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Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

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Aggregative Consequences of Removing Restrictions

by Allan H. Meltzer *

Any change or sequence of changes in the operating responsibilities, rules, standards of performance, rights or prohibitions affecting the relative and absolute positions of banks and non-bank financial institutions has many consequences. Output, prices, employment, tax collections and budget deficits, relative rates of return on real and financial assets and other aggregate measures of prices and performance are affected. There are two principal reasons. (1) Every regulatory change alters the value of the charters of one or more of the various types of financial institutions and the costs and revenues of the firms in one or another branch of the industry. Virtually all financial institutions are regulated; all are restricted from engaging in some activities and, by various inducements, many are encouraged to engage in particular activities -- for example mortgage lending. Entry, branching, and merger are regulated, and the locations at which a particular institution is permitted to operate varies with both the operation and the type of institution. (2) Each of the principal types of financial institutions is subject to a different federal tax rate ranging from zero (for credit-unions) to a rate approaching the average corporate tax rate for commercial banks. In several cases, there are differences in the procedures for computing taxable net income. It would be more than usually heroic, and in fact incorrect, to presume that changes in the lending and borrowing

* As always, I have benefitted from my conversations with Karl Brunner. Thomas Mayer suggested many improvements. An earlier version of this paper was prepared for the use of the President's Commission on Financial Structure and Regulation. This explains the absence of footnotes and references. The author will provide references for interested readers.
powers or monopoly rights and privileges of the various types of institutions would have no aggregate effect. It would be just as heroic to assume that total tax collections, in a multiple tax system, would remain unchanged in the face of changes in the lending and borrowing powers and therefore the taxable income of particular types of institutions.

The question of whether the present combinations, or changes in the combinations of laws, regulations and interpretations have both aggregative and allocative effects has, therefore, been answered affirmatively but not informatively. The direction of the changes in aggregate variables and the sizes of the changes are at least as important as their existence. The sizes cannot be measured reliably without an empirically verified theory linking financial structure to aggregates. Lacking such a theory, we must rely on the few pieces of empirical research on particular aspects of financial structure and on general principles of economics.

The financial system in modern economies performs two main tasks. One task is to provide a payments mechanism. The other is tailor the maturity distribution of the stock of the community's assets and liabilities to meet the demands of borrowers and lenders. The latter two groups include those who, at current market rates, desire to adjust their net creditor or net debtor positions; i.e. to switch from the lending to the borrowing side of the market. In the process of carrying out the two tasks, the system produces a variety of claims and debts, acquires an ever-changing portfolio of assets, transfers payments, participates in the process of allocating capital, keeps records of asset positions, provides safe-keeping and other services to producers and consumers.
The principal question that I address is whether removing restrictions on financial institutions has sizeable aggregative effects that reduce -- wholly or in part -- the welfare gained by removing the restrictions. The basis of this question and perhaps a main reason that it arises, is the persistence of the frequently repeated, but as yet unsupported, allegation of a group of unaffiliated nineteenth century writers on financial practice. The group, known under the collective heading "Banking School," claimed that the rate of inflation and the gold flow or foreign exchange position of a country depend not on the quantity of money (however defined) but on the composition of "credit" and, thus, by supposed implication, on the types of financial assets and liabilities issued and held by particular financial institutions. The same basic argument has been made repeatedly, and the best known modern versions are currently identified with the Radcliffe Report in England and the "flow of funds" school in the United States. The main proposition advanced by these groups can be summarized in a sentence: During business cycles, changes in the composition of credit affect aggregate output, employment and the rate of price change; in the long-run the composition of credit affects the efficiency of the economic system.

The policies proposed as means of dealing with the alleged effects of changes in the composition of credit cannot be summarized as succinctly. These range from selective controls on types of credit to selective controls on interest rates. They include reserve requirement ratios differing by type of asset, type of deposit, type of bank and size of deposit. Among the controls on interest rates in the U.S. are the prohibition of interest payments on demand deposits and regulation Q ceilings for time deposits.

