

Remarks by
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Good afternoon to all of my old friends and colleagues from the IFC and from the private sector real world of profit-making. As a private-sector banker for 35 years, I eagerly looked for new opportunities to lend money. In my new incarnation as a central banker, I dread the conditions which would force me to be a lender. That is one of the transition traumas from the private sector to the public sector which have made the change somewhat more difficult than I originally imagined.

Putting the trauma aside, I can assure you that the challenge of dealing with monetary policy issues in the current economic environment is awesome. Were it not for the collegial environment of the Board of Governors and the patient tutelage of staff and my Ph.D. economist associates, I might have acquired an inferiority complex. But, I am surviving.

In the area of monetary policy the Board today is a bit like Joe Dimaggio during his 56-game hitting streak in 1941, because

the United States is now in the 90th month of economic growth without recession and without runaway inflation. In the end Dimaggio's streak was stopped by an almost unbelievable fielding play by Ken Keltner, the third baseman of the Cleveland Indians. Dimaggio's line-drive toward left field was labeled "hit" all the way until Keltner came out of nowhere and snagged it in his glove.

Maybe there is a Ken Keltner kind of event lurking out there somewhere poised to spoil our 90-month streak. Is it the globalization of economies and capital markets which makes monetary policy harder to administer? Is it the integration of Europe into a new vibrant market? Is it the collapse of the Eastern European ancien regime and the resultant effects on exchange rates, inflation, and capital flows? Or is it just the fact that we have very little maneuvering room between easier money and more inflation on the one hand and tighter money and recession on the other. More inflation tends to mortgage our future. Recession, with all of the fragilities in our economy, might collapse our present and impose permanent changes on our institutions which would be equally damaging to the United States in the long run. That is why the policy choices are so very tough right now.

Since we are meeting this week at the vital center of Europe's most dynamic economy, let's take a few minutes to look at the probable effects of European economic integration:

The benefits from European integration will be large and will accrue primarily to European economies. A significant proportion of these gains will come from greater competitiveness in the financial sector although spreads and margins will probably decline considerably, particularly to the advantage of smaller customers who have not in the past had access to a competitive marketplace. These changes will tend to benefit consumers of banking services, but they will make it much more difficult for European banks, accustomed to less competitive practices, to earn an acceptable profit.

Since European banks will be able to operate anywhere in the Community on the same basis they do in their home country, regulatory restraints in banking will tend to relax to the lowest common denominator. That is to say, banking regulation will tend to move in the direction of the least regulated system in order to assure a level playing field. This phenomenon will further enhance the competitive environment.

European banks are responding to the new environment in three ways: (1) by domestic mergers to achieve economies of scale; (2) by cross-border mergers and affiliations (including

operating affiliations, exchanges of board members, and cross-purchasing of shares) to achieve economies of scale and geographic diversity; and (3) by affiliation with nonbank financial-sector companies -- notably insurance companies -- to achieve product diversity as well as access to rapidly growing components of the financial services sector.

Are these developments important to U.S. banks? Yes. Certainly U.S. banks will be affected in two ways: Good news and bad news. (1) By access to a broader and less restrained market, which should be beneficial; and (2) by more competition and lower spreads, which will make earning a profit even harder. In recent years, as you know, U.S. banks in general have found Europe a tough market in which to earn a profit. The number of branches of U.S. banks in Europe declined 10 percent from 183 at year-end 1982 to 165 at year-end 1988, and total assets of branches of U.S. banks declined about 25 percent from \$182 billion to \$137 billion over this same six-year period. But this isn't Armageddon. While in recent years some U.S. banks have withdrawn completely from Europe, and others have consolidated their activities, several U.S. banks with well-disciplined business plans have continued to profit in that market. U.S. banks have done quite well in fact in the provision of sophisticated off-balance-sheet business, an area in which they are regarded as highly professional.

Incidentally, I believe the capital flows to rebuild Eastern Europe will largely come from the private sector, but I do not expect U.S. banks to directly finance government-sponsored development projects. The sour aftertaste of LDC loan problems is still too fresh. On the other hand, I believe U.S. banks will step up to help finance investment by U.S. and foreign corporations in Eastern Europe. This financing will most probably be a combination of loans and securities underwritings using broadened securities powers.

