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Testimony by

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I am pleased to appear before the Subcommittee this morning. The issues you are raising are both wide-ranging and of immense importance to the evolution of the financial system. I could not possibly do justice to them all this morning. What I will attempt to do, and what I hope will be useful to you, is first to describe the global environment in which U.S. financial firms are likely to be operating over the foreseeable future. Against this background, I will comment on the effectiveness of U.S. banks' competition today and will then discuss some policy implications. I will also comment briefly on competition in securities and financial futures markets and on proposals to change regulatory jurisdiction in these markets.

Globalization of financial markets

Globalization and interdependence are becoming the dominant elements of world finance. Foreign-based financial intermediaries play an increasingly prominent role in U.S. financial markets, and foreign investors are adding to their already significant holdings of U.S. financial and other assets. The volume of transactions by foreigners in U.S. securities markets has increased even more dramatically than foreign holdings. For example, foreign purchases and sales of U.S. Treasury securities surpassed \$4 trillion on a gross basis in 1989, up from \$100 billion to \$200 billion early in the decade. Similarly, foreign purchases and sales of U.S. corporate stocks and bonds have been running dramatically above rates early in the decade. U.S. purchases and sales of foreign stocks and bonds also increased sharply during the 1980s, as did the activities

abroad of U.S. financial intermediaries. This surge in cross-border financial transactions has paralleled a large advance in the magnitude of cross-border trade of goods and services.

A key factor behind these trends in international trade and securities transactions is a process that I have described elsewhere as the "downsizing of economic output." By this I mean that the creation of economic value has shifted increasingly toward conceptual values with decidedly less reliance on physical volumes. Today, for example, major new insights have led to thin fiber optics replacing vast tonnages of copper in communications. Financial transactions historically buttressed with reams of paper are being progressively reduced to electronic charges. Such advances not only reduce the amount of human physical effort required in making and completing financial transactions across national borders, but facilitate more accuracy, speed, and ease in execution.

Underlying this process have been quantum advances in technology, spurred by economic forces. In recent years, the explosive growth in information-gathering and processing techniques has greatly extended our analytic capabilities of substituting ideas for physical volume. The purpose of production of economic value has not changed and will not change. It will continue as before to serve human needs and values. But the form of output increasingly will be less tangible and hence more easily traded across international borders. It should not come as a surprise, therefore, that in recent decades the growth in world trade has far outstripped the growth in domestic demand

for goods and services. This of necessity implies that on average the share of imports as a percent of gross domestic product has grown dramatically worldwide. Since irreversible conceptual gains are propelling the downsizing process, these trends almost surely will continue into the twenty-first century and beyond.

New technology -- especially computer and telecommunications technology -- is boosting gross financial transactions across national borders at an even faster pace than the net transactions supporting the increase in trade in goods and services. Rapidly expanding data processing capabilities and virtually instantaneous information transmission are facilitating the development of a broad spectrum of complex financial instruments that can be tailored to the hedging, funding, and investment needs of a growing array of market participants. These types of instruments were simply not feasible a decade or two ago. Some of this activity has involved an unbundling of financial risk to meet the increasingly specialized risk management requirements of market participants. Exchange rate and interest rate swaps, together with financial futures and options, have become important means by which currency and interest rate risks are shifted to those more willing to take them on. The proliferation of financial instruments, in turn, implies an increasing number of arbitrage opportunities, which tend to boost further the volume of gross financial transactions in relation to output and trade. Moreover, these technological advances and innovations have reduced the costs of managing

operations around the globe, and have facilitated international investment.

Investment considerations also are playing an important role in the globalization of securities markets. As the economy of the United States becomes increasingly intertwined with foreign economies, it is to be expected that both individual investors and institutions will raise the share of foreign securities in their investment portfolios. Such diversification provides investors a means of protecting against the prospect of depreciation of the local currency on foreign exchange markets and against domestic economic disturbances affecting asset values on local markets. As international trade continues to expand more rapidly than global output, and as domestic economies become even more closely linked to those abroad, the objective of diversifying portfolios of international securities will become increasingly important. Moreover, since the U.S. dollar is still the key international currency, such diversification has been, and may continue to be, disproportionately into assets denominated in the dollar. For the same reason, many foreign financial institutions find it beneficial to be represented by banking offices in this country so that they can play an intermediary role based in dollars.