1/ This does not mean that all portfolio regulations are based on this belief. Many are proposed or have been introduced to achieve allocative purposes—to favor a particular type of lender or a particular credit instrument. For example, tax exemption of interest on state and local securities is generally defended as an allocative measure.
The effects of financial structure and regulation on economic efficiency and growth can be separated from cyclical effects on output, employment or rate of inflation. I shall consider each in turn, and therefore separately, in this way postponing discussion of two important questions: (1) Do institutional changes that contribute to long-run efficiency also contribute to cyclical stability? (2) Are the arrangements that promote long-run efficiency a substitute for, or a complement of, arrangements that promote stability? Then, I consider briefly, and separately, the extent to which different types of financial institutions can be expected to coexist if many of the current restrictions are removed. Lastly, I discuss an ambiguity in the deposit insurance system that should be eliminated as part of any reform of the financial system.

Regulations, Portfolio Restrictions, Efficiency and Growth

The contribution of the financial structure to long-run efficiency and growth can be enlarged or diminished by social policy. One main policy implication of economic theory is that efficiency should be encouraged. A second is that if competition and foresight prevail, society's growth rate should be neither raised nor lowered but, instead, left at the rate determined by the decisions of savers and investors. The complex argument leading to the last conclusion can be summarized by saying that unless individuals are myopic, there is little, if any, expected net benefit from encouraging or forcing the current generation to invest more so as to raise society's growth rate. In a growing economy, per capita income rises steadily, so policies that encourage growth tax the poorer current generation to benefit wealthier, future generations. The converse is also true; policies that discourage saving and the accumulation
of capital raise current consumption by reducing standards of living for all future generations.

The effects of alternative financial structures on inter-generational efficiency and growth is one of the liveliest topics in monetary theory, and some parts of current theory are almost certain to be made obsolete and discarded as new research results accumulate. Four very general conclusions or principles about financial structure that remain standing or emerge after recent work are that financial structure contributes to individual and social welfare by:

1. permitting wealth owners to hold their preferred mixes of assets and liabilities;
2. distributing risks at lowest cost from those who wish to sell to those who wish to purchase;
3. reducing the risks to be borne to those unavoidable risks inherent in nature and in trading and producing arrangements;
4. providing a low-cost means by which individuals can allocate consumption over time and leave bequests to their progeny.

Long-run departures from a welfare maximizing position arise, as in any other industry, for the usual reasons -- such as myopia, scale economies and monopoly positions -- but also because of government financial policies and policies toward financial institutions. In the remainder of this section, I consider some long-run implications of government policies under the headings monopoly, efficiency, and risk. Then I list some policy changes for which the aggregative effects increase or do not decrease the welfare gain from increased efficiency.
Monopoly

Every main type of financial institution is chartered by government. Entry, branching and merger are restricted by federal and state regulations. It is appealing, at first glance, to treat firms in the financial industry (or industries) as monopolies and to argue that their profits are increased by government chartering and branching policies. Acting as monopolists, the firms in the industry restrict output so as to increase prices and profits. In fact, the monopoly power of the firms in the industry is limited in two important respects by the nature of the product or products produced.

First, banks and most other financial institutions produce claims and debts with fixed nominal values; i.e., the face value of the claims does not rise and fall with the price level but is fixed in dollars. The public can readily adjust the real value of money balances and, in the process, adjust the values of other claims and debts by increasing or decreasing the demand for money thereby raising or lowering the price level.

Second, the government has more power to regulate the industry's output than any single private institution or group of private banks or financial firms. Government policies determine the size and rate of growth of the monetary base -- the ultimate monetary reserve of the public, the banks and all financial institutions. If the Federal Reserve desires credit or money to expand at a faster or slower rate, or desires the nominal stocks of credit and money to be larger or smaller, they can expand or contract the monetary base by open market operations or other policy actions. The marginal social

2 The cost to society of inflation or deflation is much larger than the social cost of producing money. The social costs of inflation or deflation, however, do not affect the conclusion in the text.
cost of the expansion and contraction of base money is very low, practically zero. The marginal cost to banks or other financial institutions of refusing to expand is considerably higher. The reason for the difference in costs is that expansive open market policies replace the interest-yielding assets in the portfolios of financial institutions with lower yielding base money — under present arrangements with zero yielding base money. Failure to expand earning assets and deposits means that the profits earned by the banks are reduced.

