Good afternoon! Bill Estes and Sue Costello have been urging me to visit with FIBA since I was named President of the Federal Reserve Bank of Atlanta in 1996. I was able to meet with your directors over lunch that February, but this meeting with the full membership has been too long in coming. Pat Roth can attest to our difficulty in finding an open date, and somewhere, I’m sure, an economic model can explain the inverse relationship between the desire to meet with a group and the time available to do it.

In addition to my schedule, I’ve also been trying to keep an eye on what, in an earlier time, might have been a decade’s worth of financial and economic developments. We are now witnessing the formation of U.S. financial institutions whose combined assets will exceed the annual gross domestic product of entire nations. And in some regions around the world, economies that were previously considered miraculous are in serious need of divine (or IMF) intervention.

None of this is new for members of FIBA. Some of you work for what are already the world’s largest banks. Others have lived through crises in Latin America that—in some respects—bear an eerie resemblance to the crisis in Asia today. And all of you, by virtue of your position in America’s gateway to Latin America, are keenly aware of how U.S. policies—monetary, financial, legal, regulatory and all the rest—are transmitted through the world and retransmitted back to the United States. In a way, then, it’s probably not such a bad thing that this meeting has been so long in coming. These last two years have brought a decade’s worth of insights.

My agenda for today is to tap into those insights. I’ve brought along some concerns that have been weighing heavily on my mind recently, and which—I have to admit—I simply don’t know the answers to. But before I ask you to consider some of my questions, I suppose it’s only fair that I answer some of yours.

I’m an engineer: by training, by temperament and—for the first few years of my career with the Atlanta Fed—by profession. Most of my colleagues at the FOMC are economists, so my background makes me pretty unusual. But it also, I think, gives me a unique perspective on what’s driving events in the financial services industry and in the economy.

Generally speaking, engineering seeks to give individuals some degree of control—over land, the elements, transportation, you name it—through the development and application of technology. And in the financial services industry, communications, computing and data processing technologies have done just that. I need not explain this to members of FIBA: many of you service your customers through a variety of technologies. You market and approve loans with credit scoring software. You provide automated letters of credit facilities. Or you manage risks through derivatives portfolios and complex risk management models. The point is that financial institutions and their customers have a range of options and a degree of control that they haven’t had before. And it’s all been made possible by technology.

All of this is, without question, to the good. Taken together, the actions of individual businesses and consumers—what economists generically call “the market”—is the most efficient way to distribute limited resources, and market efficiencies have much to do with the strength and duration of the current expansion. But for bankers, consumers and policymakers, the ascendancy of the market has additional implications that we’ve barely even begun to explore. The most important, however, is that economic policies must now, more than ever, be market based. For the next few minutes, I’d like to consider the implications of this reordering for the Fed as regulator and as monetary policymaker.

In fact, the market began undermining the legalistic American financial regulatory structure more than two decades ago. Remember that the central objective of post-Depression financial policy was—and, strictly speaking, still is—preventing competition between financial sectors. Glass-Steagall erected legal firewalls between the sectors; regulators tried to keep the walls up by reducing competition post-Depression financial policy was—and, strictly speaking, still is—preventing competition between financial sectors. Glass-Steagall erected legal firewalls between the sectors; regulators tried to keep the walls up by reducing competition.

All of this began to break down in May 1975, when trading among institutional investors and competition from regional exchanges forced the New York Stock Exchange—after more than 200 years—to abandon fixed commissions. But with the demise of fixed commissions, there was little incentive for brokerage firms to compete with banks, Glass-Steagall notwithstanding. Three years later, of course, Merrill Lynch did just that with the introduction of its cash management account. You provide automated letters of credit facilities. Or you manage risks through derivatives portfolios and complex risk management models. The point is that financial institutions and their customers have a range of options and a degree of control that they haven’t had before. And it’s all been made possible by technology.

