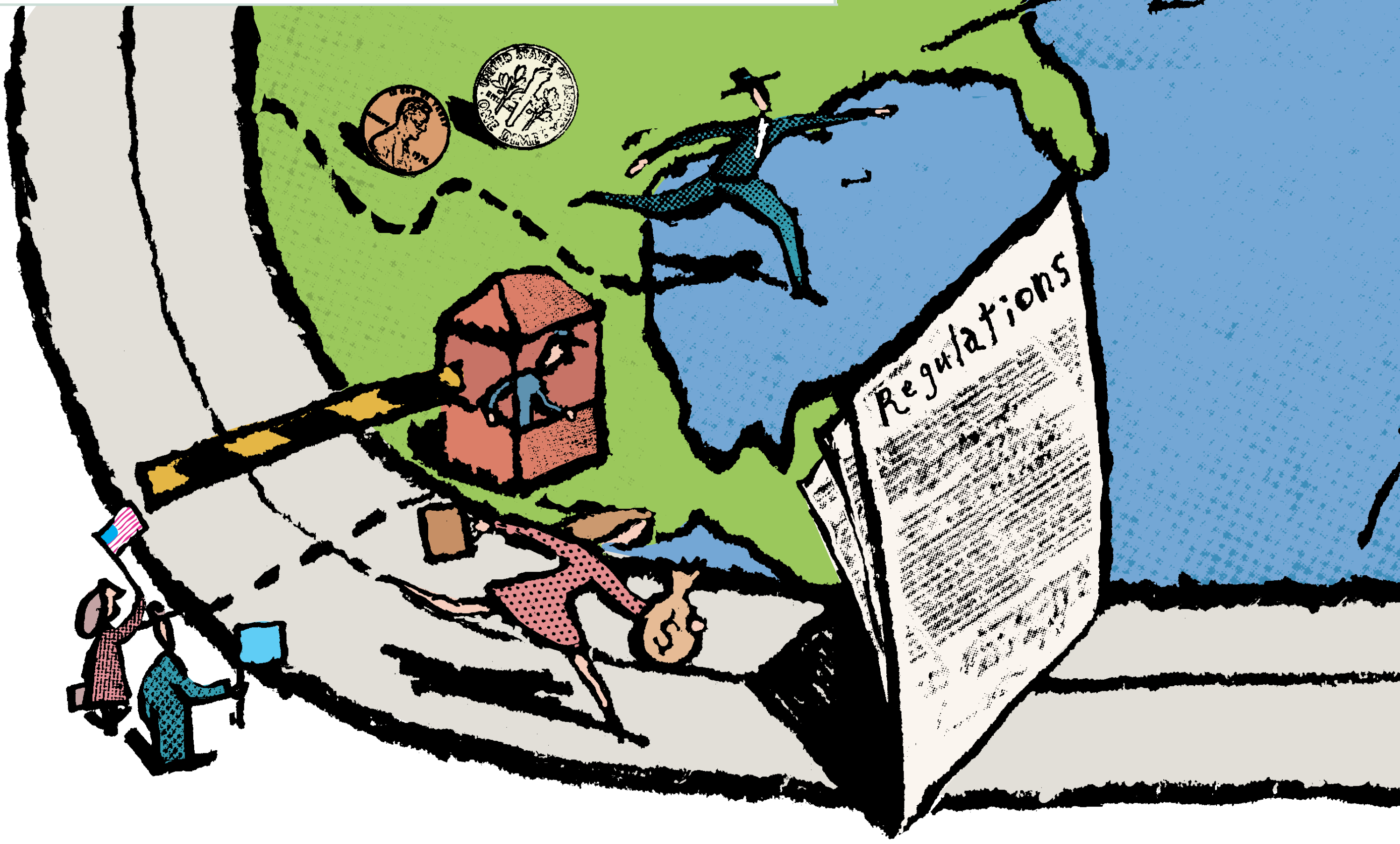
COMPETITION & OPPORTUNITY

HOW INTERNATIONAL FORCES SPURRED INNOVATION IN U.S. BANKING

By Richard N. Cooper and Jane Little

Illustrations by Daniel Baxter

U.S. MONETARY POLICY HAS a purely domestic mandate. According to the Federal Reserve Act, the Fed's mission is to promote "maximum (sustainable) employment, price stability and moderate, long-term interest rates" within the United States. Still, global developments often have a significant influence on policy decisions. As the U.S. economy has become more tightly linked to the outside world through trade and investment ties,




CD
INTEREST

timeline of selected banking legislation

1927 *McFadden Act*
Prohibited interstate banking.

