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Remarks by

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Chairman

Board of Governors of the Federal Reserve System

at the

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It is a pleasure to be in Charlotte today. Before I ever visited your fair city or state, indeed, before I had traveled very far from the environs of Yankee Stadium, I developed a special affinity for Charlotte. In the evenings when I was a boy, I often tuned in the clear radio channel stations around the country--those assigned a unique wavelength--and WBT Charlotte was one that I recall listening to quite often when the atmospherics were just right. By that time radio was not exactly on the cutting edge of technology, but it was not very far from it either. In those days, no one thought of Charlotte as an important national banking center, but as we moved from the vacuum tube of radio to the transistor and silicon chip of current technology, both technological change and the resulting erosion of restrictive laws have permitted creative management to establish financial centers in this country wherever convenient.

The implications of today's relentless technological changes are my subject matter this afternoon.

The United States is currently confronting what can best be described as another industrial revolution. The rapid acceleration of computer and telecommunications technologies is a major reason for the appreciable increase in our productivity in this expansion, and is likely to continue to be a significant force in expanding standards of living into the twenty-first century.

Technological change is but one part of a broader set of forces--an ever increasing conceptualization of our Gross Domestic Product--the substitution, in effect, of ideas for physical matter in the creation of economic value. The roots of increasing

conceptualization of output lie deep in human history, but the pace of such substitution probably picked up in the early stages of the first industrial revolution, when science and machines created new leverage for human energy. Nonetheless, even as recently as the middle of this century, the symbols of American economic strength were our outputs of such products as steel, motor vehicles, and heavy machinery--items for which sizable proportions of production costs reflected the value of raw materials and the sheer manual labor required to manipulate them. Since then, trends toward conceptualization have focused today's views of economic advancement increasingly on downsized, smaller, less "concrete" evidence of output, requiring more technologically sophisticated labor input.

The radio on which I listened to WBT was activated by large vacuum tubes, today we have elegantly designed pocket-sized units using transistors to perform the same function--but with the higher quality of sound and greater reliability that consumers now expect. Thin fiber-optic cable has replaced huge tonnages of copper wire. Advances in architecture and engineering, as well as the development of lighter but stronger materials, now give us the same working space, but in buildings with significantly less concrete, glass, and steel tonnage than was required in an earlier era.

The process of conceptualization in output seems to have accelerated in recent decades with the advent of inventions such as the semiconductor, the microprocessor, the computer, and the satellite. The cutting edge of the new technologies is evidenced by the huge expansion in the dollar value of international trade, but significantly not so in

tonnage. Pounds per inflation-adjusted dollar of American exports, for example, have been falling several percent per year during the past two decades

In the 1980s and early 1990s, many of us were puzzled that the growth of output as customarily measured did not evidence a pickup. Of course, output may have been measured incorrectly. But is it also possible that some of the frenetic pace of change was mere wheel spinning--changing production inputs without increasing output--rather than real advances in productivity?

A number of commentators, particularly Professor Paul David of Stanford University, suggested a decade ago that much of the wheel spinning, if that is what it was, reflected the extended time it typically takes to translate a major new technology into increased productivity and higher standards of living. Indeed, it was conjectured that the big increases in productivity resulting from the introduction of computers and communications equipment lay in the future. If true, he pointed out, this would not be historically unusual. Past innovations, such as the advent of electricity or the invention of the gasoline-powered motor, required considerable infrastructure before their full potential could be realized.

Electricity, when it substituted for steam power late last century, was initially applied to production processes suited to steam. Gravity was used to move goods vertically in the steam environment, and that could not immediately change with the advent of electric power. It was only when horizontal factories, newly designed for

optimal use of electric power, began to dominate our industrial system many years after electricity's initial introduction, that productivity clearly accelerated

Similarly, it was only when modern highways and gasoline service stations became extensive that the lower cost of motor vehicle transportation became evident

While the evidence of a pickup in long-term productivity growth is still sparse, recent accelerations in output per work hour have lent some credence to Professor David's speculations

The same forces that have been reshaping the real economy have also been transforming the financial services industry. Once again, perhaps the most profound development has been the rapid growth of computer and telecommunications technology. The advent of such technology has lowered the cost and broadened the scope of financial services. These developments have made it increasingly possible for borrowers and lenders to transact directly and for a wide variety of financial products to be tailored for very specific purposes. As a result, competitive pressures in the financial services industry are probably greater than ever before.

