search for higher returns.

In combination, the technological and economic forces at work have led to a search for new financial services and for new ways to package those services, greater competition between traditional depository institutions and other providers or "packagers" of financial services, and a blurring in many of the traditional distinctions among depository institutions themselves.

One reflection has been the rapid growth of such relatively new institutions as money market funds and cash management accounts. Increasing efforts are being made, by means of mergers and otherwise, by securities firms, insurance companies, and others to exploit where possible perceived "loopholes" in existing law to cross traditional industry lines into banking and the payments system. Banks and other depository institutions have responded by bidding more vigorously for consumer funds and seeking, successfully, to ease regulatory restrictions. They have, to the extent permitted by law, moved to acquire security brokers, and to develop relationships with mutual funds. Moreover, some nonfinancial firms -- retailers or industrial firms -- have sought to enter financial markets, further eroding the traditional distinction in the United States between "banking," broadly defined, and commerce.

It is worth noting that, after decades of stability in the relative position of commercial banks in our financial system, more recent years have suggested some erosion. While that may well prove temporary, the sense of greater competitive pressures, the blurring of distinctions between banks and "non-banks," and the frustration about an unsettled and partly out-moded regulatory framework have certainly contributed to uncertainty about the future of depository institutions. Concerns of the thrifts have been even more pressing. In the past few years, thrift institutions carrying large portfolios of mortgages acquired at lower interest rates have been under particularly strong earnings pressure and their capital positions have sharply eroded. With their future prospects seemingly in jeopardy, the whole orientation of the industry is in flux, responding to immediate concerns as much as any carefully conceived vision of what role they should play in the future.

Whatever the merits of the process of change in responding to felt needs -- and they are considerable -- certain problems, actual and potential, have plainly emerged. As regulators and legislators concerned with the public interest, our task is not to thwart change or block responses to new needs, and institutions need to respond to market incentives. But we also want to see change channeled along constructive lines, sensitive to abiding and valid concerns of public policy. One of those basic concerns is the safety and soundness of our payments system and the financial system generally. Matters of competitive equity, both for the providers and consumers of financial services, need to be addressed. The consistency of emerging financial patterns with the needs of monetary and credit policy must be considered. And, historical concerns over concentration of financial resources and conflicts of interest in the provision of financial services should be reexamined for their applicability in the light of today's circumstances.

Unfortunately, the interaction between the current legal and regulatory structure and market pressures provides no assurance that these concerns are adequately addressed. Instead, in some ways it has channeled pressures for change in directions that have had unintended and adverse effects. Deposit-like instruments and payments services have sprung up in significant volume outside the framework of governmentally protected and supervised depository institutions. The depository institutions themselves have today a potentially more volatile structure of liabilities and smaller capital cushions than in the past. With the enlarged powers of thrifts, we now have competing "banking" systems with different legal and regulatory philosophies, providing incentives to exploit the most "liberal" (or "lax") provisions. Anomalies in the structure of our current regulatory system -- and challenges to long-standing regulatory interpretations -- are eroding traditional constraints on combining deposit-taking with other activities, in the process threatening to undermine whatever public interest may remain in those constraints.

The new vocabulary springing up of "non-bank banks," "thrift banks," money market fund "checks" -- seemingly inconsistent on their face -- reflect the blurring of traditional institutional lines and functions. Some of it is healthy, and some is not. What is needed is a broad look at the whole, with a period of public and legislative debate concerning the desirable ends and means, followed by a reshaping of the existing legislative framework.

Possible Interim Steps

As that process takes place, we cannot expect the market forces to stand still. But I believe we can and should deal, for an interim period, with some of the most obvious distortions and loopholes in the present regulatory structure that tend to channel change in specific forms that may in some instances be contrary to a desirable longer-term evolution. To that end, the Federal Reserve has broadened the definition of "commercial lending" to forestall, or limit, avoidance of the basic purposes of the Bank Holding Company Act. To the same end, I welcome the Comptroller's moratorium on new chartering of "non-bank banks" so that Congress has time to address the underlying issues. But clearly these measures are not sufficient to maintain even a limited "status quo," as indicated by the backlog of pending applications and, a subsequent announcement of an intended combination of a state-chartered bank and an insurance company and proposed combinations of thrifts and securities houses. Therefore, I would suggest that Congress consider limiting combinations of non-bank banks (and thrifts) with non-depository institutions for a strictly limited period of time so that you can decide on an appropriate policy approach rather than be faced with a fait accompli.