The second argument implies that standard policy tools such as open market operations give the government adequate control of the industry's nominal output. Restrictions on entry, branching and merger are not required to prevent financial monopoly from restricting total output or to prevent over-expansion and "over-banking" as is often alleged. Aggregate results of aggregate policies depend mainly on the policies and not on the details of financial structure.

The government issues short- and long-term debt instruments as part of its debt management operations. At relatively modest cost, anyone who wishes to adjust the maturity of his assets can do so by choosing a mixture of short- and long-term securities. If financial institutions do not offer the exact maturity an individual demands, the individual can readily produce the desired maturity. Recent experience shows very clearly that government regulations of financial institutions -- controls on portfolios and rates of interest -- do not prevent owners of financial assets from achieving desired portfolios. Policies that prevent competition between existing institutions encourage the development of alternative instruments and institutions.
Since money is readily transferred, it is difficult for the government to prevent competition between financial institutions by restricting entry and branching or to prevent the public from obtaining desired portfolios by regulating portfolios. Government can raise the cost to the public and the institutions of achieving desired portfolios, and thus prevent some individuals from realizing returns they might otherwise have received. These are mainly allocative and distributional, not aggregative, consequences.

The aggregative effects of the government's policy, viewed as a monopoly policy, are small enough to be dismissed. The available evidence suggests that the government's policy of restricting entry, branching and mergers maintains local monopolies and reduces competition. No case has been made, and no evidence has been presented, to show that the government policy reduces interest rates or the rate of inflation attained with a given level of real output or increases the level of real output for any given rate of interest and rate of inflation.

Efficiency

If the lending and money producing services of commercial banks and other financial institutions were the only services produced by the financial system, the main aggregative consequences of restrictions on entry, branching and merger would be the loss of real output resulting from the use of resources to implement the regulations. The annual loss is equal to the annual cost of running the regulatory agencies plus the cost of complying with their requests. To this we must add, the not negligible cost of obtaining desired deposit services by mail, a principal means by which the public overcomes the inconvenience caused by policies that sustain local monopolies by restricting entry and branching.
Banks and other financial institutions offer numerous services in addition to the lending and money producing services just discussed. It is often more costly to individuals to acquire the auxiliary services that financial institutions offer, such as safe deposit boxes or check cashing, than to borrow, acquire desired portfolios or deposit services. To the extent that restrictions on the entry and branching sustain local monopolies, the public receives fewer auxiliary services. There is some evidence showing that small banks offer fewer services and that, where branch banking is permitted, the services offered in small, one bank towns increases. These and similar findings are consistent with the expected effects of actual and potential competition.

Furthermore, to the extent that there are either "true" economies of scale or a large number of small, inefficient, monopoly financial institutions protected by restrictions on entry, branching and merger, the restrictions reduce the efficiency with which society uses its resources. The available empirical evidence suggests that resource allocation could be improved by eliminating a large number of small commercial banks and savings institutions that hold a small portion of aggregate deposit balances.

A second, and probably more important, inefficiency produced by present regulations results from portfolio restrictions that require institutions to specialize in particular assets. Some part of the observed specialization by institutions is the result of market forces, not regulation. However, there is evidence that the present set of regulations forces more specialization than would occur in its absence and does not produce an optimal set of services.
or an optimal distribution of services among institutions. Given the opportunity, some savings and loan associations would offer a wider range of deposit services and acquire a wider range of assets. Commercial banks, in recent years, have not been reluctant to offer many types of services that are very close substitutes for the services offered by savings institutions.