Technological innovation has accelerated another major trend--financial globalization--that has been reshaping our financial system, not to mention the real economy, for at least three decades. Both developments have expanded cross-border asset holdings, trading, and credit flows. In response, both securities firms and U.S. and

foreign banks have increased their cross-border operations. Once again, a critical result has been greatly increased competition both at home and abroad.

Still another development reshaping financial markets--deregulation--has been as much a reaction to technological change and globalization as an independent factor. The sharply enhanced market signals emanating from the vast set of technology-driven new products have undermined much regulation which rested on the ability to maintain market segregation. Moreover, the continuing evolution of markets suggests that it will be increasingly difficult to support some of the remaining rules and regulations established for a different economic environment. While the ultimate public policy goals of economic growth and stability will remain unchanged, market forces will continue to make it ever more difficult to sustain outdated restrictions, as we have recently seen with respect to interstate banking and branching.

But change often comes slowly, and is viewed as threatening by many. Indeed, it is frequently difficult to reform the rules of the game, as it were, because change requires easing rules and opening options for some while increasing competition for others, redrawing lines that create new limits, and applying some pre-existing regulatory structures to new institutions. However, in my judgment, our financial system has clearly reached the stage where pressures from the market will force dramatic changes regardless of existing statutory and regulatory limits. The ability of financial managers to innovate and find loopholes seems endless.

Recognizing this reality, the congressional leadership appears to have made the decision to attempt to fashion a new set of rules that are both comprehensive and perceived as equitable to all participants

For the Federal Reserve, the basic focus of such a redesign has been the implications of expanded powers, that we fully support, on the special benefits now provided to banks by the federal safety net. In order to help assure stability in the banking system, our society has chosen to provide banks with deposit insurance, access to the discount window, and payment system guarantees. These privileges, while succeeding in enhancing the stability of the system, have also provided a subsidy to banks in the form of a lower cost of funds. Access to the sovereign credit of the United States has meant that bank creditors feel less need to be concerned about the risk-taking of their bank. This requires that the government oversee the risk exposure of banks through supervision and regulation, that is, for government to substitute itself for the market discipline faced by those financial businesses that do not have access to the federal safety net.

In the Federal Reserve Board's judgment, the dismantling of Depression Era separations of financial activities must consider the necessity of containing the safety net subsidy within the existing banking system. The more the safety net is expanded to cover new financial activities the greater the potential that risk-taking will not be subject to market discipline, that bank-like supervision would need to be applied over a wider

range, and that financial innovation--the hallmark of the U S financial system--will thus be constrained

In May, as you know, the House of Representatives passed financial modernization legislation, H R 10, that permits banks, securities, and insurance firms to affiliate Recognizing the problems of the safety net I have just discussed, the House adopted the holding company structure, and not the universal bank structure proposed by the Treasury, as the appropriate means to allow the new securities and insurance affiliations That decision is fundamental to the way in which the financial services industry will develop in the 21st century

The Treasury supports giving national banks the authority to conduct, through subsidiaries of banks, the same powers that are contemplated for the holding company in H R 10 Under this approach, equity investments by a bank in its subsidiary can be financed at the same subsidized cost of capital available to the bank itself The subsidy results from the bank's access to the safety net

As a consequence, the bank's operating subsidiary (or "op sub") would have a subsidized advantage in competing with nonbanking financial institutions endeavoring to offer the same services In contrast, when these services are financed through an essentially unsubsidized affiliate of a holding company, as mandated by H R 10, that competitive advantage is largely neutralized Although the Board strongly favors the

new powers embodied in H R 10, we believe they should be financed by the marketplace, not subsidized with the sovereign credit of the United States

Importantly, large losses in the bank op sub can also imperil the bank and the deposit insurance reserves. Uninsured holding company affiliates provide much greater protection for the banks, the insurance funds, and ultimately the taxpayer.