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All of this began to break down in May 1975, when trading among institutional investors and competition from regional exchanges forced the New York Stock Exchange—after more than 200 years—to abandon fixed commissions. But with the demise of fixed commissions, there was little incentive for brokerage firms not to compete with banks, Glass-Steagall notwithstanding. Three years later, of course, Merrill Lynch did just that with the introduction of its cash management account. Consumers—especially the most profitable consumers—left banks in droves, and it would become a matter of time before policymakers abandoned Regulation Q and permitted banks to offer interest on transaction accounts.

These were crucial developments: no longer did the market respond to policymakers. Now, policymakers responded to markets. It was a pattern that would be repeated over and over again, with the demise of interstate banking prohibitions, the end of interstate branching prohibitions and the expansion of Section 20 powers, to name just a few examples. Eventually, of course, it will culminate with repeal of Glass-Steagall itself. The point is, markets move first, we react later.

It’s worth emphasizing that most of the developments I just mentioned took place before derivatives, credit scoring, mortgage backed securities, ATMs and other technology-driven innovations flooded the financial services industry. And those innovations came before 45 percent of American households owned personal computers, as they did last year. If two decades ago—in a relatively low-tech environment—the market undermined four decades of financial policy that quickly, how much faster will it move when PCs are as ubiquitous as televisions?

In this market-driven environment, it would be tempting to conclude that regulators are irrelevant. Tempting, but wrong. For one thing, the market’s rules and incentives are not always aligned with the interests of taxpayers and consumers. For another, the market’s corruption-prevention record is less than stellar (although...
in fairness it should be mentioned that regulators’ record is not much better).

But by far the most compelling reason for regulation is the one offered by Senator Glass and Congressman Steagall 65 years ago: the safety and soundness of the American financial system. Think about it: the sources of systemic risk today are basically the same as they were in 1933: transaction cascades (which generally refers to a breakdown of the payment and settlement system), financial contagion and asset value implosion. But technology—the same technology that gave life to the market—has exponentially increased the speed and consequences of a financial system meltdown. And, of course, the financial system is no longer confined to our borders; it’s now global.

So the first challenge for the Fed and other regulators is to redefine the term “safety and soundness.” The goal, I suspect, will always be the mitigation of systemic risk. But it may no longer be possible or desirable to mitigate systemic risk by preventing the failure of financial institutions. Containment, I believe, will be the preferred approach, but even that’s easier said than done. Can a one trillion dollar institution really be contained?

The second challenge is now we work, or how we do the containing. The truth is that in today’s financial services industry, regulations cannot keep up with innovations in the marketplace. For example, the Basle Accord’s risk-based capital model—which took so many years to gain broad acceptance—is already inadequate as a gauge for determining capital requirements for many very large institutions. We’re making progress toward catching up (again) with work on modeling, and supervisors have also begun accepting, on a limited basis, internal models to determine capital requirements for market risk. Credit risk is now also a primary focus of modeling efforts, and I am optimistic that real progress is being made in that area. But we’re still, as ever, behind the market.

The evolution of the financial services industry has meant the movement and (in some cases) complete disappearance of long-established reference points. State boundaries and Federal Reserve Bank District lines, for example, are now poor indicators of where banks actually operate. The balance sheet is becoming far less meaningful as a gauge of an institution’s financial condition. And the concept of legal entity—always the focus of examiner efforts—has similarly become less relevant as bank management focuses on product lines with little regard for where those activities are officially housed.

The challenge for supervisors is to move beyond our historic but now myopic reference points and to begin to focus on the processes that deliver and manage those products and services. At the Fed, we’re trying. Risk-focused supervision, as I’ve just mentioned, allows our examiners to assess risk with banks’ own processes. These vary widely, depending on the sophistication of the institution. For some, it is a loan review function that requires quality testing. For others, it is portfolio management strategies driven by the most complex formulas that the financial rocket scientists can dream up. I’m aware that none of our initiatives have yet been perfected—far from it—but we think they are a good start toward forging the bank-supervisor partnership that is so critical for protecting the U.S. financial system. I’m interested in hearing what you think.