It is inefficient to require consumers to obtain several specialized financial services at several different locations. Society's resources are wasted also to the extent that the services provided by several institutions can be provided at lower cost by a smaller number of less specialized and less regulated institutions. A third, related inefficiency resulting from existing portfolio regulations is the increased resource cost of transferring financial assets from one type of institution to another when the composition of the demand for credit changes. Under present portfolio arrangements, an increase in the demand for mortgages increases the relative size of saving and loan associations and other savings institutions. Savings institutions bid for deposits held at other institutions, and by offering higher rates seek to acquire a larger part of the public's holdings of real and financial assets. A series of portfolio reallocations produces the same result that could have been obtained at lower cost and with less inconvenience if institutions with broader lending powers accommodated the changed composition of the demand for credit by reallocating their asset portfolios.

One main reason specialized credit institutions have been established and are protected by regulating interest rates is that public policy seeks to channel credit to particular types of borrowers. At one time public
policy assisted farmers: more recently, home buyers have been a main object of public concern. Attempts to reallocate credit to housing have not succeeded in increasing the average annual production of houses. Among the main results of the policies administered at various levels of government have been increases in the relative price of housing, the relative wage of construction workers, and the price of land. The number of houses built on the average during the sixties remained below the average for the early fifties. Public policy to assist housing by maintaining specialized financial institutions reduces the efficiency of the financial system. By increasing the relative price of housing, public policy discourages home ownership. The fact that the number of houses produced and purchased declined in the sixties as the number and type of interest rate regulations increased, though not conclusive, suggests that interest rate regulation does not increase the aggregate real demand for housing.

Another, related source of inefficiency sustained and fostered by public policy is the regulation of interest payments on deposits. Price controls are not very effective devices for reallocating resources, particularly when the resources are financial assets, transferable at low cost. Regulation of interest rates on demand deposits induces the public to hold fewer demand deposits and more of other assets and increases the cost and inconvenience of reallocating assets by increasing the amounts reallocated whenever rates change. Regulation of interest rates on time deposits at commercial banks at savings and loan associations and other savings institutions increases the cost and inconvenience to the public for similar reasons and in similar ways.

The nature of these costs and the reasons they arise is brought out by recalling some of the services the public obtains from specialized financial
institutions. The services include the benefits of diversification, specifically, reduced exposure to risk without equivalent reduction in return, the opportunity to choose a portfolio of assets -- a preferred mix of maturities, risks and returns, and the opportunity to adjust debtor-creditor position. If regulation of interest rates prevents existing financial institutions from competing effectively for deposits, individuals and corporations are encouraged to acquire securities directly rather than by holding deposits at financial institutions. Interest rate regulations, then, force depositors to choose between the lower risk and regulated return at financial institutions and the increased return and increased risk from holding securities directly. The benefits existing institutions receive are made at the expense of depositors who do not quickly adjust or who choose the combination of lower risk and lower return. The gain is made at the expense of the depositors who are most ignorant of market opportunities, most fearful and least willing to accept risk, and those productive individuals whose opportunity cost of acquiring information about rates of return on alternative financial instruments is relatively high. It is hard to find social benefit in penalizing the most ignorant and the most fearful or to find merit in a special tax on productive individuals.

An additional social cost arises because regulation of interest rates at financial institutions encourages individuals to hold riskier portfolios than they would otherwise choose. Deposits at commercial banks and savings institutions are insured by FDIC and FSLIC. Individuals who acquire securities directly not only forego some benefits of portfolio diversification, they also forego the benefits of deposit insurance.
A final cost item related to those above has been much emphasized in recent theoretical work concerned with the optimal rate of monetary expansion. The main point of relevance here is that by removing restrictions on the payment of interest on deposits, the government can reduce the discrepancy between private and social costs of holding money -- currency and deposits. The social cost of producing money is assumed in these analyses to be below the private cost, and the social benefit is assumed to be less than the private benefit. At an individual's optimum, marginal benefit equals marginal cost; at a social optimum, marginal social benefit and cost equals marginal private benefit and cost. Restrictions on interest payments induce the public to hold smaller average cash balances and to devote more resources to managing cash balances. Payment of interest on deposits reduces these costs by encouraging individuals to hold larger average cash balances. Welfare can be increased because the social cost of satisfying the private demands for money -- the cost of producing money -- is substantially less than the aggregate private cost of managing cash balances when money balances are less than an optimum. Aggregate output can be raised by the amount of resources freed from managing cash balances and used in other, more productive occupations.