Another factor facilitating the globalization of capital markets and the growth of foreign investments in the United States has been deregulation here and abroad. Technological change and innovations that have tied international economies more closely together have increased opportunities for arbitrage

around domestic regulations, controls, and taxes, undermining the effectiveness of these policies. Many governments have responded by dismantling increasingly less effective domestic regulations designed to allocate credit and by removing controls on international capital flows, relying more heavily instead on market forces to allocate capital.

The globalization of capital markets offers many benefits in terms of increased competition, reduced costs of financial intermediation benefiting both savers and borrowers, more efficient allocation of capital, and more rapid spread of innovations.

Competitive position of U.S. banks

A proper assessment of how well U.S. banks are competing today in the new globally competitive setting must recognize several points. First, U.S. banks are not all alike. In particular, only a very small subset of U.S. banks is active internationally. Second, among those internationally active banks, the extent to which they are competitive varies across products and over time. Third, particularly with the considerable intermediation involving foreign lenders and borrowers in this country and U.S. lenders and borrowers abroad, it follows that simple measures of competitiveness based on gross assets of national banking systems must be interpreted with care. Let me elaborate on these points.

We have nearly 10,000 banking organizations in this country -- treating a multibank holding company as one firm.

They vary significantly in terms of size, the nature of their business, and the areas they serve.

The great bulk of U.S. banking organizations, by number, are fairly small, functioning as intermediaries largely between local savers and local household and business borrowers. However, some of these local banks have become quite large and have evolved into sizable regional banks. The regional, or super-regional, banks draw on a large base of core retail deposits and serve needs of retail borrowers in their regions, but they also do a large and growing corporate business. These banks generally are strongly capitalized and so can support growth in their portfolios. It is these banks that have experienced the fastest growth in the United States over the past decade, benefitting importantly from existing interstate banking compacts.

International banking -- that is, involving transactions that extend across geographic borders -- has not been an important business for regional banks. International assets typically have been less than 5 percent of a regional bank's total assets. Instead, international banking is and has been concentrated in a small number of U.S. banks. Four out of the 10,000 U.S. banking organizations account for roughly half of international assets; 10 of them account for a little over 80 percent.

For those banks involved in it, the nature of the international business has changed. As I noted previously, technological innovations, as well as the need for large

investors and borrowers to protect themselves against the increased volatility in asset prices that we experienced in the 1980s, have led to an unbundling of financial products. With this unbundling and the more efficient dissemination of information, the value of the banking franchise -- to the extent that it was based on a unique role in evaluating credit risks -- has eroded. The international role of the banks has changed from one of simply extending credit to one of facilitating transactions. Partly for this reason, and partly also to economize on costly equity capital, U.S. banks have tended to cut back on those activities that result in assets that must be booked on a balance sheet. For example, they have chosen to reduce drastically their interbank lending business, which is essentially a high volume, low spread business. U.S. banks have devoted their resources instead to banking services that often do not result in assets held by the bank. These activities, such as risk management involving relatively high-tech, sophisticated products, are also the areas in which U.S. banks remain among the world's leaders.

Outside of the banking arena, our markets for securities and securities derivatives--most notably futures and options--also have become part of a globally integrated marketplace. In these areas, especially in the financial futures markets, we have been world leaders, developing new and highly popular risk-shifting instruments along with generally sound clearing and settlement systems. Today, most major international financial markets depend on futures and options for enhancing liquidity

and, in the case of futures, price discovery. In the period just ahead we are likely to remain in the vanguard of financial innovation, especially through the introduction of new electronic trading systems such as the Globex and Aurora systems being developed by the Chicago Mercantile Exchange and the Chicago Board of Trade, respectively. However, as in the area of banking, global competition has become intense in the markets for securities and derivatives and we cannot be assured that our lead in these markets will be preserved.

It has become commonplace to express concern about the increasing share of U.S. banking markets that is controlled by foreign banks, or the declining standing of major U.S. banks in international rankings of the world's largest banks. However, measures of total assets, or market shares related to particular national markets, can be very misleading as measures of international competitiveness, partly for reasons I have already mentioned: only a handful of U.S. banks are internationally active and a significant element of their international business does not show up on their balance sheets. Moreover, banks' operations can be booked at locations throughout the world, and the large businesses that borrow from foreign banks in the United States themselves operate around the world and can and do borrow from the same lenders at many spots on the globe.

