10-14-1994

Regulation and Supervision

Hyman P. Minsky Ph.D.

1. Introduction

Early in 1994 the Clinton administration put forward a modest proposal for the consolidation of the Federal Government's bank regulation, supervision and examination functions in a new Federal Banking Commission. Officials of the Federal Reserve System around the country, while paying lip service to the virtues of eliminating duplication and the imposition of uniform standards in bank examination, regulation and supervision, took the position that the greater efficiency that an independent Federal Banking Commission was said to promise would lead to a deterioration in the information available for the formulation of monetary policy. The argument was that the flow of information that is provided by the Federal Reserve's participation in bank examination, regulation and supervision is an important input to the formulation of a successful monetary policy. The cost reduction promised by an independent Federal Banking Commission would come at the unacceptable price of a decrease in the effectiveness of monetary policy.

The opposition by the Federal Reserve killed the administrations proposal for an independent Federal Banking Commission for the 1994 legislative year. Nevertheless the combination of the Adminstration's initiative and the Federal Reserve's knee jerk opposition together with the repeated surfacing of difficulties in the financial structure and the Federal reserves pre-emptive strike against full employment in 1994 has put public policy anent the structure and objectives of bank and financial institution regulation, supervision and examination into play. But for the opposition of the Federal Reserve, the Adminstration's proposal could have been passed off as no more than a minor efficiency enhancing shuffling of the deck chairs of bank examination, The successful opposition, which fed the *hubris* of the Federal Reserve so that unwarrented policy initiatives followed, has escalated the discourse, so that questions about the purpose, functions, operations and structure of the Federal Reserve System are now advancing unto the policy agenda: the policy discourse has been bradened.

The performance of the American economy has deteriorated over the past twenty five years. Even before the Administration's 1993 initiative anant bank regulation, the deteriorating perfromance of the economy argued for placing the a fundamental reconsideration of the structure of the banking and financial systems, as well as the fiscal posture of the government, on the policy agenda

The existing structure of banking and financial regulation, examininination, and supervision, the aims and methods of monetary policy, and the basic fiscal policy posture are legacies of public policy responses to the turbulent monetary, financial and economic history of the United States. Reform and restructuring of the banking and financing system have been periodic concerns of public policy. In the century prior to the great depression of the 1930's deep depressions were relatively common . Over this time span both deep depressions and significant sectoral dislocations were imputed to a malfunctioning of the banking and financial system. Each such imputation led to reforms that were designed to "get banking and financing right." The economic, and much of the political, history of the United States could be written as a series of attempts to get banking and finance right.

To get down to particulars, pieces of the present institutional structure of banking and financial regulation date back some 160 years when the conflict between Preident Andrew Jackson and Nicholas.Biddle, the President of the Second Bank of United States, led to the Federal government withdrawing from the chartering and supervision of banking. Some 130+ years ago, the banking crisis of 1857, was taken to imply that the system of state chartering of banks would not do for the now vastly greater naional economy. This view combined with the need to finance the Civil War led to the creation passage of the National Banking Act of 1863, which provided for a system of National Banks.

The National Banking acts sponsors envisanged it as leading to the end of state chartered banks. This did not happen and the United States' dual banking sytem. The weakness of the sytem of banking that grew up under the National Banking Act became apparent as the economy was subject to a series of depressions in the 1880's and 90's.

Finally the weakness of the structure of banking and finance was made apparent by the financial crisis of 1907. This led to the National Monetary Commission which in turn led Federal Reserve Act of 1913. The great contraction of 1929-33 was accmpanied by a cataclysmic cascade of bank and financial system failures ending with the banking holiday of March 1933. Major changes in the structure of the Federal Reserve and the introducion of new sets of players in financial markets followed this crash.

Recent history shows that the struggle to get banking and finance right is not just a matter of history. The breakdown of the Savings and Loan Industry, the various crises of banking in the past decade, and the huge budget busting costs which were required to contain the damage from these breakdowns are indications that basic reform of banking and finance may be needed. The government "bail outs", which prevented a replication of the pass through of losses on assets of banks and thrift institutions to the depositers in these instituions, such as took place between 1929 and 1933, show that we still have not gotten money and finance right.

As the monetary system, the financial system and the economy are always in the process of adapting to changing circumstances, the quest to get money and finance right may very well be a never ending struggle. Throughout our history the reaction to some "unpleasant events" in banking or finance has been to reform of the structure of banking and finance, as well as the structure of government chartering, regulation and supervision of financial institutions.

Our predecessors were not fools: They knew the institutions of their time well enough so that when legislation changed institution, the new structure succeeded in correcting the malfunctioning, for at least the time being. Such a new structure of payments and financing was apt enough, so that a 'better' performance of the economy followed.

