

FOR RELEASE ON DELIVERY  
SUNDAY, DECEMBER 2, 1984  
5:15 P.M. PST (8:15 P.M. EST)

A BROAD VIEW OF DEREGULATION

Remarks by

Henry C. Wallich  
Member, Board of Governors of the Federal Reserve System

at the

Conference on Pacific Basin Financial Reform

sponsored by the

Federal Reserve Bank of San Francisco

San Francisco, California

Sunday, December 2, 1984

## A BROAD VIEW OF DEREGULATION

Remarks by

Henry C. Wallich  
Member, Board of Governors of the Federal Reserve System

at the

Conference on Pacific Basin Financial Reform

sponsored by the

Federal Reserve Bank of San Francisco

San Francisco, California

Sunday, December 2, 1984

---

Before deregulation, there was regulation. If we want to assess the pros and cons of deregulation, we need to take a close look at the why's of financial regulation not in a spirit of "give-it-a-fair-trial-and-hang-it," but of giving the devil his due.

### Why Regulation?

The safety factor has always been a good reason for regulation. Bank failures, particularly of large banks, can have a much broader effect on the economy than failures of commercial enterprises. Moreover, banks should consider themselves as having, although not in a legal sense, a fiduciary relationship to their customers, since they deal so importantly with other people's money. Deregulation that ignores these points is likely to be reversed as the consequences become apparent.

Regulation, particularly in the American framework, has also served to support broader philosophical purposes. Concern about concentration of power is appropriate in a democracy. So is concern about conflicts of interest that may offend basic concepts of justice and fairness in addition to creating potential economic inefficiencies. These preoccupations have been strongly expressed in U.S. regulatory practice, and they must not be made to suffer by deregulation.

Regulation also has frequently been justified, in the United States and even more so in Japan and Europe, as a means of maintaining financial stability. Perhaps the best that one can say of this objective is that it depends on the nature of the regulation how well stability is served. It is not difficult to point to results of regulation that have had just the opposite effect.

Frequently, the purposes and consequences of regulation have been less positive. A great deal of regulation is anticompetitive, justified by pretexts of safety. Often regulation that originally did promote safety has survived for anticompetitive reasons. While giving preferential treatment to particular sectors of the economy, such as the U.S. housing sector, may be the expressed desire of government and electorate, it may nevertheless be counterproductive from an overall economic point of view.

Finally, the bureaucratic element should not be underestimated. Just as different groups of financial institutions use regulation to protect their turf or, if possible, enlarge it, so do the legislators, regulators, and supervisors who create and administer laws and regulations. It is not easy to make a dedicated official understand that the activity to which he has devoted (and

probably owes) his career damages the economy. Those who understand and are willing to deregulate deserve praise.

### Why Deregulation?

Perhaps I am in danger of exaggerating the importance of economics, but it does seem to me that today there is a growing belief around the world in the price system. This is not a matter of ideology, of capitalism versus other systems. It is a matter of technique. The price system can be effectively utilized, or largely ignored, under a capitalist system as well as any other. Deregulation has meant, above all, greater reliance on prices and on market forces. In this sense, deregulation means better allocation of resources, more competition, and as a result more output and faster growth.

But, of course, there have been other and more mundane driving forces. One has been inflation. Even while the predominant effects of inflation have been very negative, it has had the incidental advantage of compelling regulators to adopt more flexible positions on interest rates, exchange rates, and elsewhere.

Deregulation has been driven by competition, especially competition from abroad. It has been driven also by technological innovation, which made information instantaneous around the world and permitted instantaneous responses of lenders and borrowers through frequent interest-and exchange-rate changes. In the face of such pressures, resistance has crumbled. Anticompetitive practices have had to be abandoned, on pain of being circumvented; bureaucratic resistance had to yield to the pressures of the market.

### Price Deregulation

Deregulation has occurred in many dimensions, including prices of all kinds, as well as geographical barriers, and functions, powers, and others. By far the most important aspects have been the various forms of price deregulation. These include interest rates, exchange rates, and brokerage commissions.

Interest rates. Interest-rate regulation has been pervasive. In the United States, Regulation Q, the prohibition of interest on demand deposits, and usury ceilings, have been the most prominent instances. In Japan, rates on bank loans, bank deposits, savings deposits, and government bonds have been elaborately controlled. In Germany, loan and deposit rates have long been deregulated, but their competitive determination in the market remains subject to some doubt.

In the United States, the saver may have been the greatest beneficiary of interest-rate deregulation. The time of savagely negative real interest rates, particularly after taxes, seems to be over; greater fairness to the saver is undeniable.