1933 *Banking Act (Glass-Steagall Act)*
Separated commercial banks from investment banks, prohibiting commercial banks from owning brokerage firms or engaging in most investment banking activities.

1956 *Bank Holding Company Act (Spence-Robertson Act)*
Established comprehensive regulations for bank holding companies, which were now required to register with the Federal Reserve Board. Prohibited a bank holding company from acquiring a bank located in another state, unless specifically authorized by the host state (Douglas Amendment).

1963 *Interest Equalization Tax*
Tax on foreign stocks, bonds, and long-term loans that was meant to discourage U.S. residents from lending abroad.

Voluntary Foreign Credit Restraint Program
Suggested limitations on loans and investments in order to discourage U.S. banks from lending to foreigners and from investing abroad.

1978 *International Banking Act*
Brought foreign banks within the federal regulatory framework, imposing the same reserve requirements, interest rate ceilings, deposit insurance requirements, and interstate banking restrictions for foreign banks operating in the United States as for domestic banks.

1980 *Depository Institutions Deregulation and Monetary Control Act*
Lifted ceilings on the interest rates that banks could offer their customers and authorized interest-bearing transaction accounts.

1994 *Riegle-Neal Interstate Banking and Branching Efficiency Act*
Repealed McFadden Act of 1927. Allowed interstate banking by way of branch acquisition. States permitted to both veto acquisitions and authorize new branches at will.

1999 *Gramm-Leach Bliley Act*
Repealed Banking Act of 1933. Allowed affiliations between commercial banks and securities firms, insurance firms, and merchant banks. Prohibited nonfinancial companies from owning commercial banks, however.

Note: Included are only highlights from selected pieces of legislation.

promoting U.S. price stability and sustainable growth have increasingly required taking global trends into account. Usually, these developments are taken as "givens," inputs into the data set on which policy decisions are based. More rarely, international developments, like an international liquidity crisis or a period of dollar weakness, have elicited a Fed policy response aimed at influencing the course of these "external" events — always with the intent of improving the long-term outcome for the U.S. economy.

In addition, however, since World War II, international pressures have played an important, if generally unrecognized, role in the evolution of the U.S. banking system and, thus, the practice of U.S. monetary policy. In particular, U.S. and foreign banks have frequently been able to avoid costly domestic banking rules by taking advantage of the gaps between national regulatory systems. In some cases, for example, domestic banking law simply did not cover foreign bank operations or new products denominated in foreign currencies. Seeking to exploit these loopholes, financial firms invented new types of accounts or found ways to engage in previously prohibited activities.

THE CREATION OF AN UNREGULA
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These efforts then forced regulators to try to close the gaps or, at least, to "level the playing field" for foreign and domestic banks and for banks that could afford foreign operations and those that could not. In doing so, regulators tried to walk a thin line between safeguarding the integrity of the U.S. financial system and of U.S. policy decisions and ensuring that U.S. regulations did not place U.S. firms at a competitive disadvantage in an increasingly global market.

The result: Foreign opportunities and foreign competition — among regulators as well as firms — helped drive structural change in the U.S. financial system over the past 40 years. The development of the Eurodollar market and the role of foreign banks in breaking down the barriers to interstate banking and the provisions separating investment from commercial banking represent examples of how global forces helped spur the evolution of the U.S. financial system. The resulting financial innovations and changes in banking regulation have, in turn, affected how the Fed conducts monetary policy.

THE EURODOLLAR MARKET

The Eurodollar market was one of the first important financial innovations of the post-World War II era. The Eurodollar mar-

ket is the wholesale market for large, dollar-denominated deposits placed at banks outside of the United States. The freedom from national banking regulation provided by this market led to major changes in the U.S. banking system, including the end of interest rate ceilings on bank deposits, a diminished role for reserve requirements, and the creation of money market accounts.