Nevertheless, some have argued that U.S. banks are becoming less competitive as a result of the increasing relative size of their foreign bank rivals. While it is important to make sure that we understand why foreign banks have grown relatively

quickly, there is no evidence in the professional literature that the size of an internationally active bank by itself has a significant bearing on a bank's costs or efficiency. To be sure, that literature has not specifically addressed the possibility that some economies of scale could be realized by extremely large banks. But even if so-called economies of super-scale exist, such economies would need to be of significant magnitude in order draw inferences about competitiveness among major internationally active banks. Our research suggests that cost controls and differences in management across banks of the same size are more relevant for competitiveness than any economies of super-scale are likely to be.

Having said that, I hasten to confess that I cannot offer you satisfactory alternative measures of competitiveness. Conceptually, I believe that profitability, as measured by rates of return on equity or assets, is a proper measure of competitiveness. In practice, it is difficult to obtain comparable, up-to-date data on banks from various countries, or to adjust the data we do have for differences in tax or accounting systems. It would be necessary also to adjust realized rates of return for risk; banks can realize higher rates of return at least over some period of time by engaging in riskier activities, but of course those returns are likely to be more volatile.

However, rather than dwell on comparing the competitiveness of U.S. banks versus foreign banks, I suggest that it is more important to focus on the performance of U.S.

banks themselves. From the perspectives of the U.S. financial system, of shareholders of U.S. banks, and most importantly of U.S. consumers of financial services, it is desirable that U.S. banks be operated in as low cost and efficient a manner as possible, subject to concerns about their safety and soundness. This would be true even if U.S. banks already were the most competitive banks in the world. If we get bogged down in struggling to make comparisons of competitiveness, policymakers risk losing sight of the fundamental need to ensure that government policy does not hinder but rather enhances in an absolute sense the competitiveness of U.S. banks and other financial firms.

Policy implications

What, then, can the government do to enhance the competitiveness of U.S. banks? Perhaps the most important thing to do is to reduce the cost of capital to U.S. banks. By the cost of capital, I mean broadly the cost to a bank of raising equity and debt, or more precisely the real pre-tax rate of return it must pay in order to attract debt and equity funds to finance its portfolio of assets. It is often argued that U.S. banks are at a competitive disadvantage because their cost of capital is more than that of their foreign rivals.

For example, the Japanese stock market places very high price-earnings ratios on Japanese equities, and some have argued that the resulting lower cost of equity capital gives Japanese firms a competitive edge over U.S. firms. However, the use of different accounting conventions in Japan tends to understate

Japanese firms' earnings relative to earnings of U.S. firms and hence to overstate price-earnings ratios in Japan. Minority interests are not completely consolidated in Japanese financial statements. Japanese firms issue the same report for tax purposes and for stockholders, so that their financial statements fully reflect the maximum deductions from earnings for such items as depreciation that can be taken for tax purposes; in contrast, U.S. firms issue different reports for tax purposes and for stockholders. Japanese share prices also reflect considerable cross-holdings of equities and of land, both of which have risen sharply in value in recent years without contributing commensurately to reported earnings. It remains to be seen whether the weakening earlier this year in Japanese stock markets is signalling an end to such increases, but in any event the benefits of such holdings will not be captured in earnings unless the assets are sold.

However, even after adjusting for accounting differences, one is left with real economic differences. In addition to Japanese firms' holdings of equities and land, analysts point to the high Japanese savings rate, an expectation of strong growth of earnings, and more generally, the overall macroeconomic performance of Japan. These latter economic differences are under the influence of the policymakers. I, among many others, refer often to the substantial decline in the national savings rate in the United States. All other things being equal, our lower savings causes a higher real interest rate, raising the cost of capital in the United States and

lowering private investment. Although higher real interest rates themselves may encourage more private savings, reducing our fiscal deficit would be a more certain way to add to savings available for private investment, lower the cost of capital, and thereby increase the potential competitiveness of U.S. financial and nonfinancial firms.

Government policy also has a constructive role to play in avoiding macroeconomic instability. If investors think that U.S. banks, for example, face a more risky macroeconomic environment, they will expect lower or less stable earnings and, therefore, will be willing to pay less for each dollar of such earnings.

