

INTRODUCTION

FINANCIAL DEREGULATION IN A GLOBAL ECONOMY

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Restrictions on freedom of entry almost always reduce the quantity and quality of financial services available to the economy, and thus hinder or distort economic growth. Competition in banking, on the other hand, acts as a spur to the mobilization of idle financial resources and to their efficient utilization in commerce and industry. These conclusions do not arise from any doctrinaire attitude, but solely from examination of and reflection on historical experience.

—Rondo Cameron (1972: 25)

Removing Barriers

Trade liberalization and the information revolution have paved the way for the globalization of financial markets. The pace of financial globalization, however, will depend critically on whether governments get out of the way of the market or whether they try to block the natural course of market forces by erecting new barriers to the globalization of trade and finance.

Like other institutions, financial institutions evolve best when left alone to respond to consumer choice. In an environment of free competition and private property rights, owners will be held accountable for the services they provide, whether those services be the provision of computer software or the provision of financial instruments. History has shown that “where banking was left most free to develop in response to the demand for its services, it produced the best results” (Cameron 1972: 25). Or as F. A. Hayek (1976: 22) put it, “The best the state can do with respect to money is to provide a framework of legal rules within which the people can develop the monetary institutions that suit them best.”

The problem is to get governments off the backs of banks and to let financial markets grow without the burden of excessive regulation. "The proper role of government policy should be to make markets as resilient and efficient as possible. Government policymakers should get rid of the traditional bottlenecks of overregulation, overtaxation, and overprotection, and let markets work" (Lindsey 1993: 168). In almost every country, the financial sector is one of the most highly politicized and regulated parts of the economy. "In no other sector of the economy, with the possible exception of foreign trade, have governments intervened so broadly, so consistently, and with such telling effect—usually bad" (Cameron 1972: 9).

Even though the United States has made a stab at financial deregulation, banks are still prohibited from interstate branching, from selling securities, and from mixing banking and commerce. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980; the Garn-St Germain Act of 1982; the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989; and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 have made marginal improvements in the regulatory climate, but those reforms have left a fragmented banking system and have added to the complexity of the rules and regulations governing financial institutions. Jay G. Baris (1993: 13), a financial services lawyer, writes, "Not even well-intentioned banks could comply with the thousands of pages of complex rules now in existence," the compliance cost of which is "estimated at up to \$17.5 billion annually."

Removing barriers to a free market in financial services will not be easy, since "neither the public nor their elected representatives seem disposed to easing off on bank regulation" (Lindsey 1992: 2). Domestic financial institutions want to protect their turf from foreign competitors, community action groups want to have guaranteed access to cheap credit, and politicians want to ensure that they have ultimate control over banking and financial services. If existing barriers are to be removed and new barriers avoided, there must be a general recognition of the importance of market competition as a disciplinary force on financial institutions and an awareness of the costs of centralization and overregulation.

The contributors to this two-part issue of the *Cato Journal* address the need for financial deregulation in a global economy.¹ Emphasis is placed on the role of the legal structure in shaping incentives and

¹The papers in volume 13(2-3) were first presented at the Cato Institute's 11th Annual Monetary Conference, "Financial Deregulation in a Global Economy," held in Washington, D.C., March 18-19, 1993.

behavior. The laws that govern banking and finance and the approach taken toward regulation will determine the pace of financial innovation and the gains that can be realized from opening new markets (see Todd 1993). Volume 13(2–3) also considers the relation between the framework for monetary policy and the safety and soundness of the banking system. Monetary stability and financial stability go hand in hand. If there is no credible commitment to maintain monetary stability, and monetary authorities are not held accountable for failing to safeguard the value of money, uncertainty about the future value of money will be transmitted to the financial sector.