Are there no long-run social benefits to compensate for these losses? None at all. The best that can be said for the efficiency of any type of price control -- and interest rate controls are price controls -- is that the public is able to circumvent the regulations at modest cost.

Legal reserve requirements for demand and time deposits are another means by which social policy reduces social welfare. The maintenance of reserve requirement ratios reduces the banks' net worth by reducing their
earnings. The reduction of earnings reduces the resources invested in banking and, therefore, reduces efficiency. The inefficiency could be removed in two ways, by paying competitive interest on some or all reserve balances and by eliminating legal reserve requirements. The main justifications for reserve requirements are invalid and the maintenance of the requirements absorbs resources unnecessarily. Legal reserve requirement ratios neither improve control of the money stock nor increase the liquidity of a banking system. The case for payment of interest on the remaining reserve balances is the same as the case for paying interest on deposits.

Risk and Deposit Insurance

A main goal of government policy should be to reduce the risks that the community must bear to the minimum inherent in nature and economic activity. Very often government fiscal and monetary policies have done the opposite, increasing risk of default and inducing failures by banks and other financial institutions. Individuals cannot compete with government in supplying insurance against the type of judgmental errors of policymakers that produced numerous bank failures and failures of financial institutions in the 1930's and in earlier recessions or depressions. Nor, should they be expected to do so, given the government's responsibility to maintain a growing stock of money in a growing economy.

However, the social benefits of deposit insurance do not require that all deposits be insured, that all be insured to a single maximum, that individuals be required to buy insurance, that all banks pay an identical premium or pay a premium unrelated to the risk position taken by the bank.
Nor, should the law set the maximum amount of insurance an individual can buy. Allowing depositors to choose the amount of insurance and their preferred combination of risk and return increases the welfare gain from deposit insurance. Elsewhere, I have suggested one means of achieving this objective.

A government operated system of deposit insurance cannot prevent the central bank from making errors. Deposit insurance attempts to reduce the consequences of errors by preventing the central bank from destroying a large part of the money stock. A government insurance agency cannot, however, prevent an epidemic of bank failures and therefore cannot avoid the aggregative consequences of major policy errors unless it is authorized to issue currency in emergencies or can convince the central bank to do so. As Walter Bagehot insisted more than a century ago, maintenance of the payments and financial system ultimately rests on the lender of last resort. Deposit insurance is not a substitute.

A large part of the case that deposit insurance must be provided by government, if it is to be provided at all, rests on the belief that a public corporation such as FDIC or FSLIC is more effective than a private corporation in preventing bank failures from spreading. There are two reasons for expecting superior performance. One reason is that the risk of bankruptcy or insolvency by the insurer is reduced or eliminated. A second is, as above, based on a belief that FDIC and FSLIC would be more successful in convincing the Federal Reserve to expand the money stock to stop a wave of "bank runs" or runs on financial institutions. The latter

argument rests on an as yet untested belief that the deposit insurance corporations could convince the Federal Reserve to fulfill the role of lender of last resort.

I believe that the deposit insurance system should be strengthened. The ability of FDIC and FSLIC to carry out their functions should not depend upon their ability to convince the Board of Governors of the Federal Reserve System that a crisis has occurred. I return to this subject below.

Summary

The present set of controls, regulations and restrictions raises the social cost of providing and maintaining the payment mechanism and the financial system. Included in the cost is the waste of resources from the use of skilled personnel to police, enforce, promulgate, adjudicate and circumvent regulations, the resources wasted because regulations prevent individuals from holding optimal portfolios, the increased risk that individuals are forced to bear and the social costs resulting from the maintenance of monopolies. My list of practices that add to social cost and reduce welfare includes the following:

(1) portfolio restrictions,
(2) prohibition of interest payments on demand deposits and bank reserves,
(3) ceilings for interest rates on time and saving deposits,
(4) statutory reserve requirement ratios,
(5) usury laws,
(6) restrictions on entry, branching, and merger,
(7) fixed, uniform premiums and maximum insurance ceilings for deposit insurance,
(8) statutory ceiling for interest rates on government bonds, FHA mortgages and other guaranteed or insured securities.

