The Benefits of Bank Deposit Rate Ceilings: New Evidence on Bank Rates and Risk in the 1920s (p. 2)

Arthur J. Rolnick

Recent Developments in Modeling Financial Intermediation (p. 19)

Stephen D. Williamson
Banking

Banking certainly seems special, judging from the amount of study and attention it receives. But is banking fundamentally different from other types of businesses? And if so, do its differences require giving banks special treatment, such as insuring their liabilities or closely regulating and supervising their activities? Some aspects of these questions are addressed by the two articles in this issue of the Quarterly Review.

Compensating Depositors for Risk

Previous studies have suggested that banks are special because, unlike other businesses, they do not have to pay their creditors higher rates of return when they take on riskier investments. These were studies of banking in the 1920s, a time when the government neither restricted the rates banks could pay on their deposits nor insured those deposits. According to the studies, the deposit rates banks paid at that time were unrelated to the riskiness of their portfolios. In “The Benefits of Bank Deposit Rate Ceilings: New Evidence on Bank Rates and Risk in the 1920s” (p. 2), Arthur J. Rolnick suggests that the previous studies were wrong. Using newly discovered, better data on banking in 1926-30, Rolnick finds that banks with riskier portfolios did have to compensate their passbook savers with higher rates of return. This means that banks are not special in the way their risk and return are related. It also means, though, that if banks are special in some other way which makes policymakers want to limit their risk-taking, legal ceilings on bank deposit rates might work.

Monitoring Borrowers for Soundness

In “Recent Developments in Modeling Financial Intermediation” (p. 19), Stephen D. Williamson cites four functions that make banks and other financial intermediaries special. But those special functions do not necessarily imply special treatment by government. To determine whether it is implied, we first need economic models in which intermediaries are a logical outcome of the models’ assumptions. After reviewing different approaches to modeling banks and other intermediaries, Williamson presents such a model in which intermediation is inextricably linked to fluctuations in the business cycle. In his model, intermediaries monitor the success of borrowers’ investments to relieve their depositors (the ultimate lenders) from the expense of doing so. Although the modeled intermediaries perform some of the special functions of real-world ones, the model does not indicate that they require special treatment.