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The Financial Crisis in the U. S. and the Need for Banking Reform

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The daily headlines report new financial woes in banking, real estate, and construction. The readers of the financial press may believe that the U. S. economy is poised on the brink of deep recession and economic disaster. The most recent GNP statistics confirm a decline of over 2 percent in the last quarter of 1990. Certainly anyone working in the U. S. financial sector has reason to believe that bad times are here and are likely to get worse. We have not seen a recession for nearly eight years. Many young people have never experienced one. Many with greater seniority have forgotten what they are like.

Nevertheless, the reader should be skeptical of the gloom that pervades the U. S. financial press. There has been little change in the armory of economic protection that in the past kept recessions reasonably mild. What has changed is the public's conviction that this armory is worth the cost, creating a fear that the financial system will founder in the midst of a debate over the value of the continued protection.

A. Financial Panics of the Past

To get a truer picture of financial disaster, one has to go back into the past to see what earlier crises were like. Ralph Hawtrey, a noted English economist, wrote on financial crises at the close of the first World War. His book *Currency and Credit* describes the expansion and subsequent collapse of bank credit in terms that will resonate with the experience and the fears of today's banking community. First the expansion:

> It may be that with some new development of business the banks, from sheer inexperience, are beguiled into the easy path of granting credit in ever growing volume. They follow the line of least resistance, like a novice in the art of bicycling, who spins gaily along before the wind for the first time, surprised and delighted to cover the ground so easily, and without suspicion of the struggle awaiting him when he has to return against the wind. (p. 127, 1919 edition)

Followed by the collapse:

> The characteristic of a crisis is widespread bankruptcy. The fall of values diminishes the assets without lightening the liabilities of the merchant who is carrying on business with borrowed money. The failure of the merchant may endanger the solvency of his banker, whose assets, though so long as they are good they are of a fixed money value, depend for their security on the assets of his customers. The failure of some banks, coupled with the reluctance of those which remain to lend, drives traders to sell instead of borrowing, in order to raise the ready money necessary to meet their immediate liabilities. The extreme rigor of the crisis is due to the depreciation of values, already great enough in consequence of the contraction of credit, being intensified by these forced sales. (p. 131, ibid.)

What about the role of the central bank and other regulatory authorities in time of crisis ?

> The central bank ought to make advances on any clearly good security which any borrower may offer. It ought not to hesitate merely because the total amount of its advances appears excessive. To refuse a loan is probably to compel a sale, and every sale tends to depress prices in what is already a panic market. The pledging of a good security for a loan avoids the necessity for inquiring too closely into the solvency of the borrower. But though advances should be made without limit so long as good security is forthcoming, they should only be made at a very high rate of interest. This prevents traders from borrowing more than they really need ; if advances were granted too easily, the crisis might be surmounted only at the cost of starting a new credit expansion. (p. 152-3, ibid.)

And the moral of the story ?

> A crisis may be regarded as a struggle to maintain the standard of value...The true significance of a crisis is therefore this —— that when the monetary unit has been allowed to depreciate it can only be restored at the cost of increasing the burden of all debts, and that, if this is done too suddenly, the debts outweigh the assets of the debtors and cause a multitude of failures. (p. 151, ibid.)

Every participant in today's financial debacle will recognize a role in Hawtrey's drama : the banker who like the bicyclist has loaned money in the expectation of quick, easy, and high reward ; the central banker and bank examiner who bring the party to an end to preserve the "standard of value",i. e., to keep the price level stable. Then to maintain the solvency of the financial system they must rescue it from the wave of bankruptcies and liquidations that ensue on the collapse of inflationary expectations.

B. The Present Financial Crisis

Hawtrey describes an old fashioned financial crisis of the sort the U. S. economy last experienced in the early 1930's. What we have today is a distant cousin. The present financial malaise was not brought on by the Federal Reserve acting in defense of a stable price level, or in an attempt to halt the depreciation of the foreign exchange rate. Nor was it precipitated by a period of tight money and escalating interest rates. Indeed the most likely cause of the crisis was the failure of banks and property developers to modulate the wave of construction that propelled the boom of the 1980's. In many American cities, office space, hotel rooms, and shopping centers remain unrented, while additional space is coming on line. Contrary to some beliefs, the financial crisis and recession in the U. S. has little to do with the war in the Persian Gulf. Vacant office space in the entire country is equal to the total supply of office space in New York City.