Beyond changing the macroeconomic environment, the government should consider structural policies that could also help the competitiveness of U.S. banks. For example, there is reason to believe that the opportunity for a bank to diversify the products or services it offers or to diversify geographically may in some cases raise its rate of return and lower its risk. In addition, our laws greatly inhibit the ability of U.S. banks to evolve along with technological and other changes and to achieve the synergies that come from producing multiple, but similar, products and services. Particularly burdensome in this regard is the Glass-Steagall Act. There has been some liberalization in recent years both in geographic restrictions, through regional banking compacts, and in securities activities, through Section 20 securities subsidiaries. But the ad hoc nature of this process of liberalization is not a desirable way

of approaching significant structural reform. The Federal Reserve has supported and continues to support Congressional efforts to address these matters in a more systematic way.

We also are facing important regulatory issues in the area of securities markets, in particular jurisdiction over securities and their financial futures and option derivatives. Some have argued that existing split jurisdiction over securities and derivatives--with the SEC having regulatory authority over securities and securities options and the CFTC having regulatory authority over financial futures and options on such futures--has added to volatility in these markets. The Board has not found convincing evidence to support this view nor have we found convincing evidence that differences in margin treatment across these instruments--another frequent assertion--have contributed to price volatility. However, as I have noted in other Congressional testimony, we do see a role for federal oversight of margins on equities index futures and equity-related options to ensure that margins are maintained at levels that are adequate for prudential purposes.

All of the frequently mentioned proposals for jurisdictional reform in this area--transferring equity index products to the SEC, transferring all financial futures to the SEC, and merging the two agencies--have important costs that must be weighed carefully against any potential benefits. For our part, we are concerned about any jurisdictional restructuring that would limit innovation, a danger that rises as jurisdiction becomes concentrated in a single regulatory authority. We also

are concerned about existing impediments to innovation in this area, in particular, the so-called exclusivity provision of the Commodity Exchange Act. As the Board has already noted, we favor changes to this provision that would enhance the process of financial innovation without compromising the original objectives of the Act.

Competitiveness of U.S. financial firms and markets also is affected by those rules and regulations that can impinge on costs. Examples include non-interest bearing reserve requirements, deposit insurance premiums, capital standards, anti-trust laws, consumer protection laws, and laws to deal with money-laundering. I am not suggesting that they be abandoned simply because they impose costs on banks. What I am suggesting, however, is that we be cognizant of such costs when we weigh the benefits of our policies in terms of our other objectives. Social and regulatory policies are not free, no matter how desirable they may be perceived to be.

On the bank supervisory side, we are proceeding with the implementation of the risk-based capital standards that were negotiated in Basle. Efforts also are underway to coordinate other aspects of supervisory policy, with respect to both banking and other financial services. As banking and other financial services become increasingly indistinct, banking and securities supervisors must work more closely together. The aims of such coordination are basically two-fold. One is to monitor and ultimately guard against risks to the financial system -- risks that are becoming increasingly global and complex in nature. The

other is to minimize the extent to which legitimate prudential concerns distort the opportunities for different kinds of financial firms, from different countries, to compete fairly with one another.

That leads me to my final point. We should continue our informal and formal, bilateral and multilateral, efforts to open domestic markets abroad to U.S. and other foreign banks, both in terms of access and scope of activities. Much progress has been made in this area over recent years, in large part, I believe, because the worldwide process of financial integration I discussed earlier is forcing a liberalization of markets. In some instances, diplomatic initiatives on our part may also have affected the nature of that progress or its timing; such efforts should continue.

In this regard, however, it would clearly be counterproductive to close our own markets to foreign competition merely because foreign markets are less open than we would like. Such an action would invite retaliation and would not be very effective in any case. The globalization of financial markets means that most of the business that foreign banks do with U.S. customers could alternatively be done offshore. To the limited extent that closing of our markets to foreigners were effective, and that U.S. firms were thereby protected from foreign competition, the result would be reduced pressure on U.S. banks and on U.S. policymakers to implement the policies and management procedures necessary to improve the underlying competitiveness of U.S. banks. In the long run, this would clearly be harmful to

the best interests of both U.S. consumers and U.S. producers of financial services.