is today, and to greatly strengthen the regulatory apparatus in order to prevent private risk from being transferred to the taxpayer. This would not be my preferred approach. First, it would extend the range of regulation to a wider and wider set of financial activities as banks and thrifts gain new powers, either by legislation, by court decision, or through technology and new products. Second, the enlarged regulatory effort would continue to push activities outside established financial channels.

Finally, I doubt that regulators can, as a practical matter, provide continuous protection against perverse incentives, especially in a setting as dynamic as today's financial markets. The logical outcome of retaining the deposit insurance system in its present form is a substantial step up in regulation.

I am not especially apprehensive about letting market forces operate more fully. Federal Reserve open market operations and the discount window, when properly administered, represent a substantial defense against the classic crowd psychology of a generalized bank run. These central bank tools can provide liquidity freely to markets and to sound institutions, counteracting a crisis. There is a significant body of opinion that the collapse of the banking system in the early 1930s could have been avoided if the Federal Reserve had behaved in the same way it behaved last October.

The Federal Reserve is not, however, a deposit insurance agency. If banks are insolvent, their assets may not be sufficient to withstand a run even when liquefied at the discount window. Regardless of the specific form of the deposit insurance we choose, it would be counterproductive for the Federal Reserve to liquify insolvent institutions. By so doing, it would enable fleet-footed creditors to get their money, leaving others to absorb all losses. It is not the function of the Federal Reserve to interfere in the distribution of losses among the creditors of an insolvent bank; that is the function of a receivership.

More is at stake here than the resection of market tests in banking and regulation, critical though those tests are. The Federal Reserve is a central bank with the unique power to create base money. Liquidity crises are rare. The normal job of the central bank is to supply base money over time at a rate consistent with price stability. The independence of the Federal Reserve within our federal government, the removal of authority to make direct loans to the Treasury, and the limitation of access to the discount window to sound institutions are all vital protections against attempts to divert money creation to uses that would endanger price stability.

**Conclusion**

The objective for financial reform should be to restructure financial regulation in a way that builds on market forces. Financial reform so far has been less a choice made by Congress and the regulators to seek the benefits of market forces than a result of market forces successfully seeking to avoid the regulatory straitjacket. As I have argued, we are nearing a crossroads. We must push ahead with financial reform. Obviously, the setting for true financial reform must be changed. The risks of loss in financial decisions must be shifted away from the insurer to those financial managers (and the shareholders they represent) who make the decisions. It will be essential to reestablish the right to fail and the risks of that fate for financial institutions of all sizes and for all uninsured depositors.

Regulatory resources need to be shifted toward maintaining capital necessary to protect the insurance fund. Other changes will be necessary as well. More information about the condition of financial institutions and reductions, or at least limitations, on the amount of deposit insurance are but a few. Such changes may not be popular, but they should be the guiding principle if true financial reform is to continue.

Today, 75 years after the founding of the Federal Reserve System and 55 years after the nationwide bank holiday of 1933, financial regulation is once again at a crossroads. The conflict between market forces and regulation has created serious problems that cannot be avoided much longer. At issue is a very basic question: should we go forward with deregulation, or should we turn back? The answer will have an important bearing on the future structure of the financial services industry. Should we make market forces exert a more powerful influence in the financial sector, or should we reinforce the blanket protection of the regulatory process?

I think the choice should be clear: we should rely on market forces. Relying more heavily on market forces requires sweeping away both mental and institutional cobwebs and making a clean break with the past. A piecemeal approach—responding to immediate problems and pressures—is not likely to get us very far unless we establish economic principles to guide deregulation.

The principles we must dust off to guide deregulation of the financial sector are little different from those at work in other industries. Moreover, applying these principles to the financial industry will require a lot more than simply broadening the powers of banks.

In debating and deciding on the steps to take in deregulating the financial industry, the fundamental goal should be to reinvigorate market incentives and tests of performance in banking and other financial markets. The challenge is to eliminate regulations where possible and to strengthen regulations where necessary, building on market forces rather than overriding or suppressing them.

**The Background for Regulation**

Government has a vital role in a capitalist economy. A political and legal framework is indispensable for assuring individual liberties and property rights and for setting the rules of the game in which markets operate. Within that framework, owners of capital and labor will direct their resources toward uses where opportunities seem greatest. In general, private decisions made with full comprehension of possibilities for gain and risks of loss will produce the best results. Regulating some activities and precluding others alters the possibility of gain and the risk of loss, and affects choices with respect to resource use. In a static setting, where entry into competing endeavors is expensive, technology is unchanging, and innovation is sluggish, the costs of regulation may seem small or slow to appear, perhaps because they are hidden in public subsidies. In such circumstances, the intrusion of government regulation in the marketplace may be able to achieve politically determined results that otherwise would be missed.