This outpouring of new construction is characteristic of a banking system that has not been restrained by risk. The villains of the piece are federal deposit insurance and federal bank examiners. Insurance of Savings and Loan Deposits, combined with deregulation of interest rates and lax supervision of loan portfolios induced individuals to place their money with S & L's that promised high interest rates. Billions of dollars were poured into real estate and junk bond investments that have now gone sour. Deterioration of the real estate market and the junk bond market now threatens the solvency of commercial banks as well. The most recent victim was the Bank of New England (better know by its acronym BNE), the largest commercial bank in this region.

Federal bank examiners have gradually tightened their standards of acceptability for bank assets. Loans of questionable value must be written off against earnings in their entirety, rather than remaining on the books at the fraction of value that will be repaid. The result has been to place a number of major U. S. banks in an earnings-equity crunch. The sudden spate of write-offs has pushed them up against an equity requirement ceiling that will limit their ability to respond to the easing of monetary policy that the Federal Reserve has now begun.

However, we must not forget that federal deposit insurance will also the serve to insulate the economy from the troubles of the banking system. In the past, bank failures or their threat led to large scale withdrawals and liquidations of bank assets. Not only did this shake the market for assets as dramatically described by Hawtrey, but also reduced the liquidity of households and businesses through the reduction in the money stock. Indeed this monetary aggravation was last observed during our Great Depression of the 1930's when federal bank regulators closed banks that did not satisfy capital and solvency requirements.

As a result of deposit insurance there need be no contraction of the money stock and no wave of bank withdrawals. With no repercussions on the money

stock, today's shakeout in banking and real estate is unlikely to cause a general economy-wide depression. There will certainly be unemployment in the building trades as well as a loss of capital value in bank stocks. A number of banks will be forced to merge. This places great pressure on the federal budget, because the government is obliged by deposit insurance to make good the difference between the value of bank assets and deposit liabilities in failing institutions. But having caused this problem in the first place, deposit insurance will prevent it from generating a deep recession.

Moreover, there are unlikely to be any repercussions on the foreign exchange markets or on the foreign exchange value of the dollar. Because of federal deposit insurance, foreign holders of bank CD's and other bank liabilities are confident of the liquidity of their holdings. Despite the failure of the Bank of New England, there will be no rush to other assets or other currencies. In bailing out BNE the Federal Deposit Insurance Corporation applied its "too big to fail" doctrine, in part to assure foreign holders of uninsured liabilities of the commercial banks.

C. The Need for Reform

In the future, a reform of the deposit insurance system is needed to prevent a repetition of the investment binge we have just experienced. Indeed we need a reform of our attitude toward bank failure. So long as Congress and the Executive Branch will not allow bank depositors or bank creditors to suffer from bank failures, our financial system will continue to experience these bank investment binges. The reason is that the depositor and creditor have no incentive to monitor the quality of performance of banks, and therefore no incentive to deny capital to banks that take undue risks. Mr. Average Investor will monitor his portfolio to eliminate securities that are not performing up to expectation.

But he will pay no attention to his bank deposits or CD's. His deposits and CD's are safe, because the federal government will bail him out if the issuer defaults. This is an invitation to excessive risk taking on the part of banks who can attract funds by offering interest rates in excess of the market. If the investments fail, the banks' owners risk only their thin slice of equity. The loss falls on the taxpayer. If the investments pay off, the owners' thin slice of equity earns a high return. Taking good years with bad, when bank liabilities are insured by the government, a bank charter has been a license to print money.

The system has to change, and the sooner the better. The current state of the U. S. financial system should certainly stimulate a debate over its restructuring. Such a debate has not occurred since the 1930's, when President Roosevelt's New Deal established the present structure of banking and bank regulation.

Sixty years later, American banks are ill-suited to compete in world markets or to compete with other American institutions capable of providing similar finan-

cial services. Because of the variety of alternative institutions, American citizens and companies can do their business without banks. They can do their personal and company checking at money market mutual funds and brokerage houses ; corporations can borrow in the commercial paper market or from life insurance companies and leasing companies ; individuals can borrow to buy houses and automobiles from leasing companies, auto finance companies, mortgage companies, and life insurance companies.