However the perennial quest for the profits that successful innovators earn, energizes entrepreneurs. New financial and banking institutions and new financing patterns for business, households and government units emerge and their users prosper. Over time the initially apt pattern of regulation and supervision becomes increasingly inept: the inherited structure of regulation and supervision first becomes not quite right and later becomes perverse.[1] A cumulative effect of the institutional and usage changes that occur is that the institutions which are suppose to contain the endogenous disequilibrating forces of our economy lose much of their power to do so.[2]

Thus the crisis of 1857 signalled the break down of the Jacksonian experiment that allowed the states to determine the scope and practice of banking and finance within their borders. This breakdown, along with the needs of war time finance, led to the National Banking Act of 1863.

The crisis and crash of 1907 together with the accumulation of economic troubles that were imputed to the rigidity of the supply of currency under the National Banking Act led to the creation of the Federal Reserve System.

Federal Deposit Insurance became a reality as a result of the Federal Reserve's failure to contain the widespread bank failures that contributed to the great contraction of the American Economy between 1929 and 1933. The banking acts of 1935 and 1936 changed the Federal Reserve System by abolishing the priveleged position of real bills (private debts) as the offsetting asset for currency on the books of the Federal Reserve banks by allowing government debts to be such offsetting assets.

The recent large scale failures of banks and savings and loan organizations led to legislation that modified the practice of deposit insurance and established rules for the interventions by supervisory authorities when the capital of banking institutions has been compromised.

---

1. This was the essential message of my Central Banking and Money Market Changes, <u>QJE</u>, 1957.
2. The Federal Reserve System is now more than 80 years old and its reform during the great depression is now well nogh sixty years old.

The supervisory and regulating structure for banking and finance that is in place not only reflects institutional features of the economy stretching back over at least 150 years, it also reflects the understanding, i.e. the economic theory, of how our type of economy works that ruled at the time when the bits and pieces of this structure was first put in place.

As regulators and supervisors grapple with their responsibilities their regulatory operations adjust to the evolution of

1. the institutions they supervise,

2. the markets in which these institutions operate and

3. the ideas (economic theory) about how the economy works.

In this manner the actual workings of bank and financial system regulation and supervision necessarily deviates from what was contemplated when the legislation was put in place.

It is the strong endogenously determined evolutionary tendencies at work in a capitalist financial system which assures that the task of getting money and finance right may well be an never ending struggle. What is an appropriate structure of regulation and supervision of banking and finance at one point in time will become inappropriate as time goes by.[3] Getting banking and finance right implies that:

1. the payments mechanism is secure, safe and expeditious,

2. funds for the capital development of the economy come forth at a rate which enables a close approximation to price level stability, full employment and an acceptable rate of economic growth to be established and sustained, and

3. serious deep and long lasting depressions are avoided.

Once what "getting banking and finance right" means is stated as above, it becomes well nigh self evident that it is virtually impossible for any monetary and financial regime to satisfy these standards over any substantial period of time, given the strong evolutionary properties of the financial and banking systems of capitalist economies.

---

3. As Rick well knew even though a kiss is still a kiss, what was right in Paris is wrong in Casablanca.

The resolution, throughout our history, to the dilemma posed by the conflicting economic and financial objectives has been to emphasize some and sublimate others of the stated standards. Thus the basic issue in the Biddle - Jackson conflict over the rechartering of the Second Bank of the United States was that what was then the west believed that the Second Bank of the United States did not provide a favorable environment for the rapid development of the economy. The defenders argued that under the Second Bank a safe, secure and expeditious payments mechanism was developed.

One issue in the emergence of the National Banking Act was the unsatisfactory nature of the currency of the country under the regime of state autonomy, another was the need to create a market for the huge debt the government was taking on during the Civil War. Less than fifty years after the end of the Civil War the national debt was not sufficient to supply the currency needs of the now much larger economy. The Federal Reserve System was created to supply a currency based on private rather than Government debt.

The Federal Reserve System as constituted by the act of 1911 was unable to prevent or contain the great contraction of 1929-33. This led not only to emergency legislation but also to a thorough revision of the Federal Reserve in the acts of 1935 and 1936. Deposit Insurance was introduced as a response to the failure of the Federal Reserve to contain the great contraction. It was felt that placing the government's faith and credit behind the deposit liabilities of banks would prevent further debacles like that of the Great depression.

Experience over the well nigh half a century since World War 2 provides evidence that we still have not got banking and finance right. A massive infusion of funds from the Treasury was required in order to preserve the security of the payments mechanism. At the same time the standards set for a monetary and financial system that is right, the attaining of full employment, price stability and adequate economic growth, have been compromised: the standards of what is an acceptable rate of unemployment and growth have been ignored as monetary and fiscal policy measures have concentrated on controlling the rate of inflation.