In addition, should banking organizations be offered a choice between placing new powers in an op sub or a holding company affiliate, they will, if profit is their goal, invariably choose the op sub and its subsidized funding. As a consequence, the holding company structure would atrophy in favor of the universal bank. This is not a problem in itself. But the Federal Reserve's current ability to confront a financial crisis expeditiously rests on our role as holding company supervisor--a regulatory regime that would be quite difficult to replace. Potential significant loss of adequate Federal Reserve hands-on supervisory capability has become an especially important issue in light of the increase of banking megamergers.

The House-passed bill creates real difficulties for some observers since it would not permit commercial affiliations with banks. Technological change has already eroded the distinction between some financial and nonfinancial products. This erosion will only accelerate in the years ahead. Nonetheless, we at the Fed agree with the House decision simply because it is exceptionally difficult to predict with any degree of certainty the implications of combining banking and commerce. Since the decision to do so would

surely be irreversible, we would prefer, therefore, that the rather far-reaching financial reform embodied in H R. 10 be digested before we proceed toward combining banking and commerce. There is no time or market urgency that requires haste. Moreover, the Asian crisis has highlighted some of the risks that can arise if relationships between banks and commercial firms are too close. It is not so much that U S entities would evolve structures like those in Indonesia, Thailand, or Korea. Rather, it is the experience that the interaction of complex structures can make it extremely difficult for management to monitor, analyze, and oversee financial exposures.

I do wish to note, however, that while H R. 10 would permit financial affiliation over a wide range, and while current and proposed mergers would create nationwide banks and financial service companies, not all institutions would prosper as, nor desire to be, financial supermarkets. Many specialized providers of financial services are successful today, and will be so in the future, because of their advantages in specific financial services. Moreover, especially at commercial banks, the demand for traditional services by smaller businesses and by households should continue to flourish. And the information revolution, while it has deprived banks of some of the traditional lending business with their best customers, has also benefitted banks by making it less costly for them to assess the credit and other risks of customers they would previously have shunned. Thus, it seems most likely that banks of all types will continue to engage in a

substantial amount of traditional banking, delivered, of course, by ever improving technology

Community banks, in particular, are likely to provide loans and payments services via traditional banking. Indeed, smaller banks have repeatedly demonstrated their ability to survive and prosper in the face of major technological and structural changes by providing traditional banking services to their customers. The evidence is clear that well-managed smaller banks can, and will, exist side by side with larger banks and other financial services providers, often maintaining or increasing local market share. Technological change has facilitated this process by providing smaller banks with low-cost access to new products and services. In short, the record shows that well-managed smaller banks have little to fear from technology, deregulation, or consolidation.

Most projections of the future United States banking structure call for a substantial reduction in the number of American banks. But these same projections also predict that thousands of banks will survive the consolidation trend, reflecting both their individual efficiencies and competitive skills, on the one hand, and the preferences of the marketplace on the other. Such conclusions of the Federal Reserve Board's staff and others reinforce my own view that the franchise value of the U.S. community bank--based on its intimate and personalized knowledge of local markets and customers, its organizational flexibility, and, most of all, its management skills--will remain high, assuring that community banks continue to play a significant role in the U.S. financial

system. Technology can never fully displace the value of personal contact, the hallmark of community banking.

In closing, let me simply reiterate that the pace of technological change, of globalization of markets, and of the pressures for deregulation can only increase. These changes are affecting both financial and nonfinancial institutions around the world. In most American industries, the responses to these market forces do not require either the Congress or an agency of government to grant permission for the necessary adjustments. However, many of our regulated financial institutions find themselves unable to respond in the most efficient and effective way because of outdated statutory limitations. If these are not revised, my reading of history suggests that the affected entities will find ways to survive, but using methods that do not provide the highest quality and lowest cost services to the American public. Only Congress can establish the ground rules to assure that competitive responses provide maximum net benefits to consumers and a fair and level playing field for all participants.

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