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CENTRAL BANKING AND BANK SUPERVISION: SHOULD THEY BE SEPARATE?

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As most of you are probably aware, the Treasury Department and the Federal Reserve in recent months have been actively negotiating to find a proposal to consolidate bank supervision that both parties can support. A compromise proposal, by many accounts, seems close at hand.

Last fall, the role of the Federal Reserve in supervising banks became a target for elimination when the Treasury proposed to consolidate supervision in a new agency, the Federal Banking Commission. The Fed responded to this proposal with one of its own, which would split responsibility for federal bank supervision between two agencies: the Federal Reserve and the proposed new commission.

In the ensuing public debate, a number of issues have cropped up. But from a long-term public policy perspective, perhaps the most fundamental issue of all is whether central banking and bank supervision should be separate. It is that question which I would like to address in my remarks today.

There appear to be two arguments in favor of separating central banking from supervision. One is that supervision distracts a central bank from its primary purpose of conducting monetary policy. As proponents of this argument maintain, the central bank could conduct monetary policy more effectively if it were free of supervisory responsibilities.

A second argument is that, in certain circumstances, the objectives of monetary policy and the objectives of supervision are in conflict. Consider the following situations. First, suppose inflation is rising and threatens

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to accelerate further. If the central bank were unconcerned about its supervisory responsibilities, its objectives would be clear: pursue a restrictive monetary policy to reduce inflation. Such a policy, however, could cause large losses to banks--some might even fail. If the central bank were responsible for supervision, on the other hand, it might pursue a less restrictive monetary policy, tolerating a higher rate of inflation than if another agency had responsibility for supervision.

Now let us suppose the economy is in a recession and losses have weakened the financial condition of banks. A supervisor with no responsibility for monetary policy might put banks under relatively tight supervision, restricting the risk they assume until they can raise more capital. The central bank, on the other hand, might be concerned that such supervisory pressure on banks would delay economic recovery. Accordingly, a central bank responsible for supervision might encourage banks in weak financial condition to continue lending.

Both arguments imply that to separate central banking from supervision would improve the performance of the central bank in conducting monetary policy. The second argument implies that it would improve bank supervision as well. I do not buy either of these arguments. Both completely overlook some of the main purposes and functions of a central bank and the link between these activities and banks.

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The power and significance of any central bank--in any country in the world--rests on one activity: creating bank reserves. A central bank creates reserves by conducting open market operations and by lending to banks through the discount window. The central bank creates reserves for two purposes. One is to achieve macroeconomic goals, such as price stability and sustainable economic growth. Reserve creation affects interest rates, monetary aggregates and bank credit, which in turn help us achieve our macroeconomic goals.

A second objective is to stand ready to act when disruptions in the financial system threaten serious damage to the economy. Because of its role in the nation's payment system, the central bank is the only institution that is capable of limiting the impact of such disruptions.

We tend to take for granted the smooth operation of the payment system. Prior to the formation of the Federal Reserve System, however, occasional disruptions in the payment system damaged the economy.

As bankers, all of you here today are very familiar with the Fed's role in the payment system. While individuals and nonbank financial firms settle their transactions with currency or payment orders drawn on demand accounts at banks, banks settle payments among themselves by transferring ownership of reserve balances at the central bank. The central bank, therefore, lies at the heart of the payment system. Faced with any disturbance in the financial system, the central bank's highest priority is to avoid a system

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breakdown. The central bank attempts to avoid such breakdowns by expanding total reserves and by allocating reserves to individual banks through discount window lending.

With this description of a central bank's role in mind, let me now return to the arguments for separating central banking from supervision. The argument that supervision distracts the central bank from its primary purpose of conducting monetary policy is based on the idea that the central bank needs little information about the condition of banks or little authority over their operation. The central bank, so the argument goes, should concentrate on generating steady growth of the monetary aggregates or on hitting some other monetary policy target. If there is any disruption in the financial system, the market will limit the impact of the disruption.

I maintain that a central bank needs a great deal of information about the operation of the banking industry to be effective in pursuing its macroeconomic goals. Inasmuch as a central bank implements its monetary policy through its interaction with banks, it needs to know what financial condition banks are in and how its policy actions might affect banks' activities. For instance, to control the monetary aggregates requires accurate reports by banks of their deposit liabilities in various categories. Through its regular contacts with banks, the Fed checks the accuracy of deposit reports. During the recent period of slow growth in bank loans, our participation in supervision has also helped the

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Federal Reserve gauge the effects of supervision and regulation on the lending practices of banks.

As proponents of a single regulator point out, however, a central bank does not have to be directly involved in supervision to get the information it needs to pursue its macroeconomic goals. Instead, it could obtain such information through frequent contacts with banks and from a supervisory agency independent of the central bank.

The case for hands-on involvement in supervision thus rests on the second purpose of a central bank: to limit the damage to the economy from disruptions in the financial system. I have reasons to doubt that market participants can or will act to limit the impact of such disruptions on their own. Banking history in the United States illustrates the need for a central authority to deal with a financial crisis. Prior to the establishment of the Federal Reserve, banks acted cooperatively in ensuring that they would have liquidity during a financial crisis.

Banks recognized a conflict between their interests as individual banks and their interests as a group. In a financial crisis, an individual bank would tend to hold onto its reserves and increase its reserve ratio. If it loaned reserves to an illiquid bank, it would risk becoming illiquid itself. As a group, however, banks might worry about the failure of one bank triggering runs on many others.