2. The Agenda for Regulatory Reform.

The Treasury has advanced the notion that the regulation and supervision of banks in the United States should be reformed so that a Federal Bnaking Commission that is independent of both the Treasury and the Federal Reserve will henceforth be responsible for the regulation supervision and examination of all banks, regardless of where chartered, that operate in the United States.

The Board of Governors of the Federal Reserve System has taken the position that in principle such unification is desirable, but that the unified examination and supervisory function should be a responsibility of the Federal Reserve System. Their argument is that the information input from examinations and regulatory oversight is necessary for the operation of monetary policy.

The structure and aims of bank and financial system examination and supervision is now on the legislative agenda. But the creation of an apt unified structure for regulation and supervision cannot be approached in an intellectual vacuum: questions as to what can be expected of a monetary and financial system need to be addressed. In particular, once the examination and regulatory system for banks is on the agenda for reform, the entire apparatus by which the operations of banking and financial institutions and markets are controlled by agencies of the government is on the legislative table. To use the language of Wall Street the form and function of the Federal Reserve System is now in play.

It should come as no surprise that a regulatory structure for banking and finance, which grew by accretion over the past 140 or so years, needs a thorough overhaul from time to time. Banking and finance are among the most dynamic sectors of American capitalism. Financial institutions and usages change as a result of innovations by profit seeking entrepreneurs, legislation that is enacted in response to perceived shortcomings of the financial structure, and decisions made by regulators and supervisors as they carry on their functions.

Innovations in computing and communication technology have well nigh annihilated distance as a factor affecting financing. Furthermore the computing revolution has enabled a wide variety of new financial instruments to be introduced. An especially marked feature of the evolution of banking and finance in recent years has been that electronic techniques have rendered obsolete many of the inherited ways of making payments and financing activity. Efficiency requires that the regulation and supervision of banking and financial institutions adjust to the realities of modern markets. In particular the multiplicity of agencies that regulate and supervise banking and financial institutions increases the likelyhood that system wide instabilities can emerge.

The need to start cleaning up the landscape of regulation and supervision is especially acute now. The electronic revolution is leading to rapid changes in the national and global monetary and financial system. New institutions and instruments, along with changes in the economic significance of inherited institutions and instruments, are everyday occurrences. A financial system based upon the third millenniums capabilities to communicate and compute promises to differ greatly from the financial systems of 1857, 1863, 1911 and 1935-6, when the foundations of our regulatory and supervisory structure were laid.[4]

4. A potted history would read that
1837 saw the emergence of state chartered banks as the dominant financial structure,
1863 legislation for nationally chartered banks, the elimination of state bank notes and the founding of the office of the Comptroller of the Currency to oversee state banks and the integrity of the currency supply,
1913 the Federal Reserve System and
1930's a reformed Federal Reserve System, Federal Deposit Insurance and the doctrine of transparency as embodied in the SEC legislation.

These self evident observations imply that a unified bank and financial system regulatory and supervisory authority is likely to be good thing. The charter of this new authority, which will replace the existing complex of authorities, should require it to be sensitive to the evolutionary character of our economy and financial structure and to be independent of the particular interests of the constituent elements that exist at any moment of time in the banking and financial structure: in particular this commission is to be mandated not to be a defender of any particular vested interest in the financial structure and to be responsible to inform the Congress of how its powers and responsibilities are being affected by ongoing changes.

For the United States to be the center of the global financial structure into the third millennium the regulatory and supervisory mechanisms of the financial system needs to assure both domestic and international holders of assets that the principle of their holdings in the payments mechanism are safe and secure and that the United States provides access to markets of *unquestioned integrity* for the financing of industry and trade and for the adjustment of positions in assets.

In the Jackson - Biddle fracas over the rechartering of the Second Bank of the United States the lines were drawn between two masters that any capitalist banking and financial system needs to serve: one master requires assurance that the financing needed for the capital development of the economy will be forthcoming and the second master requires assurance that a safe and secure payments mechanism will be provided. In this conflict the forces around Biddle represented the creditor and monied interests, who emphasized the need for a safe and secure payments mechanism, and the forces around Jackson represented the entrepreneurs of the west, who were conscious of their need for financing if they were to develop the continent.

It was understood then and needs to be understood now that development financing involves taking risks, that projects would not perform up to the expectations of their promoters and financiers, and opens the way for fraud and unsafe banking procedures.

