EDITOR'S NOTE

The regulatory straitjacket that has been placed on depository institutions for more than 30 years is wearing thin as technological changes usher in a financial services revolution. With more efficient communications systems and a worldwide financial services industry, the deregulation of banking is long overdue. Yet there is considerable resistance to efforts to change the existing banking laws. While it is generally accepted that competition and open markets are socially beneficial, banking has been assumed to be "inherently unstable" and in need of government oversight. That assumption is only now being questioned in some quarters despite episodes of "free banking" in Scotland and the United States that lend support to the idea that competition in banking is in the interest of consumers. Historical evidence supports the contention that consumers of banking services in a less regulated setting benefitted from innovation and the survival of only the more prudent institutions. Meanwhile, evidence from past and present regulation suggests that government intervention often thwarts competitive forces that would impose market discipline on banks and depository institutions in general.

The experience of the Great Depression (1929–1933), during which more than 10,000 banks failed, was the primary event leading to the present regulation of depository institutions in the United States. With the passage of the Banking Act of 1933—the Glass-Steagall Act—existing regulations were reinforced and new ones added: commercial banks were prohibited from engaging in investment banking, branch banking continued to be restricted, interest rates on time and saving deposits were regulated, rates on demand deposits were outlawed, and federal deposit insurance was introduced. This regulatory climate has persisted over time, but today the rapid changes in the financial services sector demand a reassessment of the role of government in banking and financial regulation.

What is the rationale for government regulation of banking and depository institutions? Is banking "inherently unstable" or are there theoretical and historical bases for "free banking"? Do current regulations hinder or promote stability and soundness in banking prac-

tices? And what changes in the regulatory environment would best serve consumers and enhance the future efficiency of the financial services industry? These and similar questions were the focus of the Cato Institute's **Fifth Annual Monetary Conference**—"The Financial Services Revolution: Policy Directions for the Future"—held in Washington, D.C., February 26–27, 1987.[1]

The papers in this volume fall into three categories: (1) those taking a historical perspective of banks and banking regulation; (2) those investigating the current regulatory apparatus and its effects on the safety and efficiency of depository institutions; and (3) those concerned with the problem of how future changes in the regulatory climate can be implemented so as to increase competition among banks and other depository institutions, and thereby serve consumers more effectively than in the past.[2]

Within the first category, *George Kaufman* presents a historical study illustrating that one should distinguish carefully between individual bank runs and system-wide runs. The former can play an important function in motivating bank managers to take appropriate actions to keep their firms solvent. Kaufman argues that federal deposit insurance should not thwart this disciplinary mechanism and that insolvent banks should be closed and reorganized or recapitalized in a timely fashion to improve the overall safety and efficiency of the banking system. *William Shughart* examines the Glass-Steagall Act, especially as it has prevented the mix of commercial and investment banking since 1933. Taking a public choice perspective, he finds that the legal blockage of a natural tendency for combining these activities into a single financial institution was largely the result of the prevailing interests of investment and commercial bankers to protect their own turfs. Self-interest, not some mythical "public interest," was the motivating force behind Glass-Steagall, argues Shughart. By depriving entrepreneurs of the opportunity to freely combine commercial and investment banking services, the 1933 legislation was at odds with consumers' preferences. The papers by *George Selgin* and

[1]This conference was part of the Cato Institute's Financial Services Deregulation Project, directed by Catherine England and supported by grants from the Ford Foundation, John M. Olin Foundation, Sears, Roebuck and Company, and Chase Manhattan Bank.

[2]Most of the papers in this volume appeared in *The Financial Services Revolution: Policy Directions for the Future*, edited by Catherine England and Thomas Huertas, published by Kluwer Academic Publishers and the Cato Institute (1988). The exceptions are the papers by George Selgin, Kevin Dowd, and Susan Woodward, and the comment by Anna Schwartz on Kaufman's revised paper. Catherine England's major contribution in preparing this issue of the *Cato Journal* is gratefully acknowledged.

Kevin Dowd draw on banking theory and history to show that unregulated "free banking" is not inherently unstable, provided the proper institutional framework is in place.

In the second category, current regulation and its impact on risk taking and the soundness of depository institutions, *Gerald O'Driscoll* discusses the moral hazard problem inherent in the federal deposit insurance system. When premiums are not adjusted for risk and there is an implicit government guarantee to bail out insolvent institutions, the incentive structure will be biased toward excessive risk taking, weakening the fabric of depository institutions operating under this system. Substituting private insurance for the present government-supported system would change incentives and result in a more stable deposit system, argues O'Driscoll. Moreover, by eliminating the prohibition against interstate branch banking and by allowing banks to diversify, the banking system itself would become more stable, making private deposit insurance easier to implement.

Susan Woodward applies the transaction cost approach to banks and depository institutions. By treating banks as organizations designed to minimize transaction costs and by recognizing "informational assymetries," Woodward explains specific organizational features of banks and the demand for cost-minimizing regulation. She also uses the transaction cost approach to make a case for deposit insurance.

In his paper, *Mark Toma* considers the effectiveness of the Federal Reserve in setting and enforcing reserve requirements prior to and following the Monetary Control Act of 1980, which gave the Fed sole control over reserve requirements. He distinguishes between competitive and monopolistic determination of reserve requirements and shows that without competition from state agencies Fed officials have greater discretion in setting reserve requirements in line with their incentive to maximize seigniorage. Toma therefore views the Monetary Control Act as "a change in the nation's monetary constitution that enhances the wealth-extraction powers of the central government." His comparative institutions approach offers a fruitful method for analyzing all regulatory activity, including the impact of the dual system of banking regulation on incentives and behavior.

Gillian Garcia investigates the institutional and incentive structure of the Federal Savings and Loan Insurance Corporation (FSLIC) and explains why it is " 'broke' in more ways than one." To improve the zombie-like state of the FSLIC requires recognizing the source of the current problem and separating healthy thrifts from insolvent ones. As a step toward solving the S&L crisis, Garcia recommends the timely closure of insolvent institutions, which would strengthen

the entire industry. She thus agrees, in general, with Kaufman's policy proposals.

The final three papers offer new policy directions to reinvigorate banks and depository institutions. *Thomas Huertas* finds a close correspondence between banking and commercial activities, and sees no reason why individuals ought to be constrained in their decisions about owning a bank or why banks should be barred from diversifying. *Catherine England* attacks the view that unregulated banking is inherently unstable. She argues from both theory and evidence that in the absence of the federal safety net, depositors and bankers could and would develop sources of information and devise contractual arrangements that create an incentive structure conducive to more prudent decision making and stable banking. *Robert Litan*, meanwhile, argues that investment banking and commercial banking practices are compatible and that their joint production should be allowed.

The overriding emphasis of the papers in this volume is on the idea that a greater role for market discipline and a reduced role for government regulation over bank ownership and the scope of banking practices is the appropriate response to the increase in bank failures in the 1980s, not a return to the regulatory straitjacket initiated in the 1930s. As such, these papers should enhance our understanding of the institutional requirements for stable and sound banking and pave the way for meaningful reform of depository institutions. The financial services revolution can then come into full force, serving the interests of consumers as well as producers.

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