A similar, and possibly more serious, reordering of the national financial structure, without Congressional review and determination, is implicit in the recent actions and proposals in a number of states to allow the banks or thrifts they charter to engage across the country in a much wider range of financial and non-financial activities than banks or thrifts chartered by federal authorities. The motivation, in large part, appears to be a desire to compete for jobs among states, rather than careful consideration of a desirable evolution of the financial structure for the nation.

The federal concern in this regard extends beyond the fact that financial markets are increasingly inherently national in scope and the institutional setting has national implications. State-chartered depository institutions have federal support through deposit insurance and access to the discount window, reflecting the interdependence among banks and the national concern in their stability.

The Federal Reserve, in administering the Bank Holding Company Act, has for some years maintained a policy of permitting state-chartered bank affiliates of bank holding companies to engage in any activity such a bank is permitted to engage in under its State charter. This policy has been premised upon the view that a certain degree of experimentation and difference in approach among the states is a legitimate and desirable aspect of our dual banking system, and that differences in powers allowed by states would be acceptable to the extent they would not dominate established Congressional policy. In view of current developments, I believe that policy should be reviewed to consider whether the result is to undercut the federal standards set forth in the Bank Holding Company Act, particularly when the wider powers might clearly be exercised largely beyond the borders of the State providing the authority.

An Approach Toward the Regulation of Depository Institutions

In conducting a reexamination of the regulatory framework more generally, there are a number of general goals to keep in mind -- enhancing competition; promoting efficiency in the allocation of capital and credit; assuring protection of consumers, depositors, investors, and others against discrimination, conflicts of interest, and other potential abuses; and encouraging consistency and equity in the treatment of competing financial institutions. It's important to keep in mind that some of these goals will sometimes be best served by less regulation rather than more.

There is another consideration that has historically been of special importance in public policy toward banks and other depository institutions -- that is, plain, old-fashioned concern for safety and soundness. After decades in which the unfortunate experience of the 1920s and 1930s have receded in memory, there is a tendency to question the value of prudential concerns. But, as we approach regulatory reform, the old saying about the relative values of an ounce of prevention and a pound of cure is appropriate. Concerns recently expressed in this Committee and elsewhere about international lending, for example, amply demonstrate that the best time to think through appropriate approaches is before there is a problem.

Against that general background, the main lines of my own thinking about our approach toward the regulation of depository institutions can be summarized under four headings:

1. Banks perform a critical role in the financial system and the economy.

   Banking institutions, as operators of the payments system, as custodians for the bulk of the liquid savings in the economy, as essential suppliers of credit, and as the link between monetary policy and the economy, have a unique function in our economy.

   The critical role of banks implies particular governmental concerns.

   Because of their role, the deposit liabilities of banks, and the stability of depository institutions generally, are protected to a degree by a governmental "safety net." The provision of that safety net requires and justifies a certain amount of prudential regulation and supervision to protect the government and public interest. The precise terms of this "compact," to assure efficiency, competitive balance, and sensitivity to new needs, should be reexamined periodically.

A bank cannot be wholly insulated from its affiliates. In the nature of things, parts of an organization under common management and, in public perception, related to each other, will, to some degree, be affected by the fortunes of other important parts. Consequently, concern about the activities undertaken within a bank holding company or otherwise within a consumer management structure is a natural and legitimate extension of interest in the safety and soundness of the bank itself. These activities may not require the same degree of supervision as a bank, need not be frozen in an historical pattern, and should be regularly reviewed in the light of economic changes and the desirability of maintaining a reasonable competitive balance.