The need is for a regulatory and supervising authority for the financial system that accepts that financing development opens the system to losses that have the potential for adversely affecting the safety and security of the economy's payment facilities. To allow for this possibility the regulators need to try to insulate the payments system from the consequences of such losses. The problem therefore is to provide for protecting the payments system from the consequences of the losses which may ensue from development financing. After the experience of the long decade 1980-9192 it is clear that the problem of creating a financial system that simultaneously finances development and protects the payments system against excessive risks associated with non-performing assets is still with us.

3. The Institutions of the Existing Structure of Regualtion

The existing regulatory and supervisory structure for financial institutions provides the initial conditions for any reform of the regulatory and supervisory structure. The players in the current game of developing a supervisory and regulatory system for the financial structure and payments mechanism include

1. The Comptroller of the Currency
2. The Federal Reserve System
3. The Deposit Insurance Facility
4. The Securities and Exchange Commission
5. The Treasury Department
6. The Congress.

RESTART

3.1. The Comptroller of the Currency

The office of The Comptroller of the Currency was established in the National Banking Act of 1863. The National Banking Act was a reaction to the economic and financial crisis of 1857 and the needs of war financing. One aim of that legislation was to eliminate state chartered banking. This aim was never accomplished, although the National chartered banks did acquire a monopoly of the issuance of bank notes.

For purposes of the argumemt that follows the main impact of the National banking Act was the creation of a national currency based upon notes issued by banks which had Federal Government Debt as the offsetting asset on their books: the supply of currency was based upon the national debt.

After the Congress and the Jackson administration refused to recharter the Second Bank of the United States, the United States did not have a unified currency. The currency and banking regime was characterised by each state setting the rules for banking in its borders. This era has been characterized as an era of wild cat banking, although in truth it was an era of wide diversity in the institutions that carried out banking functions. Some states succeeded in establishing effective banking structures, others had a currency which almost always was at a marked discount to their face value.

During this era, except for coinage, the provision in the Constitution that called for The Congress to provide for a money supply whose value it would regulate was ignored.

The National Bank Act provided for a set of banks - the national banks - to be chartered by the Federal Government. These banks were to have a monopoly of note (currency) issue: a tax levied on the bank notes of the State chartered banks was to drive these notes out of existence.

At the time of the passage of the National Banking Act it was believed by many that the taxing of bank notes issued by State chartered banks would drive these banks out of business. However as the National Banks were not granted trust powers, state banks survived as trust companies, as providers of checkable deposits and of non checkable savings accounts.

The survival of state chartered banks meant that the United States had a dual banking system which consisted of both state and national banks.. As the capital requirements for national banks usually were greater than those that many states required for state chartered institutions, state banks played a major role in smaller towns as well as in the neighborhoods of our cities.

State banks were of special significance in the emerging ethnic communities, both urban and rural, during fifty years between the Civil War and the First World War. The existence of both national and state chartered banks as well as a variety of near banks, such as savings institutions, made the conditions for entry into banking easier than they would have been if there was only one chartering organization for banking.[5]

National bank notes were secured by United States Government Bonds: these bonds were the only assets that could serve as an offset to bank notes on bank balance sheets. The Comptroller of the Currency was the chartering agency for National Banks. One of its functions was to assure that National banks were safe and sound and that the law with respect to the issuance of currency was honored.[6] As the economy grew after the civil war the national debt that could be used as the asset that offset bank notes did not grow. Once all of the government debt that was eligible to be the asset that offset bank notes on the books of the note issuing banks were so used, the currency supply became inelastic. Currency and bank financing of activity could not respond to an expanded needs by trade for circulating medium.

The inelasticity of the currency supply meant that the supply of financing from banks was inelastic. This led to chronic constraints on the expansion of the economy and chronic price level deflation. William Jennings Bryan"s "Cross of Gold" speech and

---

5. The conditions of entry into Banking is an important issue in the move for Community Development Banks. See

6. In a little noted provision of the national banking act the Federal Government guaranteed that the bank notes would always be at par. This provision for the guarantee of bank notes can be viewed as a forerunner of deposit insurance.

populist politics, which called for the free coinage of silver at a fixed value relative to that of gold, were responses to the constraints upon economic activity imposed by the National Banking Act.[7]

The National Banking act defined a hierarchy of bank locations and bank functions associated with these locations. Locations were classified as sites for country banks, reserve city banks and central reserve city banks. The capital, reserves and functions of the banks in this hierarchy differed. Country banks could hold their reserve deposits in city and reserve city banks and city banks could hold their reserve deposits reserve city banks. (New York, Chicago and St. Louis were reserve cities) This hierarchy of banks meant that a drain of currency into circulation to the countryside as well as an increase in deposits in country banks was accompanied by a drain of reserves from banks in the central reserve cities, New York, Chicago and St. Louis, into the interior.[8]

Under the National Banking Act a network of correspondent banks developed around city banks and reserve city banks. Country and city banks used the facilities of their reserve city correspondent banks for the processing of checks, for the financing of credits that were too large for the smaller banks to handle and as sources of assets, in the form of participations in loans that the center banks or their correspondents originated.