One of the reasons the banks are in trouble is that they are hemmed in by a maze of government restrictions that reflect conflicts in federal policies. Commercial banks cannot engage in interstate competiton. They must operate in the state in which they are chartered, and indeed in many states, Illinois being a notable example, they cannot establish branches, but must operate from a single location. Banks must also satisfy minimal capital requirements, i. e. they must satisfy federal examiners that they are not threatened by insolvency. If the examiners are not convinced, they have the authority to restrict the lending activities and the dividends that the banks pay out.

These restrictions make little sense. Can you imagine the U. S. government preventing an airline from serving passengers or borrowing money in a state other than the state that issued its corporate charter ? Or can you imagine the government requiring an airline to increase its equity capital, or to refrain from paying dividends ? This is exactly the situation banks find themselves in.

Banking restrictions and regulations arose because of fears generated during the great depression of the 1930's, indeed legitimate fears, that bank failures were responsible for the depth and longevity of the depression. Bank failures wiped out the financial wealth of depositors, and led to waves of liquidation of bank assets, e. g. bonds and mortgages. New businesses could not borrow and consumers found themselves too poor to buy or to borrow.

The new Deal's solution for this problem was federal deposit insurance combined with narrow regulation of bank investment behavior. The purpose of deposit insurance was to protect the depositor against loss of his money should the banks ever fail again. Deposit insurance eliminated the fear that the banks would be unable to convert deposits into currency, and eliminated the threat that depositors would run the banks, thus forcing liquidation in times of panic. Thus deposit insurance effectively prevented sudden declines in the most important component of the money supply, checkable deposits. The purpose of narrow regulation was to monitor the banks' investment behavior, and thus prevent the banks from failing.

Now the New Deal solution itself is itself in danger of failing. Over the last 15 years, U. S. banks have engaged in a series of losing loan campaigns. One need only list the failed loans to Latin America, to oil companies in the early 1980's, the binge buying of junk bonds, and investment in commercial and residential real estate.

The only banks to have escaped this debacle were so conservatively managed in the last twenty years, that they were labelled the fuddy-duddies of the industry.

With the benefit of hindsight, one might conclude that these failures could have been prevented by intelligent and conservative regulation. But no regulator is so smart as to be able to foresee the future, and the few who forecast trouble are treated as Cassandras and ignored. Moreover, those regulators who foresaw the problem in the savings and loan sector were subjected to intense political pressure to ease up. My conclusion is that the future stability of the U.S. banking system cannot rest on the expectation that the regulatory bureaucracy will act with wisdom and courage.

The already depleted balance in the Federal Deposit Insurance system is threatened by large scale defaults of a number of major commercial banks. If the closing of Bank of New England is followed by other defaults, the Federal Deposit Insurance Corporation will need infusions of federal funds similar to the recent bailout of FSLIC (Federal Savings and Loan Insurance Corporation), when the savings and loan banks went under.

D. The Abuses of Deposit Insurance

Of course, much of the blame for the present debacle must fall on the deposit insurance system itself. Because deposits are insured by the federal government, the depositor does not care in which bank he holds his money. The money is safe. The result is that the money is made available to the bank at interest rates lower than what the bank would have to pay if there were no deposit insurance. One need only compare the lower interest rates that commercial banks pay on federally insured checking deposits with the rates paid by money market mutual funds (that do not get federal insurance) to perceive a rough measure of the subsidy that deposit insurance provides to the commercial banking system.

A more threatening consequence of deposit insurance is the elimination of care by the depositor in his selection of which bank to place his money. When an investor buys a share of stock in a corporation, he normally investigates the quality of that corporation's securities, to assure himself that the firm is well managed, makes careful investments, and has a record of dividend payments. This care is absent when the investor chooses where to open up a bank account. We have already seen in the S&L debacle the consequences of this blind placement of deposit funds. Many of the S&L's were badly, evenly criminally, managed, and the funds went into real estate investments that have now soured.

E. Eliminate Deposit Insurance

What is the answer ? I believe that the money supply should be separated

from the banking system.[1] That is to say, demand deposits should be backed 100% by guaranteed securities and issued by transfer banks that do not make loans to the private sector.[2] The income of the transfer banks would be derived from interest on the guaranteed securities and service charges to depositors. Because the transfer banks would hold only guaranteed securities, they could not fail. The money supply would be safe from fluctuation in the value of banks' assets, a feature that commercial banks cannot guarantee.