A more dynamic setting—such as the markets for financial services, where competition has been strong, entry by nonregulated firms has been relatively easy, and technology has been dynamic—the outcome can be quite different, as we are now seeing. Although competition holds down direct costs to consumers, inefficiencies are evident, and through the federal deposit insurance mechanism, risk may well be shifted from private decision-makers to the federal deposit insurance system.

The attention banking has received over the years suggests that banking has always been a special case in which regulation was necessary. Certainly as the word “bank” was used in history, there was something unique about the blend of payment services attached to bank liabilities and commercial lending. Almost from the beginning, banks received special charters from governments. Those charters carried with them restrictions on the way banks could conduct their business. Whether these regulations were initially intended to prevent fraud or to generate government revenues from a state-created monopoly is a matter of debate, but by the time of the founding of the Federal Reserve in 1913, regulation of banks was the accepted practice.

The legitimacy of the case for banking being considered special stems largely from problems with bank runs. When those same ways of numbers simultaneously demanded cash repayment from perfectly sound banks, not enough cash was available in the nation to meet the demand, resulting in a crisis. All banks, however well-run, could not convert illiquid assets into cash and had to suspend payments, in violation of the...
terms of their charter, or sell assets at reduced prices, thereby impairing capital value and maintaining solvency. The prevention of such financial crises was one of the driving forces behind the creation of the Federal Reserve System—a central bank lender of last resort. The Federal Reserve can prevent the outbreak of widespread financial crises by suppressing whatever amount of new cash is required to allay the fears of frightened bank customers. As recently as October of last year, following the stock-market crash, the Federal Reserve performed this function.

Banking Regulations

Many bank regulations have been justified as a way to assure sound banking practices and to reduce the risk of loss from unsound banks. Bank charters typically called for minimum capital holdings and broad restrictions on the kinds of activities deemed to be risky, including underwriting. Deposits of bank holding company legislation loosened some restrictions by permitting a holding company to offer a slightly broader set of products than its bank subsidiary could offer directly. In addition, of course, banks in this country have been almost universal-ly excluded from offering products in, or being affiliated in any way with firms in, telecommunications technology. Banks were forbidden by regulation (Federal Reserve Regulation Q) to pay interest on nonnegotiable local deposit accounts or to pay more than a ceiling rate on other deposits. There is still doubt as to whether the prohibition of interest on regular checking accounts was a convenient device for banks to maintain competition, or a serious regulatory effort to avoid price wars that might endanger the safety of banks. The Regulation Q ceiling on other deposit rates became a genuine difficulty for banks when it was set permanently below the market cost of attracting deposits. It was the removal of this Regulation Q restraint that marked the first significant step in bank deregulation.

Portfolio restrictions, product line restrictions, and interest rate limits have all been defended as necessary for the safety of banks by removing temptations to engage in "ruinous competition." Or at least, they have been designed to raise the cost of attracting funds to a bank largely unaffected by the risk profile of its portfolio. All the largest of depositors can be concentrated in one or two large banks and excluded among small banks. At large very large institutions, deposits and other depositors and even the depositors as well as their restricted access to uninsured creditors. In so doing, they force key resources and market resiliency. A final approach would be to retain for deposit insurance. Some doubt that risk analysis would give added incentive for shareholders to seek out but illiquid depository institutions.

Deposit Insurance

The Federal deposit insurance, which was also adopted in the 1930s, has reduced or eliminated the risk of losses to indi-

Deposit insurance is intended to defuse crowd psychology that might trigger bank runs. Insurance forestsall bank runs by assuring depositors that, whether or not a bank is solvent, deposits are safe. A deposit insurance agency, however, must protect itself from "moral hazard," the incentives that deposits will be supplied indiscrimi-nately to both solvent and insolvent banks, increasing the probable loss for the insurer. Supervision and regulation of insured banks defends against moral hazard in any event. In our view, therefore, the defense has not been effective in preventing losses. The cost of funds to banks has been financed by a flat assessment on banks and thrifts—a practice that leaves the cost of funds to a bank largely unaf-fected by the risk profile of its portfolio. All the largest of depositors can be concentrated in one or two large banks and excluded among small banks. At large very large institutions, deposits and other depositors and even the depositors as well as their restricted access to uninsured creditors. In so doing, they force key resources and market resiliency.
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Banking Regulations