There are two other key challenges for U.S. banks in the environment of European integration: (1) Can they respond to a decline in spreads and margins that consolidation of an overbanked market will bring; and (2) can they compete on a worldwide basis against the universal banks that are expected to emerge in Europe along the lines of the German model and against Japanese banks, eager to enter the integrated European market, and probably organized in the future more like universal banks?

These are important structural issues, and it is high time that the United States dealt with them, even though they are immensely complicated by philosophic, emotional, and political mind sets which will be difficult to change.

The response of U.S. banks will almost assuredly be mixed. Some will exit the market completely rejecting even the

possibility of a niche presence on a competitive basis. Others will pursue a niche where they believe they have an advantage -- merchant banking or mutual fund servicing, for example. A very few will see an opportunity to build a consumer base reliant on U.S. leadership in consumer banking innovation and wishing to build on an already developed presence that offers something more than a toe-hold opportunity. And there may be three or four banks who believe they have the corporate and government ties to survive and prosper as relationship banks, although, as Herr Remsperger said yesterday, deal-making banks will be more common.

In order to assure competitive equality for U.S. banks in Europe we must refrain from restrictive practices at home which would prompt European authorities to conclude that we are discriminating against foreign banks. In that context the "Riegle" bill just reported out of the Senate Banking Committee is particularly worrisome. Financial services are an important facet of multilateral trade negotiations and that is the more appropriate arena in which to settle differences rather than with retaliatory legislation transparently aimed at one nation but affecting all.

I should hasten to state at this point that the more competitive environment which we have described for Europe is a widespread phenomenon. In the industrial countries in general there are far too many banks serving the market. Consolidation,

restructuring, fat reduction, and greater emphasis on earnings will be common themes in banks in the U.S., Canada, and Japan as well as Europe.

I predict that the dramatic changes in the European market and the reality of a fiercely competitive and financially powerful Japan will prompt the Congress to consider, early next year, legislation to dramatically restructure the United States banking system.

While the changes I foresee will probably not all come at once, I feel quite comfortable in forecasting that by the end of this decade the following will be true.

(1) Barriers separating the various parts of the financial services industry will be dismantled and commercial banking, investment banking, securities brokerage and trading, and insurance will be conducted within one corporate structure. Initially, concerns about the federal safety net may dictate that the structure will be a holding company with at least nominal firewalls. But I believe favorable experience with additional risks and the competition of universal banks from other nations will hasten evolution to a universal bank structure by the turn of the century.

(2) There will be a heated debate on the issue of commerce and banking, but in the final analysis the need of banks for capital to compete domestically and internationally will result in commercial or industrial firms being able to be substantial investors in banks and financial services holding companies, even to the extent of exercising operating control.

(3) By the mid-1990s, the McFadden Act forbidding interstate branching will be repealed and financial companies operating in more than one state will have the option of a special federal charter which would subject them only to federal regulation overriding any state regulation of branches or subsidiary banks.

(4) The federal bank regulatory apparatus will be simplified. There will be one insurer of deposits and that insurer will not have regulatory or examination authority. There will be one regulator for federally chartered institutions of all kinds and one regulator for state-chartered federally insured institutions.

I won't venture a prediction on what reforms will be recommended for deposit insurance except the general one that market discipline will somehow be recommended in order to attack the serious issue of moral hazard.

Finally, I have a prediction in which I have more confidence than all the others. That is that there will be a renewed emphasis in the United States and in all the industrialized nations on capital in banks and financial institutions. In the last analysis, capital is the best discipline. You don't get it unless you perform well. You don't keep it unless you perform well. And when you do make a mistake, it is the parachute that can save you from a fatal fall and insure a soft landing.

It is a fascinating and challenging time in which we live. It is vastly different from the banking world I entered 37 years ago, but it is much too exciting to even consider trying to revert to those simpler days. Conferences like this and intellectual stimulators like Carter and Greg help us keep pace with our rapidly changing surroundings. It is a privilege to be with you all again.