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The Financial System in the Decade Ahead: What Should Banks Do? Setting the Policy Agenda

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Jerome Levy Economics Institute of Bard College

Conference on

The Financial System in the Decade Ahead: What Should Banks Do ?

Round Table III:

Setting the Policy Agenda

Remarks by
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April 16, 1994

There are two levels, the immediate and the longer run, to monetary and financial policy arguments. The immediate level deals with operations by say the Central Bank within a given structure of financial institutions, instruments and . markets. The longer run deals with the legislated structure of both private and public institutions, instruments and markets. Given the time frame of of this conference our interest is in public policy as it deals with and affects the structure of institutions, instruments and markets which evolves as a result of technological changes and the impact of profit seeking financial entrepreneurs.

The economic history of the United States is replete with efforts to get money "right". Recent experience in financial markets shows that we still have not gotten our monetary and financial institutions "right". One reason for this is that to be "right' our monetary and financial structure needs to provide both safe and secure means of payment and funds for the capital development of the country. In addition, in the modern climate, these twin objectives are to be realized even as a close approximation to full employment, reasonable price stability and an adequate rate of economic growth are achieved.

The demands that we place on the monetary and financial system may well be incompatible. The safety and security of the payments mechanism may require core institutions of the

financial structure to reject instruments that abet the capital development of the economy.

Early in the capitalist era it became evident that interactions among the complex of financial institutions, real economic activity and the financing of positions in assets are such that the system can "spin out of control" with disastrous effects for income, employment and economic growth. Doctrines to the effect that money and finance cannot manage themselves led to legislation governing the chartering, organization and supervision of financial institutions but also to the creation of Central Banks, that had two functions:

to guide the economy and the development of financing practices so that short run policy objectives, variously defined, are achieved and

to abort the full development of incoherence by supervising the operations of the then dominant financial institution, commercial banks, and intervening in financial markets as a "lender of last resort".

In our recent experience (the S&L and bank crisis) the carrying out of the Central Banking duty to "abort the full development of incoherence" was not done by the Federal Reserve. It was done by the Treasury, which provided the funds that recapitalized negative net worth Savings and Loan organizations and Banks so that their deposit liabilities were paid at par. The Federal Reserve was not up to

managing the systemic financial institution insolvencies of the past decade.

The Central Banker's theory of how our capitalist economy functions must include propositions to the effect that, under appropriate circumstances, financial fragility is an endogenously determined attribute of modern financially complex capitalist economies and that financial fragility is a necessary but not sufficient condition for financial instability. These proposition, which rationalizes the need for central banking, are not propositions in the orthodox economic theory that guides the Federal Reserve. In pursuit of short term policy objectives the Federal Reserve has tended to neglect how its policies abet the emergence of fragile financial structures.

The present United States financial structure was created in the aftermath of the Great Contraction of 1929-1933. The Great Contraction is an example of the Federal Reserve' inability to prevent the economy from spinning out of control as a result of the solvency problems of financial institutions. The refinancing of banks by the Reconstruction Finance Corporation after the bank holiday of 1933 brought a semblance of order out of the incoherence of the winter of 1932-33.

As a result of the crash a "new" financial regime was put in place which included a restructured Federal Reserve System, the separation of investment and commercial banking, the establishment of specialized financial organizations to

assure that financing would be available on relatively favorable terms for particular sectors (housing, agriculture, rural electrification, exports) and the establishing of "transparency" as the principal guiding corporations and financial markets, along with an agency, The Securities and Exchange Commission, to enforce standards for financing business and operating financial markets. Compartmentalization and transparency are the principles that characterize the New Deal's banking and financial reforms. These principles are being eroded as nation wide branch banking as well as universal banking are being intruded into the financial structure.

Under the "horses for courses" financial structure set up in the mid 1930's, institutions chartered as banks had a monopoly of issuance of non currency liabilities (deposits) that were available for the making of payments, either by means of checks or by exchanging deposits for currency. Combined with deposit insurance, the 1930 reforms gave us a safe and secure payments mechanism. The costs of this bank centered payments mechanism were covered by the difference between the interest paid on deposits and that earned on assets, rather than by non-par clearance or fees for services. This payments system is under pressure as a result of the emergence of credit and debit cards, the rise of money market funds, and the need for banks to pay competitive market rates for deposits.

The banking and financing system quite clearly underwent rapid changes in the past decade. It is easy to extrapolate these past changes and to assert that further rapid changes will take place in the banking and financial systems. The dominance of the holding company form of organization of banking, the soon to emerge nation wide branch banking, the increased importance of trading, with all that this implies for hazarding the capital of banks, rather than lending in the earnings of banks, and the emergence of funds, both mutual and pension, as initial financing sources indicate that the financial structure is not what it used to be. A reconsideration of the structure of regulation, supervision and examination of banks, non-bank financial organizations and of financial markets is needed. In the emerging structure of finance, the lines demarcating the authority of the banking supervisors and the supervisors of corporations and financial markets need to be redrawn.

In our history, successful major reforms of the financial structure of the United States have often been preceded by special investigations either by a joint House and Senate Committee or a broad public-private Commission with an explicit Congressional Charter. The time has come for another Committee or Commission that will examine the entire structure of government supervision, regulation and examination of banking and finance. Only a study that is convincingly serious can command the respect that is needed

for broad reforms that are necessary. The administrations proposal for a unified Federal Banking Commission, as well as the quick rejection of the proposal by the Federal Reserve, and its virtual death on arrival on Capital hill, should be the beginning but not the end of the discourse anent financial structure reform.

The 1934-1935 legislation, which still defines the structure of financial and monetary regulation, was written for as "model T" financial world. We now live in an immensely more complicated financial era. The danger of our current system spinning out of control was illustrated by market reactions to the Federal Reserve's preemptive strike against inflation. The problem of how a central bank which directly affects a decreasing portion of financial markets and financing organizations can cope with the new world of money managers and pure bet financial instruments cannot be swept under the rug.