The Federal Reserve System:
Its Functions and Challenges

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National Association of State Budget Officers
Annual Meeting

July 21, 1997

Good afternoon. I'm delighted to be here with you today in the shadow of beautiful Lone Mountain. As any of you who have skied here know, this mountain is a challenge. But I expect it's not as great a challenge as most of you are facing now that more and more Federal government programs and goals are bundled into block grants to the states. Living within your means at the state level is a daunting task, at best, at any time, and I expect it will become even more so.

I'd like to touch a bit on the national economy and then discuss the various ways the Federal Reserve System promotes economic well-being in a rapidly changing financial landscape. I won't try to cover the full depth of these topics. But I would like to share my thinking on several issues which not only are the focus of considerable debate, but also bear directly on your professional sphere.

The business of the Fed intersects in many ways with the concerns of state governments. To take just one example, the states are currently responding to the significant challenge of how to carry out welfare reform. Jobs are scarce in many inner cities and rural areas, so the challenge of matching welfare recipients with employment is not easy. But this task is bound to proceed faster and with less pain when the national economy is robust than during a recession or a period of high inflation. That's why today's news about the U.S. economy is so welcome. The national economy is quite robust; the unemployment rate is as low as it has been in more than 20 years, and inflation is as low as it's been on a sustained basis since the mid-'60s.

First quarter 1997 was a barn-burner at 5.8 percent real GDP growth. Second quarter has slowed down for sure--it had to--but first half should average around the 4 percent pace we've seen for over a year. Four percent real growth for over a year, combined with unemployment rates hovering around 5 percent, would have been a recipe for a surge in inflation in earlier times. But that hasn't been the case in 1997. Instead, inflation by most measures has either stabilized or turned down. Why this is happening --and more importantly how long it can continue-- is no small puzzle right now, but it is also very good news.

No single institution is responsible for the health of the economy, but I believe the Federal Reserve can take some pride in the nation's current economic success. This is at least in part because of the

Federal Reserve's efforts in the late '70s and early '80s to break the back of then double-digit inflation. These efforts took their toll on economic growth. However, that courageous action, and the Fed's subsequent handling of the economy over the ensuing period, has resulted in 15 years of growth, with only a slight 9 months or so pause in 1990-91 for the briefest recession in U.S. post-war history. The inflationary spiral was broken, and, in the process, an environment conducive to investment and growth was created. Clearly, by keeping its eye on the pre-eminent goal of monetary policy --that of price stability-- the Fed has contributed to stable and sustainable U.S. economic growth and standards of living.

To these ends the Federal Reserve System uses three tools: monetary policy, which acts to control the availability and cost of credit in our economy; bank supervision and regulation, which seeks to ensure that financial intermediation promotes stable economic growth; and oversight of the payments system, which seeks to ensure that financial problems do not spread systemically. Monetary policy issues hit the news all the time, but the relevance of bank supervision and regulation and payment system oversight to monetary and financial stability is often overlooked or misunderstood. Moreover, as we all can plainly see, the financial world has been changing rapidly, posing ever increasing challenges. So the Federal Reserve's functions must also be considered in the context of change and challenge from many sources.

When the Fed conducts monetary policy, it seeks to control the availability and cost of bank reserves--the balances banks keep with Reserve Banks and that they lend to one another for very short-term periods, usually overnight. This is done by buying and selling Treasury securities in the open market --hence the name open market operations-- and has a direct impact only on the very short end of the yield curve. The Fed's overall success in taming inflation affects interest rates more generally as well, by affecting the risk premium lenders require to offset the impact of future inflation --though I should note that many other things, the level of the Federal deficit for one, --affect longer term interest rates as well. The body responsible for establishing monetary policy is the Federal Open Market Committee. And I should note it is a Committee, not just Alan Greenspan, that directs monetary policy--a Committee composed of not only the seven

Governors of the Federal Reserve Board in Washington, but also on a rotating basis, five of the twelve Reserve Bank presidents from around the country.