The Eurodollar market sprang up in the mid 1950s because Soviet banks feared that the U.S. government would seize their U.S. dollar balances if they kept these deposits in the United States; instead, they arranged to hold dollar-denominated deposits at banks in London and Paris. Other early customers included Italian banks that borrowed and lent dollars to dodge the cartel that ruled lending in lire, and British banks seeking to finance non-Commonwealth trade after the U.K. government restricted foreign loans in sterling during the Suez War and the ensuing sterling crisis.

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EUROPE BEGAN A PROCESS THAT
S. INTEREST RATE CEILINGS

But it wasn't until the 1960s that the growth of the Eurodollar market really took off. Much to the consternation of officials on both sides of the Atlantic, the U.S. dollar came under considerable downward pressure in foreign exchange markets throughout the 1960s. Since the Bretton Woods agreement to maintain fixed exchange rates was still in effect, governments with weak currencies were expected to limit the supply of their currency in the foreign exchange market. Accordingly, from 1963 to 1969, the U.S. authorities instituted the Voluntary Foreign Credit Restraint Program and other measures to restrict U.S. investors from lending dollars abroad. These restrictions, in effect, drove U.S. banks and foreign borrowers to the Eurodollar market.

Once in the Eurodollar market, U.S. banks, foreign borrowers, and U.S. firms wanting to build plants overseas all discovered the advantages of operating beyond the reach of costly central bank regulation. In the early days of the market, U.S. reserve requirements and Regulation Q interest rate ceilings did not apply to these dollar deposits at foreign banks, including overseas offices of U.S. banks. And neither did foreign bank regulations, which generally covered assets and liabilities in domestic currency only. Thus, the banks could afford to offer higher interest rates on dollar deposits than they could in the United States, and borrowers could obtain dollar funding that would otherwise have been unavailable to them. By permitting transactions that could not have occurred in its absence, the Eurodollar market proved highly advantageous to the large banks able to operate on both sides of the Atlantic as well as to their large customers.

U.S. regulators grew more concerned about the freedoms provided by the Eurodollar market in the late 1960s. At that time, the Fed tightened monetary policy to fight inflation and market interest rates rose above those permitted by Reg. Q interest rate ceilings. For example, while the ceiling for savings accounts was 4 percent in 1969, rates on 3-month Treasury bills were approaching 7 percent. Under these constraints, the U.S. banks faced a serious runoff of funds from their domestic offices. As a result, they began to borrow large sums from the unregulated Eurodollar market to replace them. Fearing these Eurodollar borrowings might undermine policy and wanting to remove the "special advantage" enjoyed by large banks with ready access to the Eurodollar market, the Board of Governors instituted a reserve requirement of 10 percent on any increase in member bank Eurodollar borrowings above a base amount. Still, at the end of 1969, big U.S. commercial banks had borrowed enough Eurodollars (about $13 billion) to largely offset the runoff of domestic deposits subject to interest rate ceilings. Later, during yet another period of dollar weakness but relatively low U.S. interest rates, the Board raised the marginal reserve requirement on Eurodollar borrowings still higher. Since the reserve-free base fell as the banks repaid their Eurodollar loans, this time raising reserve requirements was meant to discourage the banks from *repaying* their Eurodollar debts and adding to the downward pressures on the dollar. But once again, market forces prevailed, and the episode ended with the banks having paid down their Eurodollar debt and the Fed having reduced reserve requirements on Eurodollar liabilities.

Even while it was trying to use reserve requirements to control the size and steer the direction of Eurodollar flows (with limited success), the Fed was also sensitive to the U.S. banks' need to compete in the Eurodollar market. Accordingly, in 1977, the Board reduced the reserve requirement on Eurodollar funds lent by a foreign branch of a member bank to a U.S. borrower to let these branches compete with foreign banks not subject to such requirements. The Fed also found a way to let U.S. banks participate in the Eurodollar market without the expense of setting up a London branch by approving the establishment of "Nassau shells" in 1969. These shell offices in the Bahamas were generally little more than a brass plate, a bookkeeper, and a set of accounts, but they allowed U.S. banks to do business under Eurodollar rules while performing the bulk of the related activity at the U.S. head office. In 1981, the Board went a step further and approved the creation of International Banking Facilities (IBFs), a set of segregated accounts that still provide a way for U.S. depository institutions and other corporations to accept large time deposits from foreign residents free of reserve requirements and interest rate ceilings.

