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COMMENTARY

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It's a great pleasure to return to Brooklyn. More than thirty years ago, I lived on Remsen Street, only a few blocks from here. The changes in the street-side landscape in New York since the early 1960s are striking. Then, the department stores in New York included Abraham & Strauss, Stern's, Gimbel's, Saks, Macy's, Ohrbach's, Korvettes, Masters, Hearns, Alexander's, Wanamaker's, and Bloomingdale's; only a few of these names remain. Similarly, there were many more banks in the early 1960s: there was Bank of Manhattan, which eventually merged with Chase; Hanover National, which was acquired by Manufacturers Trust; Corn Exchange, which became part of Chemical; Irving, which was acquired by Bank of New York; and Franklin National, which failed and was later acquired by European-American (initially a consortium and subsequently acquired by ABN-AMRO).

The development of department stores in the late nineteenth and early twentieth centuries was partly a response to demands for economic efficiency — there were significant savings from shopping for a large variety of different types of products under one roof, or what later would be called economies of scope. Moreover, the identification of the department store with family names was a guarantee of the quality of the goods; Mr. Macy, Mr. Gimbel, and Mr. Marshall Fields were providing the "Good Housekeeping" seal of approval to what were otherwise generic products that were on the counters and the coat racks in their stores, and thus were reducing the time that consumers had to spend seeking assurances about the quality of goods. At that time these stores were local, although Sears Roebuck had developed on a national scale.

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The decline in the market share of the department stores reflects both the suburbanization of America and the development of brand names on a nationwide scale. The economies of scope have become available in the mall and have supplanted the scope economies inherent in the store. Similarly, the specialty stores carry the same nationally branded goods as the department stores; the increasing reliance on national brand names has eroded the value of Mr. Macy's guarantee. The inventories in the specialty stores generally are larger than those in the department stores. Now mega-discount chains like Walmart and K-Mart are gaining a greater share of the market.

The market share of banks as a group in total financial flows has declined, even as individual banks have consolidated. The paradox is that United States banks are seeking to become department stores of finance, even as the traditional department stores appear to be fading.

The consolidation of banks is a result of two different phenomena. One is the belief that there are economies of scale in some elements of banks' production or marketing activities. The second is that once an individual bank incurs exceptionally large loan losses, so that its capital becomes depleted relative to a regulatory standard or benchmark, the interests of bank's shareholders may be better enhanced if the bank is merged.

The prospective move towards universal banking in the United States — essentially a department store of finance — reflects at least three different arguments. One is the view that there are economies of scope — essentially economies for selling several different financial products at the same time. A second is that the universal banks in Germany are likely to become the standard for the European Community. A third is that many non-banks have acquired banks or have issued liabilities competitive with those of banks, so that there are now regulatory asymmetries. Thus, Merrill Lynch has its Cash Management Account (CMA), with $26 billion of deposits; Sears owns Allstate and Dean Witter and the Discover card. Citicorp has acquired failed savings and loans in Washington, D.C., Florida, Chicago, and San Francisco.

The purpose of this Conference is to examine the public policy issues associated with the various proposals for relaxing United States regulations so that United States banks might become department stores of finance. As I listened to the various papers earlier in the morning, I was reminded of the remark by

Admiral Stockdale at the Vice-Presidential debate: "Why am I here?" The papers are rich in detail about the legal arrangements in Germany, France and Japan but, unfortunately, they provide little insight on the public policy issues for an American audience, largely because financial environments and bureaucratic traditions in these countries are very different from those in the United States.

The European Community is about to adopt uniform banking regulations. We will probably hear that, as a result, the playing field will become less level, and the United States will need to adopt the German model of banking regulations. Consider the advantages of a universal financial system — and it is useful to make a distinction between outputs and inputs. First, what are the outputs? Countries with universal banks appear to have more stable financial systems; that's an output. The inference made from this output is that the frequency of bank failure is related to the *size distribution* of banks. Perhaps, but alternatively, we might attribute this stability to the lack of shocks for the financial system in Germany, as opposed to the structure of banks. We might ask: "If the Bundesbank managed the Fed, how many s&ls would have failed?" My answer: "Very few — the failure of so many s&ls and banks reflects the sharp changes in United States monetary policy, which led to sharp changes on asset values, income and employment."

The second question is whether the universal bank provides greater efficiency. This statement is somewhat remindful of the question of why Swiss bankers are rich and the answer is: "They compete with Swiss banks." The answer is an open question.

