

The economy and the banking system*

Banking, as we all know, is inextricably linked with conditions in the economy. How can the strength of banking be maintained in the face of the tremendous economic problems that appear to confront us?

The answer, I think, is becoming increasingly clear. I am convinced that the longer-term success of the economy and of banking in our free world is dependent upon a revitalization of the free marketplace.

Solutions to general economic problems—whether energy, inflation, or recession—cannot be based on short-term myopia or short-circuiting of the free market. Time and time again we have seen short-sighted, stop-gap measures fail, only to witness the reemergence of the same problems with greater intensity a short time later. We are in danger of being drugged.

Whether the current economic problems create major and lasting disturbances to our economy, or simply require modest adjustments, depends on the nature of our response. If, for example, we react to our current inflation problem by adopting drastic policies designed to cure inflation within the next year, we will surely compound our difficulties in the long run. The problem is best attacked by policies of moderation, pursued with unremitting determination, over a period of years.

Similarly, in the case of our oil problem, if we attempt through the construction of a vast set of rules and regulations to ensure equity in distributing the burden of the reduced supply of oil and soften its impact on favored sectors—as the United States is trying so hard

to do—we will inevitably suffer far more in the final analysis than if we simply let the market do what it does best—allocate resources where and to whom they yield the greatest return. As an economic consultant was recently quoted in the *Wall Street Journal*, “There aren’t any lines of people waiting to buy lobsters.”

I believe that the very essence of our economy and our society are in the balance today as we stand poised before the two alternative paths of further government regulation and deregulation. As directors for highly regulated institutions, you must share that sense of concern.

I obviously cannot cover the whole regulatory maze in our society this evening. But let me touch on a few aspects of banking regulation that illustrate the nature of the regulatory problem confronting us.

At the outset, I should make it clear that I do not oppose *all* regulation. That would be a misguided position. Indeed, where the costs arising from any activity are borne by a third party rather than by those engaged in that activity and are very large, and the costs, measured by the administrative difficulty and effectiveness of a regulatory solution are very small, regulation is clearly in order. I would only argue that such situations are not clearly as common as is generally believed.

The contrast between my position on regulation and that of many others may be illustrated by an example taken from a recent conference on regulation jointly sponsored by the National Journal and the American Enterprise Institute. A consumer advocate attacked cost-benefit analysis as a fraud, shot through with technical and methodological errors. An honest person must agree that current approaches to measuring costs and

*Excerpt from a speech made by Mr. Robert P. Mayo, President, Federal Reserve Bank of Chicago, to the Thirty-Sixth Assembly for Bank Directors, Harbour Castle, Toronto, Canada, June 7, 1979.

benefits of public policies are deficient. They are, however, usually the best that are available and are constantly being improved. Be that as it may, my objection to such a remark is not with its appraisal of cost-benefit analysis, but with its conclusions for regulatory policy—which would put the burden of proof on those who oppose a particular extension of federal regulation. This, to my mind, is an example of the conquest of reason by ideology; I would not even consider accepting the nuisance of regulation absent a clear showing that its benefits outweighed its costs by a considerable margin. I think you will be easily convinced that some regulations in banking would not meet this test. Moreover, it seems to me that many of the regulations currently in place in banking are inappropriate for the purposes they are designed to achieve. Many are, in fact, in direct conflict with one another.

There is a fundamental question as to whether or not the banking industry is one in which regulation is likely to offer great public benefits. The answer is by no means as clear-cut as has often been assumed. To be sure, if one looks at the experience of the 19th century, with its recurring business depressions, liquidity crises, and waves of bank failures—which not only wiped out the savings of many depositors but temporarily crippled the payments system—one might conclude that strict regulation of banks was absolutely essential. For many, the ultimate proof of the need for detailed regulation of banking was given by the Depression of the 1930s, when some 9,000 banks closed their doors.

Yet, a more critical appraisal calls into question the usual interpretation of the evidence available about American banking history. For one thing, it has never been satisfactorily answered how much of the distress of the banking system in the 1930s was due to bad banking practice and excessive competition, and how much was due to preventable errors in macroeconomic policy, including the monetary policy pursued by the Federal Reserve. More recent studies of those years have tended to place much more weight on the latter, and correspondingly less on the

former, than did students of banking in 1933. Much more important, the primary external cost related to banking that might be cured by regulation—the fact that even well-managed banks often used to fail when a general distrust of banking led depositors to try to withdraw their funds—was, for all practical purposes, eliminated by the introduction of federal deposit insurance. Indeed, it might be argued that the primary justification for regulation of banks today is that the FDIC's insurance assessments are a flat percentage of total deposits rather than assessments based on the relative riskiness of bank portfolios. This subsidizes risk-taking. It makes it necessary to impose constraints on bank behavior.