The central bank has an inherent concern with the evolving financial structure.

The core responsibilities of a central bank for economic and financial stability entail concern over the strength and stability of the banking system, and the consistency of the institutional structure with the needs of monetary policy. Those concerns are appropriately and necessarily reflected in an on-going presence in the regulation and supervision of the banking system.

Banks and Their Regulation

The public concern with the safety and soundness of depository institutions has historically been related to the fact that they have been custodians of the bulk of the liquid savings of the country, a situation that still holds. That concern is interrelated with another pervasive public interest -- protection of the payments system. The individual components of the banking and payments system are, to a large extent, mutually dependent; adverse developments in one institution, particularly of substantial size, can dramatically and suddenly affect other unrelated institutions, some of whom may not even have a business relationship with the institution in difficulty. While secondary and tertiary effects are, of course, present in some degree in the failure of any business firm, seldom will the effects be so potentially contagious or so disruptive as when the stability of the banking system or the payments mechanism is at stake. Then, serious implications for overall output, employment, and prices -- indeed, for the entire fabric of the economy -- are apparent.

The first and most important line of defense is the interest of banking institutions themselves in maintaining the confidence of their customers. But long ago, in establishing the Federal Reserve System, the FDIC, and the FSLIC, the government determined that normal market incentives and protections needed to be supplemented by an official support apparatus. That support apparatus -- importantly reflected in access to the discount window at the Federal Reserve and to deposit insurance -- provides advantages in the competition for the public's funds. But there are offsetting costs as well in, for instance, reserve requirements and insurance premiums.

More broadly, the protection provided on the liability side of the balance sheet, in tempering the discipline of the marketplace, can potentially change attitudes and behavior over time with respect to risk-taking. Consequently, the logical extension of the public concern with the stability of the banking system is a continuing interest in avoiding excessive risk-taking, limiting the potential for contagious failures or drains upon the public "backstop" facilities. Those concerns are reflected in a number of restrictions and regulations on how banks (or thrifts) can do business, and the operations and assets of those institutions are examined periodically as part of a continuing supervisory process.

The practical and ongoing issue in this area, it seems to me, is not to revolutionize the basic approach, but to achieve an appropriate balance -- balance between desirable risk-taking and safety, and balance among competing depository and non-depository institutions. These considerations, for instance, are immediately relevant to the discussion by the Committee of the appropriate treatment of foreign lending and approaches toward assuring the capital adequacy of banks and thrifts.

One important area that is receiving attention is the appropriate structure of deposit insurance. The various insurance agencies have submitted reports to Congress suggesting ways to modify the current insurance system to achieve an appropriate balance of market and supervisory discipline; I have not reviewed those reports and cannot comment on them specifically. But I do welcome the process the Congress has set in motion to consider the public policy questions in this area, recognizing that deposit insurance has become such a significant element in the support apparatus for depository institutions that substantial change requires careful assessment of the possible consequences.

One corollary of the need to protect the integrity of the payments system deserves mention. In seeking an overall balance of protections and restrictions for banks, we can, and should, avoid competitive disadvantage to the depository institutions themselves; to do otherwise is to erode the vitality and strength of the very sector of the financial system deemed of special importance. To the extent that other institutions operating outside the "protected" framework nonetheless tend to "take over" the essential functions of banks, there are three alternatives:

we can encompass those institutions within the framework of banking supervision in some respects (such as reserve requirements on transactions balances); we can, if consistent with other objectives, relieve the regulatory burden (such as by paying interest on required reserves); or we can confine the performance of certain essential banking functions (such as third party payments and direct access to the clearing mechanism) to banks alone.