The challenge is to provide a stable framework for monetary policy and let financial institutions evolve naturally in response to the demands of the open market. In thinking about that challenge, one confronts the problem of how to depoliticize money and banking. As long as governments have the dominant role in shaping monetary and financial institutions, experimentation will be limited; opportunities to discover new ways to improve the institutional framework—for both money and banking—will be curtailed.²

Market Discipline versus Centralized Controls

Market prices provide incentives and information to guide decision-makers in the allocation of scarce resources. Insofar as markets are competitive and prices are flexible, resources will tend to flow to those uses deemed most valuable by consumers. Institutions that serve consumers best will survive; institutions that do not will fail. Thus, the market itself can act as a brake on inefficient institutions while encouraging the success of efficient ones.

If financial institutions were subject to global competition, if insolvent banks were allowed to fail, if deposit insurance were properly priced, and if monetary equilibrium prevailed, there would be little reason to expect banking to be inherently unstable.³ Free entry and exit, full disclosure, and personal liability for risk-taking would motivate owners and managers of financial institutions to create wealth while safeguarding their customers' deposits. And placing limits on the

²According to F. A. Hayek (1989: 103), "Under government patronage the monetary system has grown to great complexity, but so little private experimentation and selection among alternative means has ever been permitted that we still do not quite know what good money would be—or how good it could be."

³Michael Bordo and Anna Schwartz (1989: 26) argue, "Banks are not inherently unstable, provided the institutional setting in which they operate and the incentives they are exposed to do not predispose them to excessively risky undertakings."

creation of government fiat money would help achieve monetary stability. In such an environment, the market would sort out prudent and foolish decisions and, thereby, act as a disciplinary force on financial institutions (see Bordo and Schwartz 1989: 26–34).

A market-based approach to financial regulation would recognize the self-regulatory aspects of competitive markets and encourage sound institutions while allowing weak ones to fail. There would be little room for political maneuvering. Regulatory costs would fall “because markets are much more efficient at modifying banks’ behavior than regulators could ever hope to be” (Jordan 1994: 315).

The globalization of trade and finance has tended to weaken the influence of government and to strengthen the influence of the market in determining policy outcomes (see Keleher 1993). If foreign exchange traders move against a currency—because they expect policymakers to increase taxes, enact trade restrictions, hamper capital flows, or spend recklessly and finance their spending with money creation—market expectations will rule, and the overvalued currency will depreciate regardless of government intervention to support it. Thus, markets will influence policymakers and lead to policies that are more in tune with market liberalism than might otherwise be the case. Consequently, one can predict that “increased globalization of the markets for financial instruments will reduce the exploitive potential of all governments” (Niskanen 1994: 339).

Governments, however, will continue to meddle in the market and try to centralize regulatory controls. The 1991 Basle Accord, which set international capital adequacy standards, was a step toward centralization and away from market discipline (Shelton 1994). Government decisionmakers dislike markets because markets deprive bureaucrats of their power over economic life. Free markets create uncertainty for those in power. Government decisionmakers, therefore, tend to be suspicious of the market and inclined to overregulate rather than to underregulate.

The tendency to overregulate can be countered by allowing competition among regulatory agencies (England 1994) and by allowing competition among regulatory rules across political jurisdictions (Keleher 1993, Lewis 1993). The United States could learn from Europe by adopting the principle of mutual recognition, whereby home-country, or home-state, banking rules would take precedence over host-country, or host-state, rules. If home-jurisdiction regulations

were less restrictive than host-jurisdiction regulations, there would be political pressure to liberalize financial regulations in the host jurisdiction.⁴ Policy competition would lead to the least burdensome regulations, and the overall compliance costs of financial regulation would fall. Countries and states would tend to harmonize their regulatory policies via the competitive process rather than through centralized control. Moreover, unlike centralized policy coordination, "policy competition among decentralized policymakers . . . is fully compatible with the operation of the price mechanism and fosters regulatory experimentation and innovation as well" (Keleher 1993: 281).

Trying to plan the process of financial globalization from the center is impossible. Centralized control will hinder, not foster, the development of global capital markets and the spontaneous emergence of new financial instruments. If the United States is to fully participate in the financial services revolution, policymakers need to recognize the limitations of government regulation and come to a better understanding of the benefits of open competition.

