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Address questions to the Research Department, Federal Reserve Bank, Minneapolis, Minnesota 55480 (telephone 612-340-2341).

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In This Issue

A Look Back . . .

This issue of the *Quarterly Review* brings together three previously published articles which examine policy and theoretical issues in the three main areas of monetary economics: financial intermediation, foreign exchange, and money. The articles were intended to be think pieces aimed at stimulating further discussion and research in these areas. And we republish them now with the same aim. Although they were written as far back as 11 years ago, they seem just as timely today.

The policy issues addressed in these articles are still being discussed today. The article on financial intermediation considers deposit insurance reform, which is, of course, the main policy issue in the current savings and loan bailout. The article on foreign exchange considers feasible exchange rate regimes, a topic receiving much attention as Western Europe moves toward a monetary union in 1992. And the article on money considers the roles of money and monetary policy in economies under different sets of financial regulations, a topic relevant to the emerging market economies of Eastern Europe.

The central theoretical issue in all three articles is what makes their respective areas of monetary economics special. Better understanding of the nature of these areas is needed to determine whether they require separate treatment and special policy interventions. Considering the three areas together here might even help researchers move toward a unified monetary theory.

Because the articles in total contain only one puny equation, you might surmise that they are not representative of modern economic theory based on explicit mathematical models. However, the deep insights and complex relationships described in the articles all flow from such models. The articles clearly demonstrate that modern mathematical theory is useful in interpreting current and past events and is relevant for policymaking.

Good theory not only helps interpret current and past events; it also provides useful predictions. The first two articles in this issue are old enough for us to judge the accuracy of their predictions. The article on financial intermediation, first published in 1983, predicts that granting expanded powers to depository institutions before reforming deposit insurance will lead to a crisis. The article on foreign exchange, first published in 1979, predicts that a pure floating exchange rate system will be so unstable that it cannot be maintained. My predictions about the Super Bowl should have turned out so well.

If this brief introduction has not whetted your appetite to read on, I hope these brief summaries of the articles do.

. . . At Special Firms . . .

In "Deposit Insurance Reform; or, Deregulation Is the Cart, Not the Horse" (p. 3), John H. Kareken explains why flat-rate deposit insurance gives financial intermediaries an incentive to take on too much risk. He then discusses the purposes of deposit insurance and some ways reforms might serve those purposes. One of the major purposes is to prevent runs on depository institutions; their susceptibility to runs makes such firms special. The possible reforms Kareken discusses are now familiar: abolishing the insurance and requiring depository institutions to either hold safe assets or mark to market, reducing the deposit ceilings for insurance, and risk-adjusting the insurance premia.

. . . Special Markets . . .

In "Why Markets in Foreign Exchange Are Different From Other Markets" (p. 12), Neil Wallace explains why unfettered markets cannot determine a price at which the currency of one country exchanges for that of another. In effect, any price will work—something which is not true in other markets. Wallace then argues that the only feasible regimes for these special markets are floating exchange rates with capital controls or fixed exchange rates with monetary and budget policy coordination.

. . . And Not-So-Special Assets

In "A Suggestion for Oversimplifying the Theory of Money" (p. 19), Neil Wallace argues that there is nothing special about government-issued money. He explains why, without restrictions of some kind, privately issued money would be a perfect substitute for it. Wallace describes the type of intermediation his argument implies for a laissez-faire economy. One important implication is that there would be only one risk-adjusted rate of return; either all assets would pay a low return to match that on money, or money would pay interest. Another important implication is that open market operations would be irrelevant. Wallace argues that the reason we don't frequently observe economies such as he describes is that governments generally impose restrictions which prevent the private issue of money. However, Wallace does examine some historical periods when restrictions seemingly were not imposed. He concludes by admitting he has reservations about the oversimplifying suggestion.

Preston J. Miller
Editor