Bank Holding Company Regulation

In the framework of existing law and policy, concern with the activities of banking organizations has not stopped with the bank itself. The restrictions are importantly rooted in prudential considerations; experience strongly suggests the difficulty of insulating a bank from the problems of a company affiliated with a bank through a holding company. To be sure, the fortunes of the bank and its affiliates can be (and are) separated to a degree by restrictions on the transactions among them; section 23A of the Federal Reserve Act already contains a number of rules pertaining to such transactions. But I doubt the insulation can ever be made so complete -- at least without defeating the business purpose in the affiliation -- as to rely on those rules alone. The holding companies themselves, the securities markets, and the general public look upon these organizations as consolidated units. Our experience is that difficulties in a nonbank affiliate can affect the price and availability of funds to the bank (or vice versa), even if transactions between the two are controlled. The public realizes that a holding company with a troubled non-deposit subsidiary cannot be a source of strength to its deposit-taking affiliates, and will be under pressure to draw funds from the bank, directly or indirectly, to support other troubled operations. Moreover, while financial flows among affiliates can be circumscribed by regulation, management attention and expertise cannot be, and the more diverse the area of activity, the less attention the bank itself may receive at the top level.

Other concerns -- potential conflicts of interest and concentration of resources -- can also be addressed by law or regulation. But again, insulation is not likely to be complete.

At the same time, segregating certain activities of a bank holding company outside the bank itself may provide certain advantages. While it should not be assumed that, from a safety and soundness standpoint, the entities can be entirely insulated from each other, segregation may well make it easier to assure consistency and equity in the application of those regulations appropriate to particular activities conducted either in the bank or an affiliate. That consideration, for instance, could well be relevant in any extension of authority to bank holding companies to engage in securities underwriting, in mutual funds, and in insurance activities.

Regulations specific to such activities may not reflect certain of the prudential concerns of bank supervision; to that degree, non-banking activities conducted by banking organizations may have to conform to some rules that would not be necessary or appropriate for nonbanking firms. But there may also be advantages in combining certain activities with a banking license; when bank holding companies engage in non-banking activities we should seek to avoid competitive advantages arising from the ability to draw upon the implicit government support provided by the banking organization as a whole. One consideration in this regard is the capitalization of the non-banking activity; a higher degree of leverage in banking should not automatically extend to non-banking activities. Indeed, adequate capitalization of a bank holding company as a whole, taking account of the particular nature of the non-banking activities, is important to the safety and soundness of the bank.

In the end, the appropriate range of activities for a bank holding company should remain, in my judgment, a matter for determination by a balance of public policy considerations; it should not be solely a matter of market incentives, and some degree of supervisory oversight over the activities of the holding company as a whole will remain important. The traditional presumption that there should be some separation of banks from businesses engaged in a general range of commercial and industrial activities, and vice versa, still seems to me a reasonable starting point in approaching particular questions. That separation is, at the margin, arbitrary, but in a broad way it reflects continuing concerns about risk, conflicts of interest between the bank as owner of a nonfinancial firm and as creditor, and the implications of excessive concentration of economic power, especially given the central place of banks in our economy. Moreover, to the degree that affiliation with a bank implies the need for some regulatory or supervisory oversight, practical and desirable limitations on the reach of such regulation into industrial and commercial activities implies some limitation on the scope of bank holding company affiliations.

Within this general framework, the precise line dividing what ought to be permissible for banking organizations to do and what should be proscribed does need reexamination in the light of current market conditions, changes in technology, consumer needs, and the regulatory and economic environment. Some activities now denied banks would seem natural extensions of what these institutions currently do, involving little additional risk or new conflicts of interest, and potentially yielding significant benefits to consumers in the form of increased convenience and lower costs. For some time, for instance, the Federal Reserve has suggested that banking organizations be allowed to underwrite municipal revenue bonds, establish comingled investment accounts, and distribute mutual funds. Certain brokerage activities have already been approved within existing law, as have a wide range of data processing services.

Other activities seem ripe for consideration, but need a public airing of views and Congressional consideration. One general category would be further extension of brokerage activities related to the financial needs of bank customers, including sales of a variety of real estate, insurance, and travel products. Some kinds of insurance underwriting, beyond current limitations to credit-related insurance, have been urged by some.