When the National Banking System was folded into the Federal Reserve System the hierarchy of bank locations was preserved and the correspondent relations continued.

7. So was the Wzard of Oz. for the yellow brick road was the gold standard and it led to Emerald city, a false Utopia.

8. This structural characteristic of the banking structure meant that each autumn the movement of crops to the cities and to foreign customers led to an increase in currency in circulation in the "countryside" along with an increase in deposits in country and reserve city banks. The counterpart of this was a shortage of reserves in New York and the other central reserve cities. Almost every autumn this resulted in a stringency of credit and to threats of financial disarray . The Federal Reserve Act was designed to overcome this flaw by providing a flexible currency and way in which bank reserves could be created to offset these seasonal drains.

The national banking system did not force par clearing of checks upon banks. From 1863 until the Federal Reserve System instituted par clearance, the check payment system involved both checks being deposited or encashed at a discount and the payment of fees to local banks for checks drawn on a bank in a Central Reserve City (New York, Chicago or St Louis: par clearance being practiced among Central Reserve Cities banks.)[9] As a result of this fee for service arrangement, check cashing and the payments mechanism in general were profit centers for banks. Immigrant remittances were a large source of income of banks: this was an especially important source of income for the ethnic banks that grew up as the country grew.

It is noteworthy that the bank notes of the economy - the presumably variable currency - was based upon the holdings of government debt by banks. The successful operation of such a system depends upon the outstanding government debt being large enough so that a substantial amount of government debt existed that was eligible to be used as reserves against bank notes but was not being used in this fashion. Once the entire elegible debt was used as reserves supporting currency and there was no sign that the government debt would increase the National Banking Acts revission was inevitable. The National Banking Act floundered because the United Staes' Government debt was too small.

3.2. The Federal Reserve System

Just as the National Banking System was a response to the crisis of 1857, the Federal Reserve System was a response to a financial and economic crisis, that of 1907. After that crisis, which was resolved largely through the offices of the Morgan Bank, a concensus developed that one flaw of the national banking system centered around the

9. The cash checking services that have become prevelent in the poorer neighborhoods of our country are non-par clearing "banks". See Op. cit.

inflexibility of the currency: the national debt was not large enough to serve as the basis for the currency supply. The supply of currency could not expand when the seasonal flow of commerce drew funds from the eastern banks to banks in the agricultural west or to accomadate the growth of theeconomy.

The Federal Reserve Act was to provide a currency and an ability to finance that was responsive to the needs of trade. In contrast to the national banking act the initial Federal Reserve Act forbad the use of government debt to offset currency. The offset to currency, on the books of the regional Federal Reserve Banks that were to be the proximate supplier of currency, was to be either gold (a minimum of 40%) or rediscounted commercial paper (a maximum of 40%).[10]

The correspondent banks in the central reserve city banks served as the model for the district Federal Reserve Banks: the Federal Reserve district banks could be considerse as a cooperative correspondent owned by the member banks in its district. The correspondent banking system operated through lines of credit at the "city" banks by the "country" banks.

The so called real bills were the bank asset that was eligible to be used as an offset to currency. These real bills were debts supported by documents that indicated that the funds that were raised through these bills finance goods in the process of trade. These bills became bank assets when a business customer of the bank discounted them. Whenever a bank that was a member of the Federal Reserve System which held such papaer had a need for reserves such bills were eligible to be rediscounted at the Federal Reserve Bank of its district.

---

10. Federal Reserve Notes are even now the liability of the regional Federal Reserve banks. The signature of the Secretary of the Treasury and of the Treasurer of the United States on the face of the bill are really "financial" anachronisms: they are statements that this bill conforms to the rules by which these Reserve Banks are authorized to issue such bills. They are not a pledge of the full faith of the United States.

From its very conception the Federal Reserve Act was based upon the real bills doctrine, which held that if the flexibility in the money supply was the result of the discounting by banks and the rediscounting by the central bank of bills which represented goods in the channels of commerce or trade then the economy would have the right amount of money. This "right amount of money" was not only secure in its value but also provided flexible financing for the inventory part of investment.

This amount of money was right for it would not lend an inflationary bias to the economy. Not only was additional money created to finance an increased volume of trade but this addition to the currency supply was temporary. Currency was extinguished when the bill came due and the requisite sums were paid to the bank.