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The intent of bank regulations was to ensure safety. Some regu-
lar interest rate ceilings or costly reserve
requirements, money market mutual funds and other new competitors and
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larly, capital requirements, limitations on loans to a single borrower and on the kinds of assets banks could hold, as well as the rate and reserve require-
mements, have been excluded from being
themselves, all contributed to the rapid development of nonbank and offshore financial markets. By the late 1970s, the so-called "nonbank bank" had become firmly established in the vernacular of the financial markets. The intent of these regulations appears to be almost nothing a bank can do that cannot be done by a non-
bank. Furthermore, the increasing number of things that some nonbank banks can do that banks are not allowed to do, and the increasing number of things that some nonbank banks can do that are not allowed to do, may have been to ensure safety. Some regu-
lations undoubtedly have worked, but there have been other consequences as well, some of which have worked in the opposite direction. Regulation, by encour-
gaging the entry of nonbank suppliers of financial services, has driven business outside long-established channels. In some instances risk-taking has been encouraged in banking itself. Overnight financing by large banks in the repo markets, where nonbank mer-
kers has mushroomed, adding credibility to banking and money markets. Banks, seeking to compete with the thrifts, have taken business off balance sheets, with devices such as standby commit-
ments and guarantees adding new ele-
ments of risk. In many instances the requirements, money market mutual funds and other new competitors and
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Deposit insurance premiums have worsened an already difficult sit-
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Overall, the present situation is the culmin-
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ment practices. Deposit insurance has become a substitute for a strong capital base in attracting deposits. Depositors, insurers, and bank regulators alike are not scrupulously examining the risk the bank, rely on deposit insurance.

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More is at stake here than the reassertion of market tests in banking and regulation, critical though those tests are. The Federal Reserve is a central bank with the unique power to create base money. Liquidity crises are rare. The normal job of the central bank is to supply base money over time at a rate consistent with price stability. The independence of the Federal Reserve within our federal government, the removal of authority to make direct loans to the Treasury, and the limitation of access to the discount window to sound institutions are all vital protections against attempts to divert money creation to uses that would endanger price stability.

Conclusion

The objective for financial reform should be to structure financial regulations in a way that builds on market forces. Financial reform so far has been less a choice made by Congress and the regulators to seek the benefits of market forces than a result of market forces successfully seeking to avoid the regulatory straitjacket. As I have argued, we are nearing a crossroads. We must push ahead with financial reform. Obviously, the setting for true financial reform must be changed. The risks of loss in financial decisions must be shifted away from the insurers to those financial managers and (the shareholders they represent) who make those decisions. It will be essential to reestablish the right to fail and the risks of that fate for financial institutions of all sizes and for all uninsured depositors.

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Financial Reform at a Crossroads

by W. Lee Hoskins

Today, 75 years after the founding of the Federal Reserve System and 55 years after the nationwide bank holiday of 1933, financial regulation is once again at a crossroads. The conflict between market forces and regulation has created serious problems that cannot be avoided much longer.

At issue is a very basic question: should we go forward with deregulation, or should we turn back? The answer will have an important bearing on the future structure of the financial services industry. Should we make market forces exert a more powerful influence in the financial sector, or should we reinforce the blanket protections of the regulatory process?

I think the choice should be clear: we should rely on market forces. Relying more heavily on market forces requires sweeping away both mental and institutional cobwebs and making a clean break with the past. A piecemeal approach—responding to immediate problems and pressures—is not likely to get us very far unless we establish economic principles to guide deregulation.

The principles we must dust off to guide deregulation of the financial sector are different from those at work in other industries. Moreover, applying these principles to the financial industries will require a lot more than simply broadening the powers of banks.

In debating and deciding on the steps to test deregulating the financial industry, the fundamental goal should be to reinvestigate market incentives and tests of performance in banking and other financial markets. The challenge is to eliminate regulations where possible and to strengthen regulations where necessary, building on market forces rather than overriding or suppressing them.

The Background for Regulation

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In a more dynamic setting—such as the markets for financial services, where competition has been strong, entry by nonregulated firms has been relatively easy, and technology has been dynamic—the outcome can be quite different, as we are now seeing. Although competition holds down direct costs to consumers, inefficiencies are evident, and through the federal deposit insurance mechanism, risk may well be shifted from private decision-makers to the federal deposit insurance system. The attention banking has received over the years suggests that banking has always been a special case in which regulation was necessary. Certainly as the word "bank" was used in history, there was something unique about the blend of payment services attached to bank liabilities and commercial lending. Almost from the beginning, banks were regulated by governments. Those charters carried with them restrictions on the way banks could conduct their business. Whether these regulations were initially intended to prevent fraud or to generate government revenues from a state-owned monopoly is a matter of debate, but by the time of the founding of the Federal Reserve in 1913, regulation of banks was the accepted practice.

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