is today, and to greatly strengthen the regulatory apparatus in order to prevent private risk from being transferred to the taxpayer. This would not be my preferred approach. First, it would extend the range of regulation to a wider and wider set of financial activities as banks and thrifts gain new powers, either by legislation, by court decision, or through technology and new products. Second, the enlarged regulatory effort would continue to push activities outside established financial channels.

Finally, I doubt that regulators can, as a practical matter, provide continuous protection against perverse incentives, especially in a setting as dynamic as today's financial markets. The logistical outcome of retaining the deposit insurance system in its present form is a substantial step up in regulation.

I am not especially apprehensive about letting market forces operate more fully. Federal Reserve open market operations and the discount window, when properly administered, represent a substantial defense against the classic crowd psychology of a generalized bank run. These central bank tools can provide liquidity freely to sound institutions. Regulatory resources need to be shifted toward maintaining capital necessary to protect the insurance fund. Other changes will be necessary as well.

More information about the condition of financial institutions and reductions, or at least limitations, on the amount of deposit insurance are but a few. Such changes may not be popular, but they should be the guiding principle if true financial reform is to continue.

Conclusion

The objective for financial reform should be to restructure financial regulation in a way that builds on market forces. Financial reform so far has been less a choice made by Congress and the regulators to seek the benefits of market forces than a result of market forces successfully seeking to avoid the regulatory straitjacket. As I have argued, we are nearing a crossroads. We must push ahead with financial reform. Obviously, the setting for true financial reform must be changed. The risks of loss in financial decisions must be shifted away from the insurer to those financial managers (and the shareholders they represent) who make those decisions. It will be essential to reestablish the right to fail and the risks of that fate for financial institutions of all sizes and for all uninsured depositors.

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Financial Reform at a Crossroads
by W. Lee Hawkins

Today, 75 years after the founding of the Federal Reserve System and 55 years after the nationwide bank holiday of 1933, financial regulation is once again at a crossroads. The conflict between market forces and regulation has created serious problems that cannot be avoided much longer. At issue is a very basic question: should we go forward with deregulation, or should we turn back? The answer will have an important bearing on the future structure of the financial services industry. Should we make market forces exert a more powerful influence in the financial sector, or should we reinforce the blanket protections of the regulatory process?

I think the choice should be clear: we should rely on market forces. Relaying more heavily on market forces requires sweeping away both mental and institutional cobwebs and making a clean break with the past. A piecemeal approach—responding to immediate problems and pressures—is not likely to get us very far unless we establish economic principles to guide deregulation.

The principles we must dust off to guide deregulation of the financial sector are little different from those at work in other industries. Moreover, applying these principles to the financial industry will demand a lot more than simply broadening the powers of banks.

In debating and deciding on the steps toward deregulating the financial industry, the fundamental goal should be to reinvigorate market incentives and tests of performance in banking and other financial markets. The challenge is to eliminate regulations where possible and to strengthen regulations where necessary, building on market forces rather than overriding or suppressing them.

The Background for Regulation

Government has a vital role in a capitalist economy. A political and legal framework is indispensable for assuring individual liberties and property rights and for setting the rules of the game in which markets operate. Within that framework, owners of capital and labor will direct their resources toward uses where opportunities seem greatest. In general, private decisions made with full comprehension of possibilities for gain and risks of loss will produce the best results. However, some activities and precluding others alters the possibility of gain and the risk of loss, and affects choices with respect to resource use. In a static setting, where entry into closely competing endeavors is expensive, technology is unchangeable, and innovation is sluggish, the costs of regulation may seem small or slow to appear, perhaps because they are hidden in public subsidies. In such circumstances, the intrusion of government regulation in this marketplace may be able to achieve politically determined results that otherwise would be impossible.

In a more dynamic setting—such as the markets for financial services, where competition has been strong, entry by nonregulated firms has been relatively easy, and technology has been dynamic—the outcome can be quite different, as we are now seeing. Although competition holds down direct costs to consumers, inefficiencies are evident, and through the federal deposit insurance mechanism, risk may well be shifted from private decision-makers to the federal deposit insurance system. The attention banking has received over the years suggests that banking has always been a special case in which regulation was necessary. Certainly as the word "bank" was used in history, there was something unique about the blend of payment services attached to bank liabilities and commercial lending. Almost from the beginning, banks were considered special in the eyes of governments. Those charters carried with them restrictions on the way banks could conduct their business. Whether these regulations were initially intended to prevent fraud or to generate government revenues from a state-created monopoly is a matter of debate, but by the time of the founding of the Federal Reserve in 1913, regulation of banks was the accepted practice.

The legitimacy of the case for banking being considered special stems largely from problems with bank runs. When banks in large numbers simultaneously demanded cash repayment from perfectly sound banks, not enough cash was available in the nation to meet the demand, resulting in a crisis. All banks, however well-run, could not convert illiquid assets into cash and had to suspend payments, in violation of the
terms of their charter, or sell assets at reduced prices, thereby impairing capital levels through gradual changes in accounting principles were relaxed, partly to support these changes by closely scrutinizing the financial position of banks and bank holding companies. Publicly disclosing the risk profile of their business. Interests in this way, markets would be assisted by making public the continuously available information whose release is most likely to improve their financial condition.

Basic principles of capitalism should be the guiding principle in this system, which might be as simple as releasing ratings or something similar which would be as meaningful in providing information to investors as a dollar cost insurance premium. The debate about financial restruc-

turing and liability management practices. Deposit insurance has become a substitute for a strong capital base in attracting deposits. Deposits, insurance, and their use in managing the risk profile of banks has improved. But there could be two ways of looking at the same thing; one is to think of insurance as a means of spreading risk, the other is to think of it as a means of avoiding risk. Some doubt that risk analysis would be as helpful in setting premiums over outcomes in a rapid and complex environment as market discipline on financial markets. Probability is nothing if not a matter of degree, and the cost of attracting deposits is a matter of degree. The focus of regulatory resources would be to support these changes by closely monitoring and strongly enforcing capital standards. This approach would require broad and continuous information about market circumstances. The debate is over the relative risk of bank runs compared to insurance. The guidelines proposed for the present situation are the result of the debate about financial restruc-
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Banking Regulations: Many bank regulations have been justi-
cied as a way to assure sound banking practices and to reduce the risk of loss from unsound banks. Bank charters typically called for minimum capital holdings and reserve requirements, money market mutual fund and other new competitors and products grew rapidly in the 1970s, and new bands of depositors and bondholders would be permitted to enter financial markets. By the 1970s the financial markets, things that some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer. But some nonbank banks can offer a slightly broader set of products than its bank subsidiary could offer.