Other activities that have been discussed raised considerably greater questions in my mind because of factors of risk or conflicts of interest that could not be contained without the most elaborate and self-defeating kinds of regulation. Corporate securities underwriting, real estate development, and, more generally, significant equity positions in unrelated non-financial activities fall into that category.

In any event, to the extent that regulation is needed, the goal should be to minimize the costs and burdens of regulation consistent with the public interest. For example, experience has convinced us that the present statutory requirement for public hearing in the Bank Holding Company Act sometimes leads to unnecessary delays in the processing of applications. This requirement could be modified to relax the requirement for public hearing, while retaining discretion for the Federal Reserve Board to conduct informal hearings in cases where public comment is warranted. This change alone would reduce significantly the time required to process some applications filed under the provisions of the Bank Holding Company Act. Also, the statutory requirements for approval of nonbanking activities could be modified to place greater emphasis on safety and soundness and less emphasis on the finding of net benefits, and provision could be made for the Board to follow more expedited procedures in the processing of applications.

Consistency in Bank-Thrift Regulations

The observation that thrift institutions have essentially become bank-like institutions is indisputable with respect to the powers they are allowed to exercise; it is increasingly accurate with respect to the powers they do exercise. But questions are posed not just by the fact that thrift powers have been expanded to matters previously the province of commercial banks alone; in important instances thrift powers extend well beyond those available to banks. Considerations of competitive equity alone would seem to dictate that the special privileges and restrictions of banks and thrifts be brought into more coherent relationship.

The significance goes beyond equity considerations. In today's world, the kind of consideration I just reviewed with respect to the powers of banking organizations, flowing basically from banks' participation in the payments mechanism, cannot be valid for commercial banks alone; limitations on bank holding companies could not be effective to the extent thrift instititutions, with the corresponding banking powers, could simply substitute as a vehicle for combining various activities. I recognize there are difficult questions posed by the firms that already have operations on both sides of the line between commerce and thrift banking, but we will need to find some way to resolve these questions and establish a firmer policy for the future if we are to bring about a rational structure in this regard. The same consideration bears upon a number of other issues --

particularly branching and interstate powers -- where the differences between regulatory treatment of banks and thrifts has become increasingly anomalous.

The implication is not that all thrifts and their holding companies must be regulated in all ways like commercial banking organizations. There may well be ways of distinguishing among institutions, depending on the scope and extent of their actual activities, which would allow us to achieve necessary functional consistency and assure the integrity of our policy intent, while retaining the advantages of a degree of specialization among financial institutions. As I understand it, the Congress had such concerns in mind in linking the more liberal treatment of unitary savings and loan holding companies in important respects to satisfying a certain asset test originally developed for tax purposes. However, that asset test -- the proportion of an institution's portfolio in real estate mortgages, government securities, and certain other "qualified" assets -- seems to me inadequate for the purpose. The interest of investment companies and other non-banking firms in acquiring savings and loans suggests that such an asset limitation would not deter substantial non-bank participation in deposit taking and payments services.

Federal-State Relations

For over a century this country has maintained a dual system for the regulation and supervision of banking. On the whole, this dual banking system has played a useful and constructive role in encouraging innovation in the financial regulatory environment and in helping to accommodate local differences in the needs of banking organizations and their customers.

The system worked as well as it has because to a significant degree the goals and techniques of regulation were commonly shared, and the divergences between federal and state treatment were kept within tolerable bounds. As I mentioned earlier, this comity appear to be breaking down, as states consider vast expansions of powers for banks and thrifts that go far beyond standards allowed by federal law and yet still rely on federal protections for their state-chartered institutions. The issue will need to be addressed by the Congress as to whether it is properly a federal prerogative to establish the outer bounds within which the dual banking system may continue to be a useful and constructive force.

The geographic scope of depository institutions has long been a key question of federal-state relations. The proliferation of nonbank affiliates of bank holding companies operating across state lines, the loan production and Edge Act offices, the integrated national markets for money and credit at the wholesale level, the current action of some states themselves to permit entry of out-of-state banking organization, the broadened power of thrift institutions able to operate interstate, and the credit card itself have by now led to interstate banking de facto for most banking services. But, as a general matter, we still prohibit on an interstate basis that portion of retail banking and some other services that require a brick and mortar presence, and we force other activities into "unnatural," and less efficient, channels.