This regional structure is one of the Fed's unique assets. The twelve banks' locations reflect the banking and political power structure back in 1913 when the System was founded. The Northeast and mid-Atlantic are well represented, with Reserve Banks in Boston, New York, and Philadelphia; and Missouri is home to two Reserve Banks, in St. Louis and Kansas City. By contrast, the San Francisco Fed has a vast district of nine states and 50 million people.

How archaic, you might say. But I would argue that Reserve Bank numbers or location are not the issue --the contribution of regional input to the national decision about monetary policy is the important thing. Here the Federal Reserve System is served well by the regional structure and the related diversity of viewpoints, both about economic theory and about economic trends.

This regional structure connects the Fed to the real economy outside of Beltway Washington. The Reserve Bank Presidents bring information about what's happening in their regions, and these experiences can differ markedly from the national average. Thus the regional Presidents can and do sound early warnings of developments that could affect the nation as a whole.

New England provides a case in point. During the mid-'80s, Frank Morris, then-President of the Federal Reserve Bank of Boston, alerted the Open Market Committee to the excesses in real estate markets, and the related threats to bank health and overall regional economic growth. New England experienced a real estate bust and related credit crunch, which deepened the recession in that area. New England's problems were echoed in other parts of the country, but because of the early warning, the FOMC was sensitized to the contractionary effects of disruptions to the availability of bank credit. This was one of the headwinds to which Chairman Greenspan referred frequently during the early stages of the national recovery, and which contributed to the FOMC's reducing short-term interest rates in 1993 to their lowest rate in 30 years.

The financial press likes to paint most central bankers as inflation hawks, and certainly price stability, no matter how that is defined, is the goal of monetary policy. As a central banker, however, I also want the highest sustainable overall economic growth rate, and the lowest sustainable rate of unemployment. Low and stable inflation is critical to achieving these things.

Very high inflation adversely impacts economic performance and disrupts everyday life. In addition, many Americans rightly view inflation as assaulting the work ethic that places a moral premium on saving over consumption. In the mid and late 1970s, when inflation surged to double-digit levels, Americans named inflation public enemy number one.

Even moderate levels of inflation --that is, below the double-digit level --can distort investment and consumption decisions. Businesses find it difficult to make long-term contracts. Retirees become uneasy about inflation adjustments to their pensions and financial investments. The tax code induces other distortions as well.

So a low rate of inflation is a good thing. A low *and stable* rate is even better, since stability reduces uncertainty. But we central bankers don't know exactly how low is optimal. One current debate in monetary policy revolves around the benefits and the costs, in terms of lost output and higher unemployment in the short-term, of moving to zero inflation. Is zero inflation sufficiently better for the economy than 2 to 3 percent inflation to warrant the effort of getting there? And how do we measure inflation anyway? As a glance in the financial press indicates, there are many opinions on these questions.

These discussions are complicated by the fact that the Fed cannot address inflationary pressures immediately as they become evident. Let me explain. The self-perpetuating nature of inflation makes it more costly to correct than to avoid. People begin to build expectations of inflation into their wage demands and businesses into their price setting. Once inflation picks up, it tends to persist. For that reason, the broad measures of inflation, such as the CPI, tend to lag the actual inflationary pressures. In similar fashion, the Fed's monetary policy levers don't switch on and off. They operate imprecisely, and with a long lag. So we have to anticipate what will happen given current conditions, and form expectations about the future based on empirical relationships of the past. The Fed has to be forward-looking, with all that implies about action in advance of settled opinion about economic trends.

Given all these lags and blunt instruments, the fact that the economic track record has been strong --particularly now with an extraordinary combination of healthy growth, low inflation, and low unemployment-- belies the difficulty of the task. The judgment call seems particularly hard at the moment, because the economy is behaving in ways that would not have been predicted a year ago. We have more growth, more employment, and less inflation than historical relationships and most economic theory would suggest is possible. I must say I'm glad we're faced with this particular puzzle, but I also think the situation calls for vigilance. It may be that temporary factors such as the value of the dollar, an uncertain workforce, and declining health care costs are contributing to our success, and, sooner or later, some or all of these could change.