The aggregative consequences neither justify the practices nor offset the costs.
Regulation of Interest Rates as a Counter-Cyclical Policy

Many proponents of interest rate regulation and selective credit controls regard controls and regulation of interest rates as an important supplement to more general policies. Others view selective regulation as a substitute for general monetary policies, such as open market operations and discount rate changes. The unsuccessful search for independent, effective supplements to general counter-cyclical policy periodically revives interest in proposals to regulate and manipulate deposit rates.

One justification of ceiling rates on deposits is that the central bank can change these rates to achieve the objectives of the Employment Act, maximum employment and purchasing power. Proponents of ceiling rates argue that by keeping ceiling rates below market rates in periods of economic expansion, a central bank can maintain lower market rates on credit market instruments or can prevent these rates from rising as much as they otherwise would. Lower credit market rates mean lower borrowing costs, therefore, increased investment, increased demand for real assets and a higher growth rate of real output and lower rate of inflation for any given rate of monetary expansion. On this view, ceiling rates for deposits are an independent instrument of monetary policy that supplement or supplant general monetary controls.

A second justification of ceiling rates is based on the supposition that the way to control inflation or to increase employment is to allocate credit among competing uses. Some types of credit are believed to be more productive than others. If credit policy could change the mix of credits, it could, on this argument increase output and reduce the rate of inflation achieved with a given rate of monetary expansion.
The main point in these arguments is rarely made explicit. If the central bank can control real rates of interest -- market rates of interest minus premiums for inflation -- it can affect the proportion of income saved and the allocation of wealth between money and real capital. Two main issues are, first, whether the central bank can change real rates by manipulating deposit rates and, second, whether it is desirable to do so. If the central bank has less than complete success in reallocating credit by controlling deposit rates, wealth owners are forced to revise their portfolios. The social cost of shifting assets from one institution or credit instrument to another is much less than the social cost of changing prices or interest rates, so there is some welfare loss. To this loss must be added the cost of enforcing controls and the cost to society of using skilled personnel to find ways to avoid the controls. Interest rate controls are a type of price control and, therefore, reduce welfare, as I noted in the previous section.

The belief or conclusion that the central bank can offset these losses by manipulating deposit rates to more effectively achieve employment, price or other cyclical objectives rests on a partial and incomplete analysis. Deposit rates, loan rates and market rates are quoted in nominal units. They are the number of dollars paid or received each period per dollar lent, borrowed or held on deposit. Rising prices reduce the real cost to borrowers and the real return to lenders or depositors; falling prices increase the real cost to borrowers and the real return to lenders or depositors.

Every attempt to reduce deposit rates on a particular credit market instrument induces a reallocation from that instrument to others. Recent
experience with Regulation Q and its effects on the commercial paper, Euro-dollar and traditional banking markets provides clear evidence that the reallocations are sizeable. The final effect on aggregates is also clear. Ceilings for time deposit rates reduce time deposits relative to demand deposits and increase the stock of money -- currency and demand deposits -- whenever rates on alternative assets rise. The policy is, therefore, inflationary and not contractive or anti-inflationary as alleged by its proponents. A return of deposits from other institutions to commercial bank time and savings accounts, when the rates on alternative assets fall below ceiling rates, reduces the money stock or its growth rate and therefore has a contractive effect on the economy. Ceilings for time deposit rates have a pro-cyclical effect on the stock of money and, therefore, on output and prices.

Investment, saving and the demand to hold real capital depend mainly on real rates of return, not the nominal rates quoted in financial markets. The manipulation of deposit rates taxes the ingenuity of wealth owners and financial managers and absorbs their time and attention but, at most, has transitory effects that are uncertain as to direction on the amount of real capital produced and acquired and on the amount of real saving.