I believe your deliberations will need to consider whether the time has come to rationalize this situation. Appropriately structured, banking across state lines can increase competition for the delivery of financial services and by so doing should enable users of these services to obtain them at lower cost and in a more convenient manner. Indeed, broadened geographic scope can even serve to reduce risk to the banks themselves, and perhaps reduce pressures to extend their franchise to less suitable areas of activity. I recognize the controversies and sensitivities surrounding the McFadden Act and Douglas Amendment. I also know there are a number of approaches that could be taken in easing or removing those restrictions; a period of transition may still be useful. Indeed, I am encouraged that some states have already chosen to take the lead. But I sense the time for Congressional review of the issue is here.

Regulatory Structure

The rapid evolution of the financial system inevitably raises new questions about how the government's role in regulation should be organized and implemented. As you know, this subject is being reviewed by a Task Group under the leadership of Vice President Bush, on which I participate. Without going into any detail on the pros and cons of the many different ways the regulatory agencies could be organized, I do want to comment briefly on the implications, as I see them, for carrying out the basic responsibilities of the central bank for the strength and stability of the financial system.

The argument has sometimes been put forward that supervision and regulation of the banking system can be divorced from monetary policy, and that the Federal Reserve ought to stick to the latter. That argument is premised on a view of monetary policy and inherent Federal Reserve responsibilities that seems to me far too narrow; pressed to its logical conclusion, both monetary policy and supervision would be gravely weakened. The basic objective of the Federal Reserve -- and the principal reason for its very founding -- is to contribute to a stable and smoothly functioning financial system, one that is capable of supporting and responding to the financial requirements of the nation under a variety of circumstances. Out of those concerns, the Federal Reserve Act explicitly provided the Federal Reserve with both an operational role in the payments mechanism and wide supervisory authority, and I believe those concerns remain valid today.

Over the past 70 years of the Federal Reserve's existence, the specifically monetary policy function -- explicit attention to control of the total supply of money and credit and stabilization policy -- has been developed and refined. But monetary and credit policy works through the banking and payments system and the individual institutions within it; in the last analysis monetary policy cannot be successful independent of the strength and resiliency of that banking system. Conversely, history is filled with examples of a breakdown in the banking system over-riding, in its adverse economic consequences, the effects of more general policy instruments.

The interrelationships are not theoretical; they are embedded in our daily operating experience. A key "monetary policy" instrument is the administration of the discount window, through which we advance funds to meet temporary liquidity needs and can act, if necessary, to meet our responsibilities as lender of last resort to the financial system and the economy as a whole. By its nature, provision of funds through the discount window presumes an intimate awareness of the circum-stances of the particular borrowers, skill and experience in financial analysis, and a degree of supervisory authority.

More broadly, the Congress and others, quite properly and understandably, look to the Federal Reserve for advice and, when necessary and possible within the framework of our statutes, for action in dealing with points of immediate financial strain and crisis. But those responsibilities seem to me to entail a continuing responsibility for participation in the regulatory structure, "hands on" supervisory capability, and a strong voice in the evolution of the banking system.

Moreover, monetary policy, as more conventionally defined, needs to be conditioned by circumstances as they exist in the financial world. A financial system that is too fragile, for example, might constrain our flexibility to pursue certain goals -- most especially that of combatting inflation. More general tendencies in the financial system -- such as the shift toward increasingly liquid assets in recent years -- can affect the behavior of money and other policy indicators that we rely upon in conducting monetary policy, and in some cases could have destabilizing effects on financial markets and institutions.

None of this dictates a particular regulatory structure; indeed, there are areas of regulation or supervision of only peripheral interest to our central responsibilities. But we do feel that a continuing role in regulation and supervision is an inherent part of effective central banking.

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