In 1970, the large negotiable CD was freed from interest rate ceilings, in part to increase this domestic instrument's ability to compete with Eurodollar deposits. Once the two big financial innovations of the 1960s — the Eurodollar and the large negotiable CD — allowed investors with $100,000 to earn interest rates higher than those available to small depositors, the small investors began to pressure financial institutions to find ways around interest rate ceilings for them, too. In 1970, an innovative Massachusetts savings bank introduced the Negotiable Order of Withdrawal or NOW account — in effect, a (limited) checking account that paid interest. Similarly, in 1977 a handful of brokerage houses and banks cooperated to create the money market account, another transactions account earning a market rate of interest.

In the end, these efforts to escape interest rate ceilings and reserve requirements contributed to the passage of the Depository Institutions Deregulation and Monetary Control Act in 1980. Among other important changes, this act required a phaseout of the interest rate ceilings that had dominated the U.S. banking sector for half a century (see the sidebar on Reg. Q) and created the money market deposit, which let banks compete with brokerage houses offering similar accounts. In addition, reserve requirements on Eurodollar liabilities and competing time deposits have been set to zero since the early 1980s.

FOREIGN COMPETITION AND THE MOVE TO INTERSTATE BANKING

Interstate banking is another area where competition from foreign banks has served as a catalyst for change in the U.S. banking system — in this instance, primarily in the early stages of the process. The prohibition against interstate banking became

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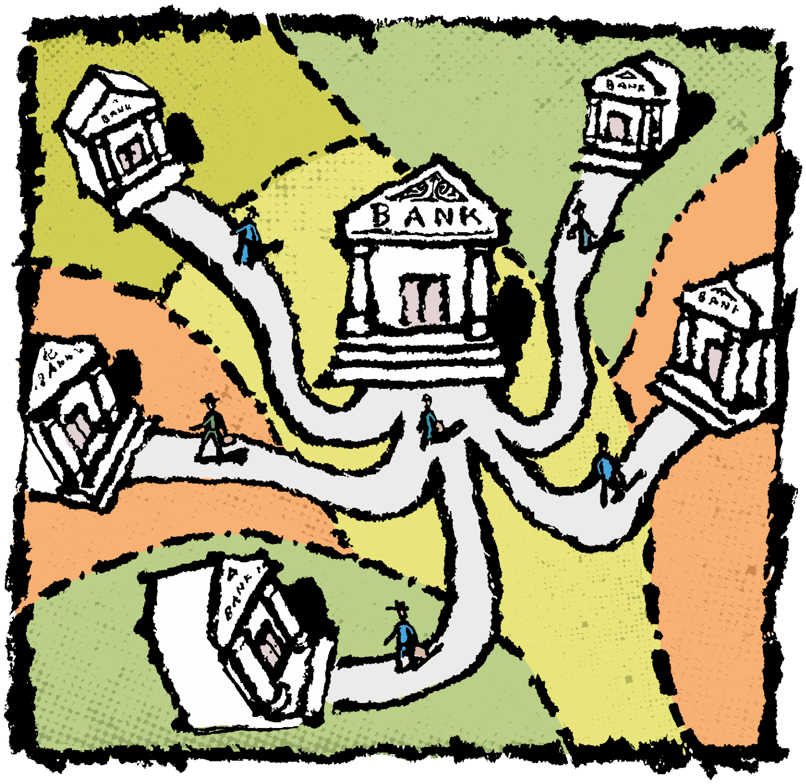

a hallmark of the U.S. banking system with the passage of the McFadden Act in 1927. This prohibition reflected Americans' traditional fear of "national moneyed trusts" and a pragmatic desire on the part of small banks and their political supporters to protect local banking interests.

But foreign banks were not covered by this prohibition. Indeed, foreign banks operating in the United States remained unregulated at the national level until 1978 and, therefore, had a competitive advantage over U.S. banks in being able to establish a full presence in more than one state. Moreover, during the 1970s a number of states began encouraging foreign banks to establish branches and agencies within their borders in order to support the international trade and investment activities of firms located in their state. Because most small- to mid-sized banks had limited experience in providing international banking services, state legislators viewed the foreign banks' presence as complementary rather than competitive.

