Technological and Regulatory Forces in the Developing Fusion of Financial- Services Competition: Discussion
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DISCUSSION

DAVID S. KIDWELL*: The paper by Edward J. Kane (1983) is concerned with providing an economic rather than political explanation for the changing structure of the U.S. financial system. Specifically why, without the consent of regulators, are depository institutions and their nontraditional competitors (e.g., brokerage firms and insurance companies) expanding into new geographic markets and/or product lines. Kane argues that economies of scope and deposit insurance subsidies provide the major economic incentive for firms to expand into one another's markets. In addition, competition between overlapping federal and state regulators facilitates change because depository institutions play authorities off against each other to win favorable regulatory changes. As its theoretical foundation, the paper depicts the desegmentation of financial service markets as an application of the theory of contestable markets which maintains that market structure is not exogenous but adapts dynamically to allow the expansion of economically efficient providers at the expense of less efficient ones (Baumal, Panzar, and Willig, 1983). Though I agree with Kane's framework of analysis, I would like to elaborate on a few areas of the paper.

First of all, I agree with Kane's basic tenant that economic forces rather than political forces are shaping the new financial structure. The current trend of deregulation is misleading to the public because it suggests that government foresight is the impetus for structural change and not economic forces. In fact, government policy actions have been directed toward slowing down the adaptive responses of financial institutions to meet customer demands. The so-called deregulation taking place is no more than expost reaction by Congress and regulatory agencies to the economic realities of the marketplace.

In discussing the apparent breakdown of the inherited system of exclusionary regulations, Kane raises the issue of why society would suddenly reveal a preference for abandoning rather than rebuilding the legal barriers in the financial service industry. He then argues that scope economies, opportunities for structural arbitrage (i.e. adaptive changes by firms to lighten their tax and regulatory burdens), and destabilizing incentives of deposit insurance are the economic forces reshaping market structure. However, Kane does not fully explain why the change in structure of the financial system began in the first

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place. We must remember that regulations partitioning the financial service industry into sets of mission orientated institutions have remained virtually intact since the 1930s. Furthermore, numerous initiatives to reform the U.S. financial system (e.g. The Hunt Commission) accomplished little.

It is my belief that the new and burgeoning "computer" technology of the 1970s is the economic catalyst driving the restructuring of the U.S. financial system. The recent evidence on the importance of economies of joint production as powerful economic incentives for change have occurred because of the new technology (Federal Reserve Bank of Atlanta, 1982). Simply stated, the age of the high-speed computer, the micro-chip, the rebotization of many labor intensive functions, and expanded data and telecommunication systems have made the generic financial service firm economically possible. Generic financial service firms can now reduce their unit cost of production by spreading the cost of production across additional production lines. Without the new technology, deregulation would not have occurred.

A second comment deals with Kane's discussion of how regulatory interference tends to slow down the rate of adaptation by imposing regulatory avoidance costs on firms. The tenor here is that except for protecting the soundness of the financial system, regulators should allow economic forces to operate unbridled. However, regulatory interference is at least in the short-run a desirable feature. The reason being is that it does provide smaller and less sophisticated depository institutions an opportunity to adjust to the evolving market structure in an orderly manner. Politically this is desirable to wholesale closings (merger or acquisition or failures) which could lead to serious political backlash and punitative regulations that could retard or stop the current trend for a more competitive and efficient financial system. An orderly transition period is also desirable in that it allows Congress sufficient time to decide on a regulatory configuration that will foster an efficient financial system while at the same time allowing the Federal Reserve Board to carry out its mission of economic stabilization. Clearly, there may have to be some trade-offs between market efficiency and the Fed's ability to control the money supply.

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