My conclusion should not be read as a denial of any effect on the size or rate of growth of particular types of assets or particular institutions. Maintaining ceiling rates on savings deposits below open market rates substantially reduces the number and size of savings institutions and, if maintained, would eventually eliminate these institutions. However, there is no reason to believe that the disappearance of savings institutions prevents other institutions or individuals from purchasing the assets, mortgages, that savings
institutions no longer acquire or reduces the number of houses built. The latter depends on the returns builders receive from home building and the services consumers receive from home-ownership. Both are real returns. Neither return is altered to any significant extent by the existence of savings institutions, their size relative to the size of other financial institutions, or the manipulation of nominal rates or interest that expand or compress the relative size of savings institutions during business cycles.

The two central principles on which my conclusions about cyclical responses rest are: (1) that the allocative and the aggregative effects of a policy operation are to a considerable extent separable, not only in theory but in fact and (2) that the allocation depends on relative prices and real rates of return, not on money prices and nominal rates of return. There is now a considerable body of evidence showing that, in most developed countries, the stock of money depends principally on the monetary base -- bank reserves and currency -- and demonstrating that a central bank's ability to control the money stock is changed very little by the existence or absence of selective controls on interest rates. The main effect of interest rate regulations is to reinforce the pro-cyclical policy that most central banks follow. Studies of the relation of money to economic activity and the price level during business cycles do not show any sizeable or important differences that either can be, or have been, attributed reliably to various selective controls on interest rates. Attempts to use selective controls for general policy purposes have produced no evidence of their effectiveness in controlling inflation or expanding output. Empirical studies of the determination of market rates of interest show that
the level of market rates depends on aggregative variables such as the
monetary base, the outstanding stock of government debt, the level of
real income, the price level and the actual and anticipated rates of price
change. Together, the evidence supports the proposition that the movements
in output, price level, market interest rates, and money are to a considerable
extent dependent on past, current and anticipated future policies, on the
anticipated rate of economic expansion and other real variables but independent
of the types of allocative policies I have discussed.

Two Remaining Issues

My separate discussions of long-run and cyclical effects of various
regulations and controls avoids an important issue, the extent to which
changes that promote long-run growth and the efficient use of resources
increase the cyclical stability of the economy and the contribution of
counter-cyclical policies to counter-cyclical objectives. Several of the
changes that I have recommended mainly affect the system's long-run efficiency.
Elimination of restrictions on entry, branching and merger and elimination
of legal reserve requirement ratios improve efficiency without substantially
changing the effectiveness of counter-cyclical policies. Other recommended
changes not only increase the system's ability to adjust to cyclical changes
but add to long-run efficiency. Elimination of usury laws and interest
rate ceilings falls here.

One argument for removing portfolio restrictions to increase both
cyclical stability and long-run efficiency merits attention. History provides
abundant evidence that financial crises have been worsened by the failure or
anticipated failure of financial institutions that issue liabilities with shorter term to maturity than the assets they acquire. When interest rates rise, the market value of the asset portfolio declines much more than the market value of the liabilities. Fear of deposit withdrawals and insolvency creates uncertainty and adds to the pressures on the financial system.

Removal of portfolio restrictions increases the stability of the financial structure by reducing one source of insolvency. Permitting institutions to choose from a wider range of assets enables each of them to adjust more flexibly to cyclical changes in market conditions and to longer-run changes in demand. The importance of increased ability to adjust to the consequences of variable government policies is illustrated by the problems of savings and loan associations in recent years.

An objection to removing interest rate ceilings and eliminating legal restrictions on the assets and liabilities that particular institutions acquire is that all financial institutions would then be "the same." The disadvantage of having a unique type of financial institution is rarely made clear. At times, there is a suggestion that some group of lenders, now accommodated by one or another specialized institution, would be systematically excluded from the market or, perhaps, the organized portion of the market. Mortgage credit is often used as an example.