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DOWN THE RESTRICTIONS THAT
FROM CROSSING STATE LINES

By 1978, 63 of the 122 foreign banks operating in this country already had facilities in more than one state, noted G. William Miller, then Fed chairman. Of these, 31 banks were operating in three or more states, a number that most observers expected to grow since additional states had passed legislation allowing branches or agencies of foreign banks to begin operations. Three large foreign banks with multistate facilities had also announced an intention to acquire a large domestic bank. Forty-five of these foreign banks had worldwide assets of more than $10 billion and thus were comparable with the largest domestically chartered banks. In supporting the passage of the International Banking Act (IBA), Chairman Miller argued that it was incongruous that foreign banks could operate in this country without being subject to the rules of the central bank. And it was unfair to domestic banks (and inconsistent with the favored principle of national treatment) that foreign banks be allowed to continue to expand across state lines.

When the IBA was passed in 1978, it required foreign banks operating a federally or state-chartered branch or agency to pick a home state. Existing branches outside of that state were grandfathered, while additional branches could only be set up under the same rules that would apply to a domestic bank — that is, so long as it was welcome in the host state and all of its business was related to foreign commerce. In effect, these branches were meant to function like the limited-purpose Edge Act corporations that national banks had been permitted to establish in New York and other financial centers to conduct international banking since 1919.

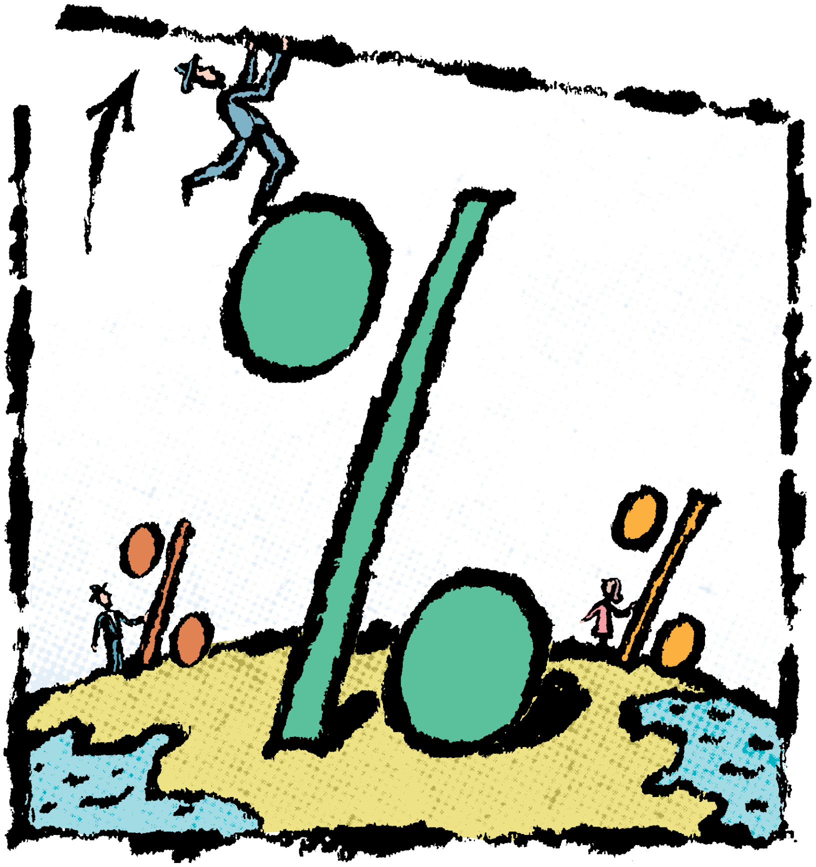
Perhaps more significantly, the IBA also allowed these Edge Act corporations to branch interstate. (This provision was advantageous because allowing an existing Edge to branch requires less capital than setting up a new Edge Corp.) As a result, as of 1978 domestically chartered commercial banks could in effect establish a national branch network — so long as they limited these branches to providing banking services related to international trade. For a time, these Edge corporations became a favored way for some of the large U.S. banks to step across state lines.