Perhaps more than anything else, the conventional wisdom has held that it was excessive competition for deposits and the consequent “reaching for yield” in the form of riskier loans and investments that brought about the debacle of the 1930s. As a consequence, the most important restrictions placed on bank activity by the Banking Acts of 1933 and 1935 involve restrictions on entry into banking and on the payment of interest on deposits. During the subsequent 30 years, the effect of new entry restrictions was to reduce new capital investment in banking by an estimated 50 percent below what it would have otherwise been. Meanwhile, the interest ceiling restrictions, becoming inoperative when market rates fell far below the ceilings in the mid-1930s, had little effect. Beginning in the early 1960s, however, interest rate constraints pinched banks more and more as the economy and loan demand expanded and bankers' memories of the Depression faded.

Unfortunately, just as more and more bankers and regulators were becoming convinced that deposit rate ceilings were not necessary for the maintenance of bank solvency, the credit stringency of 1966 brought a new rationale for their existence—the protection of thrift institutions and the residential mortgage market from the ravages of disintermediation. That the use of interest rate ceilings for such a purpose must eventually prove futile has only recently come to

be widely recognized.

Concern for maintaining competition in banking, rather than simply solvency, was reawakened in the early 1950s by a wave of bank mergers that threatened increased concentration in local banking markets. This concern, after several attempts to adopt new legislation in the early 1950s, produced the Bank Holding Company Act of 1956 and the Bank Merger Act of 1960. It also resulted in several antitrust suits attacking collusive price fixing by local bank clearing houses. The same concern over the lack of aggressive competition in banking led the Comptroller of the Currency in the early 1960s to ease restrictions on entry and authorize banks to enter a number of new activities.

Thus it was that, by the early 1960s, a distinct inconsistency had developed in bank regulations. On one side, regulation had the expressed purpose of restricting bank competition and risk-taking. Yet other laws and administrative rulings had the clear purpose of enhancing competition in banking. For example, freer entry and legal sanctions against merger or collusion to hold down interest rates on depositors' funds was intended to encourage banks to compete for funds. At the same time, Regulation Q ceilings on deposit rates either prevent such competition from occurring or force it to take other, nonprice forms. This inconsistency of purpose is what I would characterize as the schizophrenia of current bank regulation.

Of course, inconsistency is one thing; simple wrongheadedness is something else. And it is under the heading of the latter that I would like to discuss the phenomenon of interest rate ceilings. Let us accept for the moment the conventional wisdom that banks need to be protected from excessive competition. It is, nonetheless, true that deposit interest rate ceilings, including the zero ceiling on demand deposits, have been the most costly and ineffectual interferences with the free marketplace in the financial arena ever devised by man. They are costly because competition has forced banks to resort to ever more circuitous and ingenious, but highly inefficient, means of circumventing the

regulations in order to stay in business. They are ineffectual both because the banks have kept a few steps ahead of the regulators most of the time and because other, less heavily regulated institutions have found ways to invade markets that formerly had been the exclusive preserve of commercial banks.

The net consequence of deposit interest rate ceilings through the years has been that the high costs the ceilings were designed to protect the banks from are still paid, but in a different form. Depositors have been deprived of the option of taking their interest in cash but are in effect forced, instead, to accept stuffed lions or kangaroos or a clock or a rose bush. Banks have lost position in the competitive financial markets. One of the few areas where the ceilings have been relatively effective is on small passbook deposits whose owners have few investment alternatives. There we witness the spectacle of the federal government enforcing a negative real rate of return on the savings to maintain the profits of banks and thrift institutions. This is not a radical's perception of how the system works; it is a simply factual description of the effects of deposit rate regulation. It is this aspect of the ceilings that led the late Professor Ross Robertson of Indiana University to characterize Regulation Q as "wicked."

It would take more time than I have at my disposal to catalog the many and varied direct and indirect social costs of deposit interest rate ceilings through the years. Many of the most renowned financial "innovations" during the past two decades—the development of the negotiable CD market, Eurodollar borrowing by U.S. banks, the sale of loan participation notes, the sale of commercial paper by bank holding companies, the nonbank repurchase agreement market, the advent of NOW accounts, money market mutual funds, telephone transfers from savings accounts, and, most recently, automatic transfer accounts—are all costly and cumbersome means of getting around the law's proscription of the payment of market interest rates on deposits. What any first-year economics student is taught to recognize as an economic absurdity has been codified for more than

four decades as the law of the land.

