Speeches by Bob McTeer

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I'm pleased to be invited to the Cato/*Economist* monetary conference. This is the 20th monetary conference for Cato. That's a long time searching for the best route to stable money, and Cato is to be commended for its contributions.

Some people say that when I went to Texas in my present position, I adopted Sam Houston's views on money and banking. He was for money and against banking. Like his friend and mentor Andrew Jackson, he was for sound money and plenty of it. As their friend Mae West said, "Too much of a good thing is just about right."

The overall theme today is "International Financial Crises: What Role for Government?" One just never knows what position libertarian Cato is going to take on such issues.

Last year I attended a conference in France celebrating the 200th birthday of Frédéric Bastiat, the Adam Smith of France. Lots of libertarians were there. I could tell by the commentary on the bathroom wall. On the first day, there appeared the admonition "Defy authority." On the second day, written just below that, was "Who the hell are you to tell me what to do?"

I know the proper role for government is a traffic light and a constable. Perhaps, as a courtesy, you'll allow me to substitute a central bank for gold, just to get me through the day. But some of the issues on today's program are not as clear-cut.

The question in the first session had to do with international bankruptcy, the role of the IMF and market discipline vs. politics. I thought I could anticipate the Cato position on that one. (Although I must say, the anticapitalism demonstrators in Seattle and since have made me more sympathetic to the IMF than I ever thought I could be.)

The second session on lessons from the Argentine crisis didn't seem too hard to anticipate. Different market-oriented people might emphasize different lessons, but their lists would likely be similar. The session on currency competition vs. currency unification was harder for me to anticipate. I could argue that one square or I could argue it round. A classical liberal case can be made for both those alternatives, in pure forms. Just not for much in between.

But banking stability and the Basel capital standards I wasn't so sure about. I'm a last minute substitute on this panel and have no claim of expertise, especially on Basel II. So Jim Dorn said I could just focus on banking stability and economic prosperity. Well, here goes: Each helps the other. Banking stability contributes to economic prosperity. And economic prosperity contributes to banking stability. I'm not sure what more to say.

I'm probably as convinced, as you are, that free markets promote prosperity. But I'm told that many of us free market types "go all wobbly" when asked to apply free market principles to banking. Especially central bankers and those who keep company with central bankers. "We're all Keynesians now" is easier to resist for a central banker than "Banks are special. They need some regulation, or at least some adult supervision." For the record, Reserve Banks are supervisors—i.e., examiners of banks, not regulators. Within the Federal Reserve, bank regulation is the province of the Board of Governors. Reserve Banks supervise—i.e., examine banks under our jurisdiction under delegated authority from the Board of Governors.

I must admit that recent revelations have given me a nudge away from complete laissez-faire in banking. For example, after decades of knee-jerk advocacy of Glass-Steagall repeal on my part, the apparent trading of IPO windfalls for investment banking business is an eye-opener. In the matter of the crisis in corporate governance more generally, economists have always assured us that if we get the incentives right—if the interests of the managers and decisionmakers are aligned with the interests of owners and customers—outcomes will be mutually beneficial. I still believe that, but I never realized how easy it is to get the incentives out of alignment. Hands-off is suddenly very out of favor these days. I'm afraid that the proponents of less regulation would do well to help figure out how to make existing regulations work better and what form inevitable new regulations might take to minimize damage.

Regarding banking stability, efforts to promote it have often backfired, so that "stability through competition" may be more attainable as a practical matter than "stability through protection." The S&Ls showed us that deregulation after years of severe regulation led to a major crisis that required taxpayer funding. But which was the culprit? The deregulation or the prior regulation?

On the question of economic prosperity, we all know the value of creative destruction. Competition promotes innovation. New products or services or technologies are created, which destroys older, less efficient ones. Disruptive in the short run, over time this competition leads to greater wealth and a more prosperous economy—more stability.

The U.S. now has a low inflation rate, close to that of the euro zone. But our unemployment rate has been only half as high as European unemployment in recent years. Ours hasn't exceeded 6 percent in the recent recession or in the so-far jobless recovery. That is stability through competition and allowing creative destruction to work and not be bottled up to explode later. Europe's higher unemployment rate—and greater labor market instability, if you will—results from their efforts to limit competition and protect labor. Our greater stability in labor markets comes from creative destruction, what they try to avoid.

When it comes to banking, competition and creative destruction are less admired. Many policymakers want to safeguard banks from competition and prevent destruction, creative or not. Of course, bank customers (depositors) do have more at stake in a bank failure than a failure of their supermarket. I shouldn't overstate the position of the regulators, however. In trying to prevent bank failures, most authorities acknowledge that zero failures are too few. No failures suggests too little risk taking. Bankers should take some risks. Some should lose money, some should go broke, but not too many.

In addition to the S&L crisis, the banking crisis of the late '80s and early '90s also ensued when product and geographic limits that had restricted competition for decades were finally liberalized and creative destruction finally asserted itself. This is typical worldwide, and all too often the consequences are thought to be the consequences of competition, rather than its prior absence along with the concomitant absence of innovation.

In some ways—especially sluggish job growth—the recovery from the 2001 recession is similar to the recovery from the '90–91 recession. But because of the better health of banking going in, a credit crunch is not the main element of 50 mph head winds this time around. Brazil fared better than expected in the 1998 Asian crisis that threatened Latin America in large part because of timely previous work in shoring up its banking system.

The difference in the performance of the U.S. and Japanese economies during the 1990s had much to do with the fact that the U.S. bit the bullet and fixed its banking system a decade ago while Japan did not. Japan's lost decade owes in large part to that simple difference.

Banking is not everything, however. I had not thought about it before then, but one of the lessons of the Asian crisis a few years ago was that economies are vulnerable if they must rely only on their banks for financial intermediation. I've long felt sympathy for our banks because bank regulation restricted their activities severely over the years, while their nonbank competitors and the money and capital markets were left relatively free to innovate. It wasn't fair to the banks, but it was fortunate for the vitality of the U.S. economy that alternatives to bank financing were well developed. Money and capital market efficiency in this country have contributed greatly to our more efficient and productive economy in recent years. This is not an advantage enjoyed by countries that must rely almost exclusively on their banks for credit.

While I'm not a particular fan of limits on freedom to compete, it does seem to me that minimum capital standards for banks within and across national borders is a rather benign form of bank regulation. Limiting freedom to compete by increasing leverage and betting the farm, capital floors still leave room for price and service competition and innovation. I'm no expert on the Basel II capital standards, but I feel good knowing the large and important role that my friend and colleague Bill McDonough played in their development

While the whole Basel process has been controversial from the beginning, I agree with Chairman Greenspan that by responding to greater market demands for strength in financial institutions, Basel I has contributed to banking and economic stability. And Basel II has even more going for it.

Basel II recognizes that innovation in risk management should occur in the banks themselves and not in the offices of bank regulators or supervisors. Bill and his counterparts should be commended for allowing banks to build their own systems for allocating capital against risk, based on industry best practices. This is quite an improvement over Basel

I, which was one-size-fits-all, rule-based and static. Innovation eroded Basel I. The growing recognition and promotion of industry innovation is, I feel, a sign of better times ahead. That also applies to the new accord's emphasis on greater transparency and market discipline.