In the language of the day, a supply of money based upon real bill was self liquidating. Whereas an increase in such money might set off an inflationary movement when it was created, the paying down of the debt when the bill became due no only destroyed money but it also set off a disinflationary thrust to the economy. When banks discounted these bills and the reserve banks that rediscounted the bills they became less liquid, and when the debtor paid off the bill the bank and the reserve bank became more liquid.

This doctrine was flawed for a money value of the real bills were discounted and any rise (fall) in prices would lead to a rise (fall) in the value of bills that were discounted: both inflation and deflation could feed upon such a rise or fall in the value of bills eligible for discounting.

The initial Federal Reserve act provided for the Federal Reserve Banks to have a two part balance sheet. Ignoring both the role of the Federal Reserve Banks as the government's deposit bank and the equity of the Federal Reserve Banks, the Federal Reserve Banks had two liabilities: reserve deposits of member banks and Federal Reserve notes (currency). The Federal Reserve Bank's balance sheet was split between these liabilities. To offset Federal Reserve Notes the Federal Reserve Banks needed a minimum of 40% gold and a maximum of 60% eligible paper, i. e. assets which the Federal Reserve acquired by rediscounting real bills of member banks.[11] To offset deposits of member banks the Federal Reserve Banks needed 25% gold and 75% of any other asset. Government debt could serve as an asset offsetting member bank deposits but were not eligible for bank notes.[12]

This system lasted until the great depression. Under the pre great depression Federal Reserve a rise in Federal Reserve Bank notes in circulation combined with an equal fall in member bank reserve deposits would lead to an increase in the gold needed by the Federal Reserve Banks. Furthermore whereas the non gold asset that could offset a Federal Reserve Note had to be real bills that had been rediscounted at a Federal Reserve bank, any asset held by a Federal Reserve Bank could support memeber Bank deposits.

As the great Depression played its course a heightened skepticism about the viability of banks permeated the economy. This led to a rise in currency holdings relative to holdings of bank deposits. Furthermore because of both a fall in the price level and a decrease in economic activity a decline in the money value of the real bills being

---

11. In the 1913 bill, banker's acceptances, which reflected goods in the process of production, were also eligible as "backing" for currency. During the 1920's the Federal Reserve System tried to establish a market for banker's acceptances and failed. The Federal Reserve was trying to set up markets which would enable it to deal with markets rather than individual banks. It was trying to create a structure of finance in the United States which emulated what it believed the structure to be in Britain.

12. During the great collapse of the American banking system and economy between 1929 and 1933 there was an increase in currency outstanding, even as there was a decline in the value of bills that were discounted. As the Federal Reserve supplied currency the ratio of gold required not only shifted from 25% to 40% but, because of the shortage of eligible paper, on the margin Federal Reserve Notes were absorbing 100% gold. Even as there was a large flow of safe haven funds and of gold to the United States fears were voiced that the United States was in danger of running out of gold: of going off the gold standard. The flaw in the 1913 arrangements was at least in part responsible for the failure of the Federal Reserve to play a positive role as the United States' banking and financial system degenerated into chaos in the winter of 1932-33.

discounted took place. As a result on the margin 100% gold threatened to became necessary as the offsetting asset as the depression continued.

The original Federal Reserve System assumed that banks would regularly be financing part of their position by discounting paper at their regional Federal Reserve Bank. Member banks which regularly submitted paper for rediscounting at their districts Federal Reserve Bank were in a customer relation with their regional Federal Reserve Bank. As a regular borrower it was "normal banking relation" for member banks to demonstrate their credit worthiness to their lender, their Federal Reserve Bank. Federal Reserve Bank regulation, supervision and examination of member banks was a legitimate activity as long as member banks were regularly discounting paper at their district Federal Reserve bank.

It is worth noting that there was an element of micro-management of bank lending in the doctrine of "eligibility" which underlay the rediscounting function of the Federal Reserve System. Government, State or municipal bonds, as well as Loans based upon a borrower's general balance sheet and cash flow strength, were not "eligible" for rediscounting, whereas loans with proper documentation that represented goods taken into manufacturing or trading inventories or in transit were eligible.

In the vision that underlay the Federal Reserve Act banks were not to finance the putting in place of durable capital assets. The common role of banks as the providers of construction finance, even as Savings banks and Insurance companies provided take out financing, was foreign to the structure of the Federal Reserve act. The vision of the act restricted the role of banks to the financing of the movement of agricultural products from farm to city and abroad and of imports and manufacturing from source to market. The image of what went on in the economy that underlay the 1913 act was obsolete even as the act was being enacted.

In the discounting and rediscounting banking system Federal Reserve Bank inquiries as to the soundness of member banks business practices had a legitimacy that was derived from the customer relation of the member banks. This customer relation lent legitimacy to Federal Reserves examination and supervision relation with banks.