Now, we might look at this question in terms of the inputs. If the two factors that I have noted before are correct, efficiency and stability, what are the sources of the advantages? Are there economies of scale? Are there economies of scope — the department store analogy? In terms of a Coasian metaphor, are there significant cost savings if transactions are internalized within the firm, rather than compared with similar transactions that go through the market? Are there significant advantages for universal banks in terms of either geographic or industrial diversification? Do universal banks have a longer term view of the problems of their clients?

Now, you may sense some skepticism about the universality of institutions, and the usefulness of taking a model which has been developed in one country and applying it to another country, anticipating similar results. Baseball is the national pastime in Japan, but it is not American baseball. Football in Canada differs from United States football. Democracy has been exported to many countries; at least there are elections in these countries, frequently with higher participation rates than in the United States elections. But the large number of political prisoners in many of these countries suggests that their model of democracy is very different from the United States model.

Even if an institution developed in one country could be successfully applied to another country, there may be significant costs in the change-over from one system to another. The British drive on one side of the road; we drive on another. They have 220 volts; we have 110 volts. There are economies from uniformity — but is it worthwhile in terms of transaction costs to make the change?

Consider the relevance of the foreign banking experience to the United States and the question: "Why did these countries develop universal banks?" Several papers allude to this question, which involves the nature of the market for debt and, more particularly, the market for equity. The countries which have developed universal banks almost always have feeble bond and equity markets — that is an association. But we might ask, "Do countries have feeble bond and equity markets because they have universal banks or do they have universal banks because they have feeble bond and equity markets?" The plausible answer is that the feebleness of the markets for bonds and equities in many countries led to a void that was filled by the development of universal banks.

Certain idiosyncratic features distinguish the United States from other industrial countries. One is its massive geographic size. A second is that the United States is very diverse ethnically. Many countries appear to work well, in part because of centralized management; many of these countries have a population smaller than the greater Chicago area, and most of the population is blonde and blue-eyed. A third is that the United States federal system is a part of our history which bears on the locus of regulation. A fourth feature involves the skills and prestige of United States regulators; traditionally the American bureaucrats have not ranked high in terms of prestige compared with bureaucrats in France, Japan, and Germany. Finally, the United States approach toward the rule of law differs from that of Japan or Great Britain, where gentlemen's agreements and understandings are an important part of the regulatory structure. What's not forbidden — explicitly forbidden — is more or less permitted.

The studies on the banking systems in France, Germany, and Japan are not especially relevant for the choices about the appropriate United States public policy toward the expansion of the role of banks. There is very little in these papers about the economies of scale, the economies of scope, external and internal transactions costs, or about deposit insurance. These country studies are orthogonal to the United States policy choices.

Let me conclude with two notes. One of the central issues for United States policymakers is the relationship between deposit insurance and universal banking. Deposit insurance has gotten many well-deserved criticisms because it has led to abuse; some banks may have taken on too much risk because of deposit insurance. The benefits from deposit insurance, given the macro-level financial mismanagement that we've had in the last fifteen years, is that we have avoided another Great Depression. We look at the costs of deposit insurance in terms of the Charles Keatings and the Keating Five, and we neglect the stability of income or the lack of variability because there have been no significant bank runs.

Which leads toward my conclusion — why not let the market decide the appropriate expansion of banks and the range of their activities? Well, the first answer is that banking is different from other industries. What's the public policy interest and what do we really want to protect? The system is excessively protected, largely because the response to each macro-crisis has been to add one more layer of protection. Deposit insurance was added to the lender of last resort which had been superimposed on top of asset examination and portfolio regulation. Most of these regulations were developed to protect the macro economy from the failure of groups of banks. Some regulations were developed to protect individual investors from their ignorance; one analogy is the Food and Drug Administration, and another is the Consumers' Union.

A major concern is whether deposit insurance should be available to a universal bank. My answer is no. Banks could then choose between becoming a universal institution and giving up deposit insurance or retaining deposit insurance. The second question is whether banks that choose the deposit insurance option should be allowed to engage in commerce. My answer is no.

The third question is whether non-insured banks should be allowed to engage in commerce. On that one I punt; I don't have an immediate answer, but my inclination is that there should be no restraint. And the fourth is whether universal institutions should be subject to reserve requirements. Part of the explanation for disintermediation — and the declining role of banks — is due to the taxation of banks in the form of reserve requirements. As a result, we've had end-runs around the banks in the formation of the banks and money market funds.

It would be hard to predict household shopping patterns thirty years from now; consumers' shopping patterns are likely to evolve so as to minimize their time spent shopping and amounts spent. Similarly, it would be hard to predict the pattern of demand for financial services. Let's perform an experiment.