In addition to its regulatory responsibilities, the Fed is also the nation’s monetary policymaker. And just as we’re still pursuing an indispensable but six-and-a-half decade old goal on the supervision and regulation end—safety and soundness—we’re also pursuing a time-honored public goal on the monetary side: national economic stability, as reflected by GDP growth, the unemployment rate and, most importantly, the inflation rate. But as with safety and soundness, the environment in which we’re expected to achieve economic stability has been completely transformed by markets.

The market is no longer domestic. Trillions of dollars change hands every day. But quite apart from allowing countries to pursue comparative advantages, this ebb and flow of resources also serves as a particularly vigilant enforcer of market discipline. Policies that defy or obstruct the operation of the market, or that obscure the true condition of an economy or business, are not tolerated. And when punishment comes, it is swift and painful.

The most recent demonstration of market discipline, of course, has been in Asia, where countries with exchange rates inconsistent with economic fundamentals have been punished with an overwhelming capital flight. (In this respect, the Asian crisis resembles the peso crisis a few years ago.) But the market has also become much more sensitive to weaknesses in property rights, accounting conventions and bankruptcy and commercial law. For countries on the receiving end of market discipline, the challenge is implementing reforms. Real reform—the kind rewarded by markets—takes time, but markets punish now. It reminds me of that bitter old labor saw: the beatings will continue until morale improves.

For the United States, the current seven-years-and-counting expansion of economic growth can probably be viewed as a reward for the right kind of economic policies. But this doesn’t mean our job is finished. As long as countries are vulnerable to exogenous shocks such as wars, oil production cuts (and year 2000 problems)—which is to say, always— monetary policymakers have got to be able to understand all of the market’s signals. And in a global environment, that’s incredibly difficult.

One of the more basic challenges we face is simply discerning the indirect effects of our policy choices. Whether we want it to or not, an action by the FOMC immediately affects the availability of credit around the world. Investment portfolios are reallocated and capital spending campaigns reassessed. As those decisions are made by counter-parties and trading partners, they influence again the very economy that U.S. monetary policymakers tried to influence in the first place.

Understanding how these indirect effects work remains a very daunting challenge.

A related (and even more basic) challenge for monetary policymakers is modeling the economy. The standard econometric models—those with the longest historical track records—are relics of a day when the U.S. economy was basically closed (at least compared to what it is now). Moreover, modeling an economy with more than two participants—especially when one of them is the dominant global player—is an enormous technical challenge. Almost no factor can be considered external (exogenous), and the policy effects we observe in so much domestic data are nearly impossible to extract.

At the Atlanta Fed, we’re trying to understand all aspects of the global market. Economist Tao Zha is developing what’s known as a dynamic multivariate model. Tao’s model accounts for the effects of monetary policy in a rigorous, transparent way that has been previously unavailable, and it seems to be demonstrating good potential as a forecasting tool.

We’re also exploring some of the more important global policy issues of the day. Recent research by Atlanta Fed economist Marco Espinosa seems to indicate that in countries where the economic infrastructure is not well developed, completely open capital markets may not be ideal. In other words, under certain circumstances and at certain stages of economic development, some degree of financial capital restrictions may be beneficial in some countries.

Theoretical research by economist Roberto Chang—and recently tested with data from Latin America and Asia—goes a long way toward explaining recent crises by illuminating the connection between exchange rate regimes and banking crises. Among other things, Roberto’s work suggests that during a currency crisis, any intervention should begin with an injection of liquidity. Otherwise, a currency crisis can quickly become a banking crisis. Structural reform may be essential, but
financial obligations must be honored first in order to prevent a problem from spreading. This observation has obvious implications for preventing and correcting future crises.

But this is your territory, and I told you I was here to listen. Before I stop, though, I’d like to share one final observation. Much of the reason the Fed needs to change the way it reaches its goals—as a supervisor and as a monetary policymaker—results from its past success in achieving them. The soundness of the American financial system and the stability of the economy have made the American economy the envy of the world. But that very success has changed completely the way those goals will be pursued tomorrow. It is incumbent upon us—consumers, bankers and policymakers—to continue to find a way to reach them.

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