The situation of the housing sector under deregulated interest rates does not seem to have changed all that much. Under Regulation Q, the housing market suffered from periodic disintermediation of thrift institutions. Today, a cyclical rise of interest rates, without benefit of nonavailability of funds, still pushes would-be homeowners out of the market. Something can be said in favor of rationing by price rather than availability, but the cyclicity of the housing sector seems not to have changed much.

The cyclical volatility of interest rates has increased greatly, creating problems for borrowers, influencing exchange rates, raising concerns over the safety of financial institutions, and possibly creating problems for monetary policy. In part, this volatility still reflects uncertain inflation expectations. On the whole, it seems that the system has been able to cope with interest-rate fluctuations better than earlier regulatory concerns might have made it appear.

Interest-rate volatility has generated new sensitivities in various sectors. Housing has always been vulnerable, but, as a result of variable-rate mortgages, an increasing number of people who own homes instead of just wanting to buy them may now be sensitive to interest rates. This may enhance the power of monetary policy, but also creates obvious problems of an economic and even political sort. Thrift institutions, which under Regulation Q experienced liquidity problems, under the new dispensation see themselves exposed to solvency risk. Farmers, developing countries, and automobile dealers are encountering a new degree of interest-rate vulnerability. Countries that do not want to expose themselves to wide exchange-rate swings have found that they must accept swings in interest rates possibly quite unrelated to their domestic needs.

Exchange rates. It would be an unwarranted stretching of the term "deregulation" to apply it to the abandonment of fixed exchange rates. Nevertheless, floating exchange rates imply lifting of a price rule that has had major economic effects. Most particularly, it was a defensive maneuver on the part of national authorities by which they avoided what would very likely have become a system of widespread exchange controls. In a regulatory context,

floating exchange rates are the opposite, not so much of fixed rates, but of a congeries of controls over international trade and payments.

Floating exchange rates were welcomed by most economists when introduced in the early 1970's. Their results, however, have surprised many. Contrary to expectations at the time, exchange-rate movements have been spectacularly wider than changes in purchasing-power parity. Also, benefits in terms of greater domestic policy independence have been disappointing because wide exchange-rate swings, actual or feared, have sharply limited policy freedom. Meanwhile, wide rate swings threaten to bring on the trade restrictions that floating rates had been expected to prevent. As conditions of international competition change drastically, quota restrictions and other forms of trade "regulation" are mounting.

Uncompetitive securities market practices. Deregulation of anti-competitive commission setting has been another aspect of price deregulation. In the United States, securities markets went to negotiated commission rates in 1975. In the United Kingdom, a similar process is underway. In its impact on industry structure, deregulation in the United States has had the effect, as in other industries, such as airlines, of squeezing out inefficient firms, forcing considerable consolidation, and raising efficiency. Less encouraging is the fact that the benefits of negotiated commissions have gone principally to institutional investors with large transactions. The individual investor with his small orders has seen his commissions rise, mitigated only in part by the availability of discount brokers. While this may serve efficiency, I find it very unfortunate in a system relying on private ownership. Moreover, the fact that enormous turnover activity has been encouraged in a market that many

observers regard as a random walk and therefore probably unresponsive to skill, seems to encourage unnecessary social costs. But it is not clear that, in the absence of deregulation of the securities markets, the course of events would have been much different.

### Geographic Deregulation

The deregulation of geographical constraints could be discussed simply in terms of worldwide integration of banking systems, were it not for conditions in the United States, where geographic deregulation means interstate branching. Except as legislation in other nation states and the McFadden Act-Douglas Amendment have geography as a common denominator, they are a very different kettle of fish.

In the United States, market restrictions touch some very deeply rooted concerns -- the fear, in many parts of the country, of the concentrated power of the money-center banks; the fear, on the part of local banks, of outside competition; the concern that nationwide branching will drain deposits; and, still more fundamentally, belief in states' rights. Some of these concerns clearly are anticompetitive. Moreover, they may not even be factually well founded. For instance, in the absence of demonstrable economies of scale in banking above very modest levels, concern about excessive competitiveness of entering money-center banks may be greatly exaggerated. Likewise, deposits can be drained to the money centers through, for instance, the federal funds market, as well as through a branch system.