The reforms of the Federal Reserve System during the great depression marked a shift away from the real bills structure of the original act. Two items in the 1933 -1936 reforms of the Federal Reserve System are of special interest:

1. The gold requirement was equalized at 25% for both Federal Reserve Notes and Federal reserve deposit liabilities.

2. The asset requirements for Federal Reserve Note and Deposit liabilities of the Federal Reserve banks were equalized. In particular this meant that Government debt could be used as the assets offsetting Federal Reserve Notes.

As the depression was followed by the Second World War the government debt increased. As we all know it has remained at a much higher ratio to Gross National Product than it was at the end of the 1920's. Today the currency of the Unites States is mainly offset by government debt. The shift from discounted eligible paper to Government debt as the principle asset offsetting the liabilities of the Federal Reserve Banks has been welll nigh complete. This shift has been accompanied by a change of the non specie asset of the Federal Reserve banks from rediscounted private debts to debts of the Federal Government. Federal Reserve operations have changed from discounting (lending) to banks at a posted rediscount rate to increasing or decreasing reserves by purchases and sales of government debt on the open market. This change has meant that the tool of Federal Reserve monetary policy operations has changed from posting an interest rate at which it wouild discount eligible paper to the purchase and sale of government debt on the open market.

With this change the legitimacy of the Federal Reserve Systems claims be the proper examiner, regulator and supervisor of member banks vanished. There is no legitimate reason that supports a role for the Federal Reserve as the regulator and supervisor of banks now that discounting no longer is the main instrument of the Federal Reserve which affects the reserve base of the commercial banks.

There are many differences between a central bank that feeds reserves to member banks by way of the discount window and a central bank that feeds reserves to banks by way of the market for government debt. In a discount window - eligible paper system the Federal reserve sets the discount rate and then stands ready to supply all funds required at this rate. Presumably the Federal Reserve Bank's rediscount rate was somewhat higher than the rate at which banks would finance their position from their normal customers. The control over the quantity of Federal Reserve liabilities was through the discount rate, but the focus was on financing terms for banks which quite naturally controlled the financing terms for bank customers.

In an open market approach to reserve banking the emphasis is upon the quantity of reserves supplied, especially as the interest rate on the securities purchased and sold by the Federal Reserve may be quite different than the interest rate at which loans were being made.

It is important to note that the regional Federal Reserve banks had a legitimate function in a rediscounting system in a world where communication and transportation are time consuming. It is hard to find a serious reason for the existence of the regional Federal Reserve Banks in a Central Banking system that relies upon open market operations in Government debt by the Federal Reserve System and which possesses our late 20th century capacity to communicate and keep and retrieve records. Knowledge about the credit worthiness of banks and bank customers by the central bank may have been important in determining whether a particular bank was worthy of access to the discount window 80 years ago, but such knowledge is of little significance in the modern, world where individual banks buy their reserves on the Federal Funds market and Federal Reserve Operations are almost exclusively open market operations which aim to get the correct amount of a global aggregate of bank reserves.

A Federal Reserve System, whose sole concern is the provision of the right amount of reserves to the deposit banks, and where the present anomalous archaic institutions, the 12 Federal Reserve Banks, become regional offices of the Board of Governors with managers rather than a President, makes more sense than what we have. The regional banks serve no useful function that could not be as well or better served by regional offices of the Federal Reserve system.

The First and Second Banks of the United States were wisely set up with a date certain at which the charter would terminate. The Congress in 1837 was faced with the need to recharter or eliminate the Second Bank of the United States. It is difficult to believe that any provision for the regional Federal Reserve Banks would be made if the Federal Reserve System were being set up today. If the Federal Reserve charter was up for renewal now I very much doubt that the twelve Federal Reserve districts with Federal Reserve Banks would not be part of the new Federal Reserve System. As it is difficult to find a serious purpose that these banks serve, they are expensive boondoggles.

There may well be a need for the Federal Reserve System to have branch banks in the main money markets to carry out operations. In particular some of the Federal Reserve's operations that affect the reserve base are executed by the Federal Reserve Bank of New York. In a reorganized Federal Reserve System with a somewhat enlarged Federal Reserve Board of Governors one member of the Board could be designated as the operating head of the Federal Reserve Branch in New York.

3. The Deposit Insurance Facility

Since the 1930's the FDIC, which insured deposits at Commercial and Mutual Savings Banks, and the FSLIC, which insured deposits at Savings and Loan Associations have been the main Federal Government Agency with which banks had ongoing financial relations. As these organizations were holders of a contingent liability on the deposits of banks and S&L"s they had an underwriter's right and duty to be knowledgeable about the business operations of those they insured. These agencies were responsible for the integrity of the insurance funds. As the lending (underwriting) standards of those they insured could place the funds at hazard they needed regular oversight to determine whether the insurance should be kept in force for any particular bank.