The way to accomplish this reform is to eliminate federal deposit insurance entirely. The effect would be to create a market for the services of a financial institution that is presently in the wings of the banking scene, but would now take center stage. This is the money market mutual fund that invests in short-term U. S. government liabilities, e.g. Treasury Bills. This type of institution presently offers liabilities payable on demand such as checking deposits. The deposits are in effect fully guaranteed, because they are backed 100% by Treasury Bills, yet they are not protected by a deposit insurance fund. Because of the certainly of conversion into currency on a dollar for dollar basis, there is never a problem of converting the fund's assets into cash at full face value. The depositor need never fear for the safety of his money. And this guarantee operates without federal deposit insurance.

Once deposit insurance is eliminated, individuals will seek to transfer their money to such money market funds. A money supply that is backed by Treasury Bills cannot default, because the depositor can immediately on demand convert his holdings into an asset with a guaranteed nominal value (at its maturity date). Such funds already exist. They are offered in the U. S. by the money market mutual fund operators such as Fidelity and Dreyfus. At the moment, their popularity is limited by the existence of federal deposit insurance on commercial bank deposits. But once deposit insurance itself is eliminated, these T-Bill funds would come into their own.

The advantage of my proposal is that it eliminates the danger to the money supply from threatened insolvency of commercial banks. It would do away with the potential need for the taxpayer to bail out a financially embarrassed FDIC, the way

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1. This proposal was made famous in the 1930's by Henry Simons, an economist at the University of Chicago. Simons called it 100 percent money, and advocated that the government require the banks hold 100 percent reserves against demand deposits, thus assuring the conversion of deposits to currency. My proposal differs from Simons. The government need not mandate the 100 percent reserve requirement. As I describe above, the same effect is achieved by the total elimination of deposit insurance and the consequent voluntary shift of deposts to transfer banks that hold 100 percent reserves in the form of short term government debt.
2. In the economics literature, transfer banks are sometimes referred to as narrow banks, to distinguish them from banks that carry out the full range of commercial banking transactions.

in which the U. S. has already spent billions to bail out the Savings and Loan industry. In the future, commercial banks will have to attract capital by offering sufficient yields to investors to offset the lack of insurance on their liabilities. The commercial banks will then act as investment intermediaries, mutual funds if you like, offering ownership shares with either variable or fixed face value, but without the guarantee of deposit insurance. Banks will lend money to individuals and corporations just as they do today, but they will have to offer a rate of return to investors in their shares that compensates for the risk. At the moment, depositors who provide the lion's share of bank funds face none of the risk. Under the new arrangement, those depositors who prefer certainty in the face of higher returns on commercial bank deposits will keep their funds in the transfer banks. Others who wish to trade certainty for the higher yield will keep their money where it is now, in the commercial banks.

Once the separation occurs between the money supply and the commercial banks, there is no longer any need to need to subject these banks to a higher degree of regulation than ordinary commercial enterprises, and no excuse for restricting the degree of competition in the banking market. The banks themselves will become more efficient and profitable, because they will be allowed to enter markets without restrictions, whether it is the sale of insurance, the underwriting of securities, or the sale of other financial services. Moreover, other firms should then be allowed to go into banking. The present balkanization of the securities and financial markets can disappear.

F. What Can Japan Learn from the U. S. Experience ?

What is the moral for the Japanese financial system ? Some Japanese observers will opine that the problems of the U. S. system are due to deregulation, and that a properly regulated banking system could never experience the asset degradation and the financial losses that have occurred in the U. S. In one sense this is true. Japan does not have the anomaly of the unit banking system that afflicts the U. S. A smaller number of banks are easier to regulate, and with their relatively larger size, they may be better able to enjoy the benefits of portfolio diversification. Significant portfolio losses in the Japanese banking system, were they to occur, could not be blamed on the small size or the restricted portfolios of such banks.

But the Japanese banking system may be subject to the same problem that afflicts portfolio managers in the U. S., namely the land speculation disease. No speculative market enjoys price increases forever. Those Japanese banks that base their equity position on their holdings of land or their holdings of real estate mortgages have to worry about the same problems that have already occurred in the U. S.