The ramifications of the regulation of interest rates on deposits extend well beyond their costs to banks and bank depositors. One of these, which has come into the limelight recently, is what the ceiling has done to the informational content of the traditional monetary aggregates the Federal Reserve must rely on in formulating monetary policy. The ceilings encourage the long-term growth of money substitutes. This, in turn, tends to produce a long-term upward trend of income velocity based on any narrow definition of money (with pronounced discontinuities marking the advent of major innovations in the financial system). The ceilings also result in a confusing cyclical pattern in the relative growth rates of narrow and broad definitions of money. At the present time, for example, we are seeing a rapid growth of nonbank repurchase agreements, some portion of which functions as demand deposits during most of the day before being taken off the bank's books at the close of business, thus making it more difficult to interpret even the basic thrust of monetary policy.

One may argue with some cogency that the most recent trends in regulation are in a generally sensible direction, toward the elimination of arbitrary price controls in banking. Certainly, the advent of NOW accounts and ATS accounts has moved us a long way toward the simple payment of interest on demand deposits. And the authorization a year ago of the issue of money market certificates tied to the Treasury bill rate has cushioned financial institutions against ceiling-induced disintermediation on the scale that occurred in 1965 and 1969. Moreover, the recent testimony of Governor Partee before a House Banking Subcommittee makes it clear that the Federal Reserve now endorses in principle the payment of interest on demand deposits, desiring only that any such move be tied to a resolution of our Federal Reserve membership problem.

However, at the very time that sanity appears to be emerging on one regulatory front, a disturbing new trend is making its appearance on another front. I am referring

to the increasing tendency to regard the regulation of financial institutions as an appropriate means for effectuating broad social goals and the increased willingness to substitute official views of what is desirable for the judgments of the free marketplace.

This trend has its roots in the consumer movement of the late 1960s and 1970s. It has, however, moved far beyond Senator Paul Douglas' Truth in Lending law and its reasonable demand that bankers state, in as uniform, simple, and accurate a fashion as possible, what rate of interest they are charging for various forms of credit. We might speculate that if Senator Douglas were alive today, he would be appalled at how complex and difficult to understand the regulations designed to implement this seemingly simple goal have become. Examples of what I have in mind here are the Fair Credit Reporting Act of 1970, the Fair Credit Billing Act of 1971, and the Equal Credit Opportunity Act of 1974, the Consumer Leasing Act of 1976, the Real Estate Settlement Procedures Act of 1974, the Home Mortgage Disclosure Act of 1976, the Community Reinvestment Act of 1977, and the Financial Institutions Regulatory and Interest Rate Control Act of 1978. These pieces of legislation have laudable purposes. They hopefully ensure that people's credit records are properly reported, that they are billed accurately on their revolving charge accounts and have adequate opportunity to make their complaints heard, that lessees have the terms of leasing contracts fully and accurately disclosed, that homebuyers are advised well in advance of the closing date of all charges related to the extension of credit on home mortgages, and that financial institutions actively serve the credit needs of the communities in which they are located.

On paper, these laws remedy many of the complaints consumers have made about the credit granting process over the past decade or so. In practice, however, it is often difficult to determine whether a particular financial institution is in compliance. It is even more difficult to ensure that the laws will be observed in the future. The process of trying to do so involves enormous costs in terms of

reporting, disclosure, surveillance, and litigation. What has not been established with any degree of certainty is whether the benefits actually realized from the laws justify the costs of the regulatory apparatus designed to ensure compliance with the laws. Some recent research suggests that the costs of compliance with the Equal Credit Opportunity Act—estimated at \$293 million—exceed any plausible estimate of benefits. Indeed, some of the more careful research done in recent years fails to find evidence of either systematic discrimination in lending on the basis of sex or of the commonly charged offense of redlining, the systematic denial of credit to borrowers in certain areas of cities without regard to the actual lending risks involved.

This is not to deny that these types of discrimination may, in fact, occur in isolated instances. Of course, there is evidence of systematic discrimination in lending in some cases. But it suggests to me that consumers may be better served, in the overwhelming majority of cases, by relying on freer entry and more intense competition to ensure fair treatment—not on forced compliance with an extensive regulatory apparatus. It is especially distressing that these laws were adopted in the absence of any credible estimates of the magnitude of the alleged problems they were designed to deal with or even the most remote notion of the costs of implementing them.