Subject to limitations on concentration of resources, channeling deposits to money centers through a branch system rather than through outside channels would have considerable advantages. Severe limitations on



branching in certain states make some large banks more vulnerable to liquidity pressures than their counterparts abroad. Lack of a core deposit base of sufficient size, and consequently heavier dependence on purchased funds, is a potential element of instability. It can be counteracted by other means, to be sure, including stronger capitalization. It is true also that "core deposits" are not as inert today as perhaps they were before interest rates became more volatile. Nevertheless, insurance of deposits up to \$100,000 should provide more stability than can be expected of largely uninsured purchased funds. In my personal view, removal of restrictions on interstate banking, subject to concerns about concentration of resources, would strengthen the American banking system. But I also believe that it should come about through Congressional action rather than through loopholes.

Deregulation of barriers to international flows of funds and international migration of banks represents the worldwide side of geographic deregulation. Dismantling of payments restrictions is a very basic goal promoted and implemented by the International Monetary Fund. Capital movements today enjoy a much higher degree of freedom than was anticipated when the IMF was created in 1944. The Euromarkets are prototypes of very free markets. Securities issued in the Eurobond market are virtually exempt from any regulation. But nevertheless it should be noted that overseas branches and subsidiaries of U.S. banks operating in these markets are regularly examined by U.S. authorities for prudential purposes. General supervisory responsibility for international banking is the subject matter of the Basel Concordat. A mounting element of (very desirable) prudential regulation in Eurocurrency banking is the tendency toward consolidation of foreign subsidiaries and branches with head offices for bank supervisory purposes.

The concern that difficulties of a single bank might produce a chain reaction seems to be forestalled by wide diversification of placements. Even the risk posed by branches and subsidiaries of some LDC banks, which at one time became a matter of concern, can be dealt with if, as regulators insist, banks treat their money-market placements with these institutions as country risk exposure. Finally, the fear that the unregulated Euromarket would eventually run the regulated domestic markets out of business so far seems to be very far from realization.

Macroeconomic concerns about the lack of monetary control over the Euromarkets so far have appeared exaggerated and unjustified. The massive inflationary potential sometimes attributed to the market has revealed itself as an illusion. The great bulk of the deposits are interbank deposits, whereas monetary deposits, i.e., liabilities to nonbanks, constitute only about 25 percent of the total. That means that the total monetary liabilities of the Euromarket, in all currencies and to residents of all countries, are of the order of one-half trillion dollars. Their monetary character probably is closest to U.S. M3, in which monetary aggregate U.S. statistics include some \$80 billion of term Eurodollars held by U.S. nonbank residents. An amount of about \$12 billion of overnight Eurodollars similarly held is included in M2. These amounts are not large relative to total M3 of \$2.9 trillion and M2 of \$2.3 trillion, and would pose problems for U.S. monetary policy only if they grew very substantially.

Progress toward further integration of world banking can be seen in diminishing resistance to foreign banks and their activities in countries where foreign banks until recently were not admitted or were severely limited.

New or broader entry has been achieved in Australia, Canada, Norway, Portugal, Spain and Sweden. Liberalization of foreign bank powers in Japan is an important step. The United States has always been very open toward entry of foreign banks. Indeed, prior to the International Banking Act and to some extent even today, foreign banks have had some advantages in the United States over U.S. banks. From time to time, proposals are heard for a more reciprocal treatment between U.S. banks abroad and foreign banks in the United States. More deregulation abroad would help satisfy these demands. The recent agreement between Japan and the United States over powers of Japanese and foreign banks and on increased access to the Euro-yen market is a major example.

Deregulation of restraints on foreign banking is very much an ad hoc process, unilateral, or at most bilateral. Multilateral coordination of bank regulation and deregulation is not a realistic prospect in the near term, although for the European Economic Community a long-run project of that sort is underway in Brussels. A much more modest effort, seeking to compare bank capital in the Group of 10 countries is underway under BIS auspices. Regulation of bank capital is one area where in the past the authorities may have done too little rather than too much. Stronger rules may be required. This would provide a natural counterpoise to the greater risks created by deregulation in other dimensions.

Examination of the rules governing bank capital in different countries demonstrates that these matters are deeply rooted not only in present supervisory practice, but in commercial law and accounting conventions. Easy changes and quick coordination are not to be expected. But at least it should become possible to compare bank capital in countries with different treatment of such

matters as hidden reserves, specific provisioning, tax deductibility of write-offs, revaluation of assets, revaluation reserves, write-downs to market, and the like. For the United States, international comparability of bank capital is particularly important in view of efforts of foreign banks to acquire American banks and thus become bank holding companies. These acquiring banks are expected by the Federal Reserve, under the Bank Holding Company Act, to act as a source of strength to their U.S. subsidiaries. Finally, removal of the withholding tax on interest-bearing portfolio investments in the United States and in Germany is a further step in the integration of world financial markets.