The growth of financial regulation in the United States is not encouraging. "Congress has overreacted to the S&L collapse by an extraordinarily complex web of new regulations on the premise, apparently, that if some regulation is desirable, more regulation is even better" (Niskanen 1994: 339). Policymakers also have started to shift attention from regulations designed to promote the safety and soundness of financial institutions to regulations designed to promote "fairness" via centralized credit allocation (Lindsey 1992: 3). If credit allocation becomes a reality, financial markets will become more, not less, politicized, with dire consequences for U.S. capital markets.⁵

Safe and sound banking is not obtained by socializing risk via federally subsidized deposit insurance, nor is it obtained by prohibiting

⁴Robert T. Clair and Gerald P. O'Driscoll, Jr. (1993: 42-44) discuss the principle of mutual recognition as applied by the European Community. The principle "constitutes home-country control over banking regulations" and "guarantees that each EC member state recognizes the rules and regulations of the other members" (42). Clair and O'Driscoll (44) contend that Europe's adherence to the principle "will facilitate and hasten the liberalization of banking regulation compared to the slow pace in the United States." Unless the United States reforms its outmoded regulatory climate, "Europe, or at least the European Community (EC), will have freer trade in banking (and other services) than will the United States." See also Lewis (1993).

⁵Federal Reserve governor Lawrence B. Lindsey (1992: 3-4) states: "One could envision credit rules allocating the types, volume, and location of loans that banks could make. One could also imagine racial, ethnic, income, and geographic guidelines regarding the recipients of those loans. A shift in the regulatory framework in this direction is not inevitable, nor, however, is it inconceivable."

interstate branching and limiting the scope of banking activities. The surest route to safe and sound banking is not through centralized control but through privatizing risk, full disclosure, open markets, and a limit on the discretionary power of central bankers and regulators (see Kane 1994). Central planning and market socialism have failed elsewhere; why should we expect them to be successfully applied to money and banking?

Financial Stability and Monetary Stability

It makes no sense to talk about financial stability without talking about monetary stability. Banks and nonbank financial institutions operate within a specific monetary regime. If that regime is unstable, as evidenced by erratic variations in the quantity of high-powered money and an uncertain price-level path, the financial system will be adversely affected. That is why Bordo and Schwartz (1989: 33–34) have concluded:

Price-level stability in our view is a prerequisite for safe and sound banking. If the price level is stable, any mistakes that banks make in acquiring assets will be attributable to faulty credit analysis, not to price-level or inflation surprises. If the outlook for future price-level stability is doubtful, the success of a self-regulated banking system is also doubtful.

The discretionary, fiat-money regimes of today do little to create confidence in the global financial network. Typically, monetary authorities pursue multiple objectives and are not held accountable for failing to achieve price stability.⁶

W. Lee Hoskins (1993) points to the need to rethink the framework for U.S. monetary policy. He wants the Federal Reserve to be held accountable and to be constrained by a monetary rule that will result in zero inflation over the long run. The problem is to effectively constrain the Fed in an environment that is politically charged and in which the government has a monopoly over the creation of high-powered money. Will the Fed give up its discretion and commit to a policy of zero inflation? Can it be held accountable? And, if so, for how long?

Lawrence H. White (1993) is skeptical about the possibility of any central bank sticking to one objective and giving up its discretionary authority. For him, as for Hayek (1978), the best path toward monetary

⁶New Zealand is an exception. The central bank is committed to zero inflation and the governor can be fired for failing to achieve the inflation target (Fischer 1993).

stability is free banking with competing private currencies. If that path is not politically feasible, one should at least make sure that the central bank's power to print high-powered money is limited, either by freezing the monetary base (as proposed by Milton Friedman [1987]) or by limiting its rate of growth by adopting a feedback rule to stabilize nominal income (as proposed by Bennett McCallum [1984, 1989]).⁷

Regardless of the rule chosen, there needs to be a monetary constitution that fosters the predictability of the future path of the price level and of the monetary regime within which financial institutions operate.⁸ Predictability would make property rights more secure and increase the efficiency of the price system. Banks would make their investment decisions without the threat of unexpected swings in the value of money, and relative prices would convey more information without being distorted by monetary shocks.