The basis of the argument is that, at the margin, the existence of specialized institutions increases the demand for mortgages. Faced with a choice between cash, government securities and a home mortgage, the savings and loan association or other specialized lender chooses the mortgage. The commercial bank has a wider set of opportunities and is expected to choose some other type of earning asset.
If these were the only relevant facts, the argument would be correct. However, savings and loan associations, mutual savings banks and similar institutions must compete with commercial banks and other corporations for capital and for deposits. The above argument suggests that by investing in mortgages they earn lower rates of return per dollar of liabilities and capital. If this is so, they are in a poor position to compete for deposits and capital, and their decline or demise is only a matter of time. If the usual argument is correct, it is hard to explain why saving institutions attracted capital and deposits during the period in which they were permitted to compete with other institutions.

The argument is not correct. It is unlikely that all financial institutions would be alike or even similar if all restrictions were removed. Specialization in particular sub markets occurs for many different reasons, including the existence of specialized skills, costs of entry, minimum efficient sizes for performing particular tasks and the well-known benefits of division of labor in a large market.

The clearest evidence that all financial institutions would not be "alike" comes from observing existing institutions. Existing commercial banks and savings institutions differ considerably in type of activity, size, and range of services offered. Some banks operate numerous branches; others engage in large-scale lending at a single location. Some acquire the techniques and specialized personnel to offer a wide range of consumer services; others avoid consumer lending and concentrate on loans to business or trust activities. There is no more reason to expect all financial institutions to adopt a unique form or to choose a unique portfolio than to expect grocery stores, drug stores, department stores or other industries to offer identical services or to develop identical characteristics.
The market has started to develop a means of reducing the costs of shifting deposits and assets from one type of financial institution to another. The financial holding company that combines a savings institution with a commercial bank is often able to lower the cost of reallocating resources from one financial institution to another. Public policy should encourage this form of integration as a market solution to some of the problems discussed in this section.

A Final Problem: The Lender of Last Resort

Every financial system requires an institution to serve as lender of last resort to the system. In the event of widespread financial failures, large deposit withdrawals, and a rising demand for currency, the lender of last resort issues base money, particularly currency, on demand. The failure of the Federal Reserve in the thirties to function as lender of last resort added substantially to the depth and severity of the panic and the size of the losses to individuals and to society. Eventually, a large part of the financial system was destroyed.

The experience of the thirties produced two changes affecting the lender of last resort. First, the Federal Reserve System has accepted responsibility for preventing widespread failures. Experience during the recessions of 1966 and 1970 shows that the Federal Reserve now holds a different view of the appropriate activities in time of crisis and its responsibility as lender of last resort to the financial system. Second, deposits at most commercial banks and savings institutions are now insured by FDIC and FSLIC. In any future panic, depositors are insured against losses.
As I noted above, no mechanism is established by law or agreement that assures that FDIC or FSLIC can promptly pay depositors during a panic. Both corporations hold government securities with a relatively short-term to maturity. Generally, their securities are readily marketable. In a major financial panic, however, FDIC and FSLIC would have difficulty finding buyers other than the central bank. If the central bank refused to buy, delayed purchasing, or refused to purchase sufficient quantities, prompt payment of depositors' losses could not be made by the deposit insurance agencies.

However small one believes the probability that the Federal Reserve would repeat its errors of the 1930's, there is no reason to leave the decision to intervene to the judgment of the individuals who happen to be on the Board of Governors of the Federal Reserve System during some future crisis. A main reason for government insurance of deposits is to avoid the risk that the insurer would be unwilling or unable to pay depositors promptly.

Two changes are required to clarify the lender of last resort function:

(1) The conditions under which FDIC and FSLIC have the right to demand that the Federal Reserve purchase securities for base money should be made more precise.

(2) The responsibility of the Federal Reserve as lender of last resort to the financial system -- not just to member banks, commercial banks, or some other subset of the system -- should be established by law or binding agreement among the relevant groups.

Both changes would contribute to stability and efficiency.