Once again, then, foreign competition helped to provoke early changes in the domestic status quo. While most analysts believe that the high failure rates of geographically constrained banks and thrifts in the 1980s made interstate banking acceptable in the 1990s, the fusion of national and global financial markets had helped pave the way. By 1993, most states were allowing bank holding companies to cross state boundaries, and several permitted interstate branching by state banks that were not members of the Federal Reserve System. Many argue that, by the time the Riegle-Neal Interstate Banking and Branching Efficiency Act was passed in 1994 to allow bank holding companies to acquire banks in any state and, as of 1997, to allow banks to merge across state lines, the legislation was largely unneeded; interstate banking already existed.

THE DEMISE OF GLASS-STEAGALL

In a similar fashion, competition from foreign banks contributed to the demise of the Glass-Steagall provisions that had long separated commercial from investment banking. Foreign banks usually operate in a more permissive regulatory environment than do U.S. banks, and U.S. regulators have generally been quite sensitive to U.S. banks' need to compete overseas. Accordingly, the Fed's Regulation K has allowed U.S. banks operating abroad to engage in activities not permitted within the United States. For instance, foreign branches of U.S. banks were allowed to underwrite the debt obligations of the host country, to act as an insurance agent or broker, and, with Fed approval, to engage in other activities connected with the business of banking in the foreign country.

In the case of foreign bank operations in this country, U.S. law and U.S. regulators have taken the view that prohibiting all activities allowed abroad but not permitted to U.S. banks might be unnecessarily harmful to the foreign banks. For this reason, under certain circumstances, foreign banks have been allowed to conduct any business in the United States, such as invest-



THE INVENTION OF NEW TYPES O
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ment banking, that is "incidental" to their business outside the United States.

In this way, the greater leniency granted U.S. banks abroad, together with the broader scope permitted to foreign banks operating in the United States, contributed to broadening the range of business activities permitted to all banks operating in this country. Indeed, by the late 1990s some observers had come to believe that the repeal of Glass-Steagall was no longer necessary, given the flexibility with which the authorities were defining "permissible" activities, notes Carl Felsenfeld in *Banking Regulations in the United States*. Yet, in 1999, when the Senate Banking Committee asked Fed Chairman Alan Greenspan to comment on proposed legislation to remove the legal impediments to the integration of banking, insurance, and securities activities, he strongly endorsed the need for change. Greenspan emphasized that U.S. financial institutions compete in global financial markets and noted that "archaic barriers to efficiency" could "undermine the competitiveness of our financial institutions . . . and, ultimately, the global dominance of American finance."

FINANCIAL INNOVATION AND THE EVOLUTION OF MONETARY POLICY ANCHORS

As the innovations and regulatory changes described above took shape, the traditional relationships between various measures of the money supply and inflation began to break down. In the early 1980s, with the introduction of money market deposits and sweep accounts, among other innovations, the frequently redefined monetary aggregates like M1 (basically currency plus various types of checking accounts) and M2 (M1 plus small savings and time deposits) became increasingly unstable and hard to predict.

M1 had been a favored target for monetary policy, particularly during the late 1970s and early 1980s, because it was thought to have a relatively close relationship to economy-wide spending and was easily influenced by Fed policy. Before deregulation, targeting M1 appeared attractive largely because laws prohibited checking accounts from earning interest, and other types of accounts could not offer checking privileges. These differences forced depositors to keep all the money they intended to spend in the near future in checking accounts while encouraging them to minimize these non-interest-bearing transaction balances. But when deregulation and financial innovation led to checking accounts that paid interest, and it became possible to write checks on other types of deposits, the division between the various monetary aggregates broke down. "Small changes in interest rates caused individuals to move in or out of M1, which, in turn, led to substantial swings in the aggregate's growth rate that had little to do with individual spending plans," San Francisco Fed researchers Bharat Trehan and Kelly Ragan pointed out in 1998. As the growth rates of the various Ms turned unstable, targeting any particular monetary aggregate became a far less effective way of conducting monetary policy.

This article was adapted from a paper presented at a Boston Fed conference in honor of Frank E. Morris, former President of the Federal Reserve Bank of Boston. The complete proceedings can be found in The Evolution of Monetary Policy and the Federal Reserve System Over the Past Thirty Years: A Conference in Honor of Frank E. Morris, *Conference Series No. 45.*

By July 1983, Frank Morris, then president of the Federal Reserve Bank of Boston, was arguing that no targets should be set for M1 and M2 because they were no longer "predictably related to nominal GDP." He argued that it would be far better to target broader aggregates, such as total liquid assets or total domestic nonfinancial debt.