The systematic deterioration of underwriting standards at Savings and Loan Associations occurred when S&L"s were permitted to finance and even to acquire land for development and later when they were allowed to acquire portfolios of non-investment grade bonds. Any agency which had as an objective the preservation of the integrity of deposit insurance would have forbidden the use of insured funds for such placements. It was a gross neglect by the responsible officials not to withdraw insurance from such organizations or alternatively to raise the rates for the insurance to such levels that the stretching of the risk parameters by particular banks would have been unprofitable.

The root of the S&L debacle of the late 1980's early 1990's lay in the interest rate inversion that was part of the Federal Reserves anti-Inflation monetarist posture of the late 1970's and 1980's. Any bank regulatory and supervisory agency worthy of its keep would have had to go public in opposition to the Federal Reserve's unwarranted excursion into practical monetarism in the Volcker years because of what the Volcker policy was doing to the net worth of the savings institutions. The destruction of the savings banks and the thrifts, which, shades of Jimmy Stewart served our country so well, and the enormous increment to the federal debt that this led to was a consequence of ill conceived if not irresponsible Federal Reserve policies. If deposit insurance, bank supervision and bank examination, and a successful home financing set up centering around thrift deposits and insurance reserves, are to be part of the United States' economic structure in the third millennium of the common era then the cotton picking hands of the Federal Reserve System should be kept out of the bank and financial system's supervision, regulatory and examination process.

3.4 The Securities and Exchange Commission

Perhaps the most significant New Deal reform was the establishment of a rule of law in both the governance of corporations and the operations of the markets for corporate debts and equities. The essential character of the reforms was the recognition that the economy was a corporate capitalism and that this implied that information about the operations of corporations was to be broadly disseminated, available to all who might possibly have an interest in taking a position in an equity or a debt liability of the company. Furthermore as the taking of such positions was accomplished through markets, the markets must be open and transaction information must be both honest and broadly available. Governance, information about the earnings and balance sheets of corporations, the operations of financial markets and the operations of financial firms were to be transparent.

Note that the United States' requirements in re transparency are stricter than those of most (almost all?) other capitalist countries. There is always pressure for a relaxation of the standards of transparency. The image in the United States' transparency requirements for financial markets is that of the individual position taker, an individual whose position is modest.

The growth of large position takers in the form of Mutual and Pension Funds has compromised the transparency of financial markets as changes in positions by such entities often takes the form of sales to position taking traders who then sell out their position over time.

One element that the Congress needs to address is the relation between the Unified Banking and Finance Supervisory Commission and the Securities and Exchange Commission: this has already surfaced in the question of whether particular Bank

Liabilities are securities in the sense of the Securities Commission and therefor require the public supporting information required of a securities issue.

It is worth noting that transparency implies that there exists a set of businesses that analyze and evaluate the information about individual issues. The security analyst is a necessary adjunct to the operations of a corporate economy where transparency is the protection of the individual investor.

The Office of the Secretary of the Treasury

As the ultimate responsibility for deposit insurance rests with the Treasury and as the fiscal position of the government is a main determinate of flow of aggregate profits the Secretary of the Treasury needs to be "represented" in the deliberations of the various banking and financing agencies: The Federal Reserve System, The Bank Regulatory agency and the securities and Exchange Commission.

@@@@@@@@@@@@@@@@@@@@@@@@@@@@@@@@@@@@@@

#. FINANCIAL SYSTEM EXAMINATION AND SUPERVISORY AGENCY.

There is a need for a unified financial system supervisory agency. Ever since the financial system has evolved away from the dominance by banks there is a need for an agency that can look at the financial system in a unified and coherent way. Over the years The Federal Reserve has demonstrated an inability to deal with financial crises. In fact its misguided and seriously wrong headed operations in the late 1970's early 1980's are undoubtedly responsible for the malaise that has struck the American Economy.

The home financing set up that the United States has had ever since the great depression rests upon a long term fixed interest rate mortgage. The weakness in our system is that we melded this mortgage with a set of savings banks which had to meet the short term market for its funding. This set up was viable as long as the Federal Reserve operated to keep interest rates within the boundaries that would keep the long lenders solvent. The Federal Reserve ignored the effect that its operations had upon the solvency of the thrifts and conservative insurance companies when it acted to create and sustain interest rates that were incompatible with the long term assets in the portfolios of these institutions. The experience of the past decade and the prospects for the further development of financial institutions in the next decades indicates that the supervisory, regulatory and examining functions be carried out by an organization responsible to the Congress that is independent of the Federal Reserve Board of Governors but not of the Treasury.

****

A