But, let us assume for purposes of argument that there have been some pervasive and well-documented abuses in the granting of credit that need to be remedied and that this can only be done by regulation. Nevertheless, there are serious grounds for objecting to several provisions of the laws enacted in recent years. For they go beyond ensuring that the consumer is fairly treated and knows what he is paying. They go beyond what his obligations are. They arbitrarily dictate the substantive provisions of credit contracts and direct the allocation of credit toward areas or purposes deemed worthy by one or another special interest group or federal agency. Many examples can be cited: High on the list are limitations on the amounts

a lender can require for tax and insurance escrow payments under the Real Estate Settlement Procedures Act, the current prohibition of variable rate mortgages to federally chartered savings and loan associations, the federal limitation of cardholder losses from unauthorized use of lost or stolen credit cards to \$50, and the requirement under the Community Reinvestment Act that the geographic distribution of a bank's loans be considered in judging its application for a new branch. And it is not only Uncle Sam who is so zealous. State usury ceilings, and the increasingly restrictive state limitations on such creditors' remedies as wage garnishment, wage assignments, deficiency judgments, and "holder-in-due-course" clauses, all inhibit sound financial dealings.

The least of the undesirable consequences of the restrictions on creditor remedies is to raise the cost of credit to all borrowers and require good credit risks to subsidize the credit extended to poor credit risks. And in conjunction with the liberalization of the personal bankruptcy laws, these restrictions have had the very damaging social effect of undermining the belief, to which most of us have subscribed all our lives, that the repayment of freely contracted debt is a serious moral obligation. The extent to which the recent swing of the pendulum away from the rights of creditors in favor of debtors has altered traditional views of borrowers' responsibilities was documented in a recent article in the Chicago Tribune's Sunday magazine entitled "Bankruptcy and the new state of grace." In it, a Chicago lawyer—who obviously asked to remain anonymous—is quoted as saying:

People have been brainwashed that it's wrong not to pay their debts no matter what. I want everybody to know that you don't have to. That it's *right* not to pay when they can't. I want everybody to know they have a legal and moral right *not* to pay. And the U.S. Supreme Court in 1973 backed that up.

It would be hard to imagine a more clearcut indication of decline in the moral fiber of our

society, or one with more ominous undertones for the continued efficient functioning of a credit-based economy.

Other new laws and regulations attempt to achieve by indirection, goals whose costs the electorate apparently refuses to bear through direct taxation. For example, the Community Reinvestment Act's emphasis on local lending essentially requires the banks' depositors and shareholders to subsidize what is deemed a worthy social goal—i.e., lending in declining areas of cities that pose above-average lending risks. Generally, one would think that the pursuit of such goals, if deemed worthy by the electorate, should be funded by a broadly based tax such as the federal income tax. But the indirect tax approach of forcing financial institutions to invest in ways that are not in their stockholders' interest may be favored simply because the proponents of such measures do not feel that they could get a straightforward, visible subsidy enacted into law. In any case, I think this whole approach of subsidization through what amounts to credit allocation—an approach long confined to policies designed to stimulate residential construction—should come under closer scrutiny.

In the long run, of course, most of the laws and regulations that I have described become superfluous anyway, as ways are found to circumvent them and new institutions are developed to carry on the activities prohibited to existing ones. In the meantime, we suffer higher costs, an inefficient allocation of resources, and all the frustrations and limitations on freedom that accompany any arbitrary and rigid constraints on the market mechanism.

Why the same tired measures continue to be tried, year after year and decade after decade, is something of a mystery. But it is not totally inexplicable. The fact is that many people distrust the free marketplace because they do not understand it. Their basic economic education has been totally neglected. They fail to recognize that our system reflects the interactions of total wants of the entire populace (weighted, to be sure, by purchasing power), as embodied in total demands, with the inescapable fact of limited means, as embodied in supply conditions. They naively believe that the marketplace is likely to yield results that contradict what the populace actually desires. They are led to believe that profits are bad and that anything big is bad. The propensity to regulate also stems from a myopic view of its effects—a view that fails to take into account its side effects and longer-term ramifications. This accounts for the “patchwork quilt” nature of the existing body of regulations, most of which were adopted as short-term, ad hoc responses to immediately perceived needs.

What I would like to leave you with is a considerably greater skepticism toward the frequently made promise of great benefits and minimal costs for someone's pet regulatory scheme. I believe that few such claims can stand up under the glaring light of close analysis. Even fewer can stand up under the longer-term pressures of the free marketplace—and our economic freedoms are at the very heart of our democratic institutions and our personal freedoms. Let us never forget this simple and fundamental truth.