In time, Morris's views came to be widely shared. By the early 1990s, the Federal Open Market Committee was warning the Congress and the public regularly that the monetary aggregates were unreliable guides for policy. Finally, in August 1995, the FOMC changed the wording of its domestic policy directive to the New York Fed to include a specific target for the Fed funds rate, the overnight interbank lending rate. This change clarified the fact that the FOMC had actually been targeting the Fed funds rate, rather than any of the Ms, for some time.

CONCLUSION

Foreign competition and foreign opportunities resulting from gaps between national regulatory frameworks have provoked substantial change in the structure of the U.S. financial system.

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These external forces were an important factor in breaking down the geographical and business barriers that had shaped the U.S. banking system since the 1930s. They also led to important financial innovations that required major changes in the regulations governing U.S. banks. These innovations, in turn, affected how monetary policy works in this and other countries since many of the new types of accounts blurred the distinctions between the monetary aggregates and made them increasingly poor guides for policy. The ensuing search for a substitute has led many central banks, in the United States and abroad, to choose short-term interest rates as their operational target. Others have adopted a specific inflation target, choosing to highlight what they view as the central bank's ultimate goal. Which is the better approach? Once again, foreign forces will likely help shape the future conduct of U.S. monetary policy as policymakers here and abroad observe the outcomes of their differing national experiments. ☼

RICHARD N. COOPER IS MAURITS C. BOAS PROFESSOR OF ECONOMICS AT HARVARD UNIVERSITY. JANE SNEDDON LITTLE IS VICE PRESIDENT AND ECONOMIST AT THE FEDERAL RESERVE BANK OF BOSTON.

The birth and death of Regulation Q

Interest rate ceilings on bank deposits loomed large on the U.S. banking landscape for over fifty years. The Banking Acts of 1933 and 1935 prohibited commercial banks from paying interest on demand deposits (that is, checking accounts) and allowed the Fed to set ceilings — via Regulation Q — on interest paid on time and savings accounts. This legislation reflected a widespread belief that the bank failures during the Great Depression had resulted from excessive competition. Supposedly, high interest costs and low profit margins drove banks to make high-yield but risky investments. In addition, the Congress thought that limiting interest rates would encourage country banks to lend more in their local communities.

The ceilings were not binding until the mid 1960s, as market interest rates remained well below the Reg. Q limits. But in 1966 inflation began to pick up, the Fed tightened policy, and unregulated interest rates on assets like Treasury securities rose above those permitted by Reg. Q for bank deposits. At the time, policymakers were very concerned that investment funds were flowing disproportionately toward business investment rather than into mortgage lending. Thus, they extended Reg. Q to cover the thrifts (the savings banks and savings and loan associations) but imposed slightly higher ceilings on these institutions because they traditionally specialized in mortgage lending. The lawmakers thought that doing so would let the thrifts attract more deposits. Instead, both the banks and the thrifts faced a runoff of funds into assets, like Treasury securities and commercial paper, with unregulated interest rates.

Facing a loss of deposits every time interest rates rose, the commercial banks sought to work around the restrictions. Aside from turning to the Eurodollar market and other unregulated markets to raise funds, commercial banks also started enticing U.S. depositors by offering them a variety of gifts, to compete in areas other than interest rates. The ceilings harmed low-income savers disproportionately. Wealthy depositors could shift their deposits to unregulated investments and, after 1970, deposits of $100,000 or more were exempt from Reg. Q. "According to some studies, small savers lost several billion dollars in interest earnings as a result of Regulation Q ceilings," R. Alton Gilbert of the St. Louis Fed pointed out in 1986.

By the late 1970s, it was clear that Reg. Q was not producing the desired results. Money market mutual funds had become major competitors with banks and thrifts for small investment accounts. And Reg. Q was not increasing the supply of funds for mortgages. If anything, it was making mortgage lending more sensitive to the business cycle. In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act, which began the phase-out of the interest rate ceilings. By 1986, all Reg. Q ceilings had been eliminated.