#### Deregulation of Functions

Banking powers, in some countries, are strictly regulated. In others, legislators and regulators seem to believe that banks, like retail stores, should know best how to serve their customers. The United States and Japan are among the former kind. In the United States, federal and state legislation and regulation narrowly circumscribe what banks can do, while the Bank Holding Company Act limits bank holding companies to essentially the same activities as banks. Abroad, American banks generally can act with somewhat greater freedom. Thrift institutions operate under another set of regulations, designed to capture part of the national flow of savings for the benefit chiefly of the housing and consumer sectors. In Japan, banking activity has been even more severely structured, with particular powers reserved for commercial banks, long-term credit banks, trust banks, and others. In the United Kingdom, tradition rather than law tended to separate commercial banking from the mortgage business and the securities business although changes are underway.

In Germany, on the other hand, banks have been free to engage in any financial business as well as to own participations in commercial and industrial enterprises. The rapid growth of the German economy in the latter part of the nineteenth century, contrasted with the slower growth of the British economy, sometimes has been attributed in part to this difference in the ability of the respective national banking systems to support economic development. Whatever the merits of this analysis, it seems plausible that in developing countries a broad range of functions and powers for banks will be most conducive to growth. They can thus better cope with the scarcity of savings and narrowness of financial markets which developed countries have had time to overcome.

Specialization, such as is enforced in some sectors of the Japanese banking system and in the thrift sector of the United States, has sometimes been regarded as presenting opportunities for greater efficiency. If that were the case, however, one would assume that the market would produce specialized institutions without benefit of legal compulsion. Specialization in housing finance, as practiced by thrift institutions in the United States, has more nearly the earmark of a captive source of finance. Somewhat the same can be said of arrangements in Japan, where the principal beneficiaries of regulated institutions and markets have been business and the government.

A different view of specialization is that banks do not specialize so much in particular activities as in particular customers. For customers with whom the bank has established a close relationship, it can perform a wide range of functions. With these customers, the bank may have a comparative advantage over its competitors. Usually, these are more moderate-sized customers that have not yet reached the stage of being able to substitute

the open market for services supplied by banks. Typically, this constellation then leads to a belief on the part of the bank that it should expand its activities toward a larger constituency, in a wide range of activities. Thus, a bank's belief that it could serve a customer through insurance, real-estate financing, and securities operations may be justified in connection with a particular group of established customers even though the bank may have no special aptitude for those activities.

This may offer a contributory explanation of why American banks today are pressing to enter fields so far not open to them. Banks may be acting under the inducement of particular opportunities in those fields, rather than because insurance, real estate, and securities are intrinsically more profitable than banking. Much the same seems to be happening to nonbanking firms, in the insurance, securities, and commercial fields, that have entered areas of banking or are still trying to do so. Complementarities may exist between the banking business and the businesses of insurance, securities, and retailing, given that firms in each of these fields have customers that also need banking services. A customer base, in other words, seems to impel institutions in quite different fields to reach out toward a variety of financial activities to more fully serve these customers.

In terms of efficiency, the foregoing argument does not provide a strong reason for expansion either of banks into nonbanking areas or of nonbanking and even nonfinancial firms into banking. The customer may prefer the convenience of a one-stop financial relationship for all his needs. But, other than for the saving of shoe leather, gasoline, and tires, will he be better served?

The answer could be that competition might increase when banks enter into other areas. An example is offered by the securities industry. Studies seem to show that revenue-bond underwriting by commercial banks would reduce the cost of this underwriting, although, as usual, there are other studies that question this. A possible reflection on the degree of competitiveness, or lack of competitiveness, of the securities industry is the high return earned in that industry, reflecting, of course, not only underwriting gains, but other income including putting together mergers. Another possible indicator of a need for greater competitiveness is the high cost of securities transactions for small investors, which is only gradually being reduced by the entry of discount brokers.

As for possible benefits from banks' entry into real estate, these seem to be demonstrable mainly in times of inflation, when it is difficult for a bank to finance construction projects without some equity participation. There should be less need of this in less inflationary times. Another competitive benefit might materialize if bank entry into homeowner real-estate brokerage helped erode the very high commissions prevailing in that activity. The entry or nonentry of banks into the insurance area, finally, seems to be largely a matter of who is best able to enlarge or defend his turf, with the insurance side having had the best of it so far.