Evolution of the Global Economy

The integration of the global economy has not been planned; it has evolved through a competitive market process. Governments have intervened, but markets have responded by circumventing regulations and creating new financial instruments, such as derivatives, and new financial institutions, such as nonbank mutual funds. Since their creation, the new instruments and institutions have evolved rapidly and pretty much spontaneously. If this evolutionary process is to continue, however, institutions and markets must be allowed to grow without the threat of government intervention.

Experience has taught that international economic coordination is best achieved by decentralized rather than centralized decisionmaking. In a regime of floating exchange rates and independent monetary authorities, major trading partners are free to pursue price stability and constrain the growth of government spending. If, instead,

⁷McCallum's feedback or adaptive monetary rule would provide for changes in the monetary base to achieve a target growth path for nominal GNP consistent with long-run price stability.

⁸James Buchanan (1962: 156) regards "*predictability* in the value of the monetary unit" as the key criterion for judging a monetary regime and emphasizes the importance of a monetary constitution in achieving that predictability. (See his section on "Predictability and Constitutional Attitude" [180–83].)

Peter Bernholz (1986) also emphasizes the importance of a monetary constitution. He advocates a genuine gold standard and free banking as his preferred alternative to achieve predictability. He would "abolish the central bank, institute a pure gold standard, and allow free banking. The monetary constitution would only postulate that each creditor had the right to demand payment from each debtor in gold at the fixed parity. Any violation of this rule would be severely punished by private and/or public law" (498).

they choose inflation and increased spending, they must bear the consequences.

There is no reason to believe that economic integration requires monetary integration. The European common market does not necessitate a single currency and a European central bank. As Anna Schwartz (1993: 277) notes: "Free trade is achievable without fixed exchange rates or monetary union. Fixed exchange rates have economic costs, and monetary union is a political pipe dream."⁹

Yoshio Suzuki (1994) cites the experience of Japan in the late 1980s as an example of misguided international coordination. Instead of adhering to a noninflationary monetary policy, Japan was pushed into an expansionary policy by the 1987 Louvre Accord, which was designed to lower interest rates in Japan and strengthen the dollar against the yen. The expectation of lower interest rates inflated asset prices in Japan until the asset bubble burst in 1990, after a series of increases in the interest rate. The lesson for Suzuki is that leading economic powers like Japan and the United States should "have autonomy in their economic policies." If either economic superpower "sacrifices its domestic stabilization policy for the benefit of the other superpower, the resultant domestic destabilization will eventually cause serious harm to global stability" (449).

The smooth evolution of an integrated world economy will stem not from forced international coordination but from policy competition among sovereign nations. Each country seeking to liberalize and stabilize its own domestic economy will help liberalize and stabilize the global economy. A decentralized, competitive approach to global policy coordination is useful because it allows countries to discern policy mistakes and to discover the most beneficial policy mix (Vaubel 1986: 41).

International coordination works best when it is voluntary and there is a general appreciation of and adherence to a common set of rules that limit the power of governments to tax, spend, regulate, and print money. A rules-based approach to macroeconomic policymaking and a competitive approach to regulatory policymaking will help promote economic liberty and achieve domestic and global stability.¹⁰ Continuation

⁹Compare Lewis (1993). He argues that common markets are facilitated by common currencies and that "fixed exchange rates are not necessarily at variance with free markets and offer many of the benefits of a common currency, but only if they can be maintained credibly" (270).

¹⁰Robert Keleher (1993: 285) examines alternative approaches to international policymaking and concludes: "Virtually the only examples of persistent successful policy coordination or harmonization are . . . the policy competition approach and the common rules approach. Both approaches are fully compatible with the workings of the price system. Consequently, as the world becomes more integrated, these may be the only truly viable policy alternatives."

with a discretionary policy regime—with government fiat money, managed trade, pegged exchange rates, excessive government spending, overtaxation, and overregulation—will only frustrate the natural evolution of the global economy and further politicize economic life.

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