Banks in various communities attempted to deal with these conflicting incentives by acting cooperatively to allocate

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reserves through a clearinghouse. Normally, their clearinghouse limited its operations to the exchange of checks among its members. On several occasions between 1860 and 1914, however, when the banks in a community faced massive deposit withdrawals as a group, their clearinghouses issued loan certificates to their members. During such periods, the clearinghouses established committees that functioned much like the Federal Reserve's discount window in its early days. The committees examined the collateral pledged by member banks and issued loan certificates to those who qualified. Banks that received the certificates paid interest until the clearinghouse was repaid. For most of this period, loan certificates were redeemed at the clearinghouses within three to four months of the dates they were issued, once the financial crisis had passed.

While the clearinghouses limited the damage of financial crises on the economy, they were not fully effective in preventing them. In 1914, the Federal Reserve was established to provide liquidity to banks in financial crises, as the clearinghouses did, but more effectively.

A central bank must also be prepared to deal with a disruption in the financial system that originates from outside the banking system. To illustrate, I will discuss the Fed's reaction to the sharp decline in stock prices in October 1987. That event created uncertainty among banks about the solvency of both their depositors and other banks. Because of this uncertainty, some banks could have refused to honor

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payment orders by their depositors, especially if honoring such orders would create overdrafts in their deposit accounts. Banks that needed additional reserves to honor their customers' payment orders might have been locked out of the federal funds market. What we could have seen was total gridlock in the flow of payments to clearinghouses to settle securities transactions, possibly forcing a suspension of trading in securities markets.

The Fed responded to this event in classic central bank fashion. First, it increased reserves rapidly through open market operations. Second, it announced that the discount window was open to banks that needed reserves to facilitate the settlement of securities transactions. Thus, reserves were available to solvent banks that might have had limited access to the federal funds market. In addition, the Fed encouraged banks to make whatever payments were necessary to settle securities trades.

What information and what authority did the Fed need to respond so quickly to the decline in stock prices? First, it needed basic information about the financial condition of the nation's major banks. In addition, it needed information about the relationships between these banks and securities firms to determine which banks were the most critical in settling securities trades. The Fed also needed the authority to lend reserves to individual banks so they could make whatever payments were necessary to settle securities trades.

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Finally, the clout of the Federal Reserve as a supervisor may have been essential in inducing banks to make these payments.

Suppose we buy the argument that the intervention of a supervisory authority was critical in dealing with this disruption in the financial system. Was it necessary that the Federal Reserve be that supervisory authority? Possibly not, as long as the Federal Reserve had been able to coordinate its response with that of the supervisory authority. This possibility raises a critical question: Would the central bank and the independent supervisory agency have been able to develop an effective response within a matter of hours? The only way to know for sure would be to remove that authority from the Fed and repeat the experience. Barring that, let us discuss the likelihood that the two agencies could act cooperatively.

What possible conflicts might the central bank and an independent supervisory agency encounter in this situation of a sharp decline in stock prices? An independent supervisory agency would tend to focus on the condition of individual banks. It might have counselled banks to hold up the payment orders of securities firms and limit their lending of reserves to other banks until they had more information about the effects of the declines in stock prices. Such counsel could have worsened the disruption in the financial system and had broad economic implications.

On the flip side of the coin, the central bank's concern about the condition of banks and about the operation of

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financial markets might conflict with good monetary policy. The central bank might end up adding too many reserves through open market operations and discount window lending, laying the foundation for future inflation. As it happens, the Fed did add reserves to stimulate rapid money growth just after the stock market crash, but quickly withdrew those reserves. As a result of Fed actions, seasonally-adjusted M1 rose rapidly in October 1987, but declined in November and December. Thus, the Fed dealt with this potential problem by adding reserves rapidly in the short run without sacrificing price stability in the long run.

In any case, it is inconsistent to argue that there are serious conflicts between the goals of central banking and supervision, yet argue that the central bank and an independent supervisory agency could quickly coordinate a response to a disruption in the financial system. Our experience indicates that it can take separate bank supervisory agencies months to develop common approaches to supervisory issues. In light of that experience, why should we assume that the central bank and an independent supervisory agency would develop an effective crisis strategy within hours?

If we agree, then, that the central bank should remain involved in supervision, how do we deal with the sometimes conflicting goals of monetary policy and supervision? I think the answer is for the central bank to adhere to a long-run strategy for monetary policy aimed at price stability. An

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unstable macroeconomic environment, with accelerating inflation and large swings in market interest rates, is detrimental to the performance of the banking industry. Such performance problems are minimized in a stable macroeconomic environment. Thus, responsibility for bank supervision reinforces a central bank's incentive to pursue desirable macroeconomic goals. Likewise, a strong banking industry affords a central bank the flexibility to pursue appropriate monetary policy at any point in time. Accordingly, a central bank's monetary policy responsibilities reinforce its incentive to pursue consistent bank supervisory policies over time that keep the industry strong.

In conclusion, it is clear that central banking and bank supervision, rather than candidates for separation, are in fact integral activities. The central bank's role in macroeconomic policy, though it may not require hands-on involvement in bank supervision, is probably better off for it. Its role in maintaining financial stability, however, absolutely requires hands-on involvement. Furthermore, while there are at times conflicting short-term goals between central banking and bank supervision, such conflicts need to be resolved promptly and with an appropriate long-term perspective. A central bank that is largely free from short-term political pressures can keep an appropriate, longer-run focus on both macroeconomic and banking stability.

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