Two broader questions remain with respect to the ongoing effort to deregulate the functions of banks and to enlarge their powers. One relates to the allocation of credit. A strengthening of the flow of savings into the areas of insurance, real estate, and securities generally seems to point in the direction of strengthening the productive forces of the economy. This

can be said even though much of the proposed activity is aimed at consumers rather than at the business sector. One may indeed be concerned that, in all these deregulatory proposals, the business sector rarely is singled out for improvement in its financing situation. Nevertheless, the proposed initiatives do not seem to forebode a shift of financing toward consumption and away from production.

This cannot be said, however, of the wholesale creation of nonbank banks either by the banking system or by nonbank institutions. Consumer banks, to the extent that they are not simply a means of gaining access to the Federal Reserve and other payment services and to deposit insurance, clearly will emphasize financing consumption. A country that has net savings of only 5 to 7 percent of GNP is not well advised to shift still further resources into consumer credit. To say that we can compensate for this by borrowing \$100 billion a year from abroad can at best be a temporary answer. Yet the main form of bank deregulation that currently is moving forward vigorously is the approval of nonbank banks.

A second consideration, dealing with the timeliness of bank deregulation, has to do with the recent loss experience of the banking system. Critics of deregulatory proposals argue that banks should first raise their capital, write down classified loans, and establish reserves against possible contingencies before they move into new fields. It is difficult to deny that corrective measures of a predominantly supervisory character are in order. But it can rightly be argued that strengthening of bank finances and deregulation can proceed at the same time. If it does not, the long seesawing of the American banking system's market share may take another turn downhill. In contrast



to the banking systems of many other countries, where bank credit and liabilities are the dominant forms of credit and saving, the United States has a large sector of nonbank credit and nonbank investment media. This is wholesome in terms of competition and of preventing excessive bank margins. Other countries might find it beneficial to move in the U.S. direction. But in the United States, at least, the movement should not go too far, lest it lead to a progressively weaker role for the intrinsically valuable function of financial intermediation.

#### Deregulation and Safety

Much bank regulation purports, at least ostensibly, to make banks safer. Much regulation also has been introduced for the avowed purpose of "avoiding excessive competition." Deregulation, therefore, almost inevitably will lead to additional risks. If banking reform includes greater emphasis on the discipline of the market, risk may mount. There can hardly be market discipline unless there is visible evidence of the consequences of not heeding that discipline.

In some of its aspects, however, deregulation may also contribute to bank safety. One such step would involve an expansion of interstate banking. A larger base of insured consumer deposits, which would result from interstate mergers, would reduce dependence on purchased funds, as already noted. A second move toward greater safety could come from diversification of activities. Life insurance inherently is an activity with only moderate risk. The same cannot be said of securities and real estate -- that is why banks so far have been kept out of those areas. But the principle of risk diversification

would nevertheless be operative if a bank had three irons in the fire rather than just one. Critics instead might speak of three balls in the air. Surely there is risk from entering into new activities. The net effect is difficult to assess and no doubt would work out differently for different banks.

Greater risks from deregulation can be countered by appropriate supervisory action. The present preference is for more capital. This is surely desirable, in view of the long period of attrition of bank capital since the 1960's, even though interrupted now and then by often short-lived recoveries. In view of the high cost of primary capital, subordinated capital also deserves attention. Given that, even with present dividend payout, most large banks are unable or very reluctant to sell common equity, perhaps a period of dividend restraint could be considered. If practiced universally, it would not create invidious impressions concerning individual banks. Regulatory emphasis on liquidity could be constructive insofar as the first problem faced by banks is not a threat to ultimate solvency, but a run based on fears and rumors. With disclosure requirements stepped up, the opportunities for such market disturbances might increase.

Looking much farther ahead, one might ask whether the present structure of banks is really optimal for an economy in which there is a simultaneous demand for market discipline with its associated risk, and for complete safety of the monetary and payments system. It might be possible to separate out the components of the banking system that relate directly to the monetary and payments system, to protect them fully against illiquidity and insolvency, and then let the remaining components act as nonmonetary financial intermediaries exposed to liquidity and solvency risk. Failure of this residual

banking system would not pose a threat to the monetary and payments system. One way of accomplishing this would be to insure totally all transactions balances. Perhaps some part of nontransactions balances, such as money-market deposit accounts, which many people regard as monetary, would have to be added. Alternatively, the money part of the bank might be split off, and would hold only high-grade assets. The remaining -- and larger -- part of the banking system would do a normal banking business, with its liabilities partly in medium-term form to protect liquidity. I see no present possibility of implementing a system of this kind. But its principles are worth thinking through because they reflect what we all want -- a monetary and payments system that is perfectly safe, and a banking system that bears its proper share of the risk in the economy.