Supervising and regulating banks, in my view, has a direct and immediate relevance to the Federal Reserve's goal of maintaining stable economic growth. Banks are special--they mobilize savings, allocate savings to effective use, and are the operators of the nation's payment system. These functions are considered critical to economic stability, so much so that publicly-backed deposit insurance and other safety nets exist here in the United States --and in most other countries as well-- to ensure that these functions continue uninterrupted in the face of financial or economic problems.

Bank regulation seeks in part to protect the deposit insurance system. More importantly, regulation exists because of the threat that problems at one bank can have broader implications, or present what is called systemic risk. The failure of one large bank, or a group of banks, can ripple out to impact borrowers, co-lenders, and others, with serious consequences for the economy. And it is that threat to the overall economy that argues most strongly for Federal Reserve involvement in bank regulation.

The special nature of banks endures. As is widely noted, however, dramatic advances in information and telecommunications technologies, combined with modern financial theory, have allowed banks and financial markets in general to develop new and more customized products, and deliver them over a broader geographic area and with greater efficiency. Such innovations have increased the sophistication and complexity of bank lending, investing, and trading.

More to my point, they have also blurred the lines between banks, particularly the large banks, and nonbank financial institutions. We see a growing overlap in the activities and product lines provided by both banks and other financial service firms. By creating derivatives, firms can now slice and dice risks of a variety of underlying assets. These innovations make it possible for investors facing different tax and regulatory structures to invest more efficiently and to offset risks that occur in the rest of their portfolio.

Financial modernization has raised policy questions regarding the breadth and scope of what banks can and cannot do, and the appropriate organizational structure through which banks should gain any new functions. Financial modernization has prompted the Fed and other regulators to respond with innovative regulatory changes. And broad legislative reform seems imminent as well. The formal demise of the barriers created by the 1933 Glass-Steagall Act has been predicted for years, but now it may come to pass, as Congress is debating several proposals. All involve repeal of Glass-Steagall, expanded insurance activities for banks, the entry of insurance and securities firms into banking, and at least a modest mix of banking with commercial business.

Advocates of loosening restrictions on banking and commerce make various arguments, from synergies in cross-selling to diversifying risks. They vow to erect fire walls to ensure that banks wouldn't use their preferential access to money to fund nonfinancial ventures. That may be wishful thinking. There's little in U.S. or other experience to give me confidence about the benefits of combining banking and commerce. Yet even if there were, allowing a bank to hold both a debt and an equity stake in a commercial firm could come at a price --an expansion of the federal safety net, potentially dangerous conflicts of interest, and excessive concentration of power or some combination of all three. In short, in my view, an unacceptable threat to the safety and soundness so essential to banking.

Beyond the issue of how the U.S. financial system should be restructured lies the issue of how it should be regulated. There are some who believe that the central bank's role in such regulation should be minimal, and there has been movement in the U.K. and elsewhere to take the central bank out of active involvement. I find this trend disturbing. Central banks exist to promote stable economic growth--financial stability is a large part of this. Thus, central banks are always the lenders of last resort, and the bulkwark in times of crisis. I would argue that the ability to provide hands-on solutions in times of crisis cannot be developed, and certainly can't be implemented, using hands-off supervisory insights and relationships. There is a risk the Federal Reserve could lose the ability to be the source of stability and comfort it was so many times during the '80s without direct supervisory authority over at least the larger, multi-national institutions. Thus, I believe there is a clear and ongoing need for Federal Reserve presence in the supervision and regulation of large banks and, as they evolve, the broader-based financial services companies that may house banking institutions in the future.

The potential for systemic risk is a primary driver for bank regulation; it also drives the Fed's interest and involvement in the payments system. The payments system has been likened to the bloodstream of the economy; if it stops, the consequences can be severe, but as long as it keeps functioning, people simply take it for granted. At the wholesale level, the payment system allows corporations and other institutions to transfer the value that results from commercial transactions among themselves. Here the number of transactions is relatively small, but the values are high--better than $3 trillion a day flows through U.S. wholesale systems. At the retail level, the system lets institutions and individuals transfer value, whether by check or electronic payment. Obviously, values are lower here but volumes are enormous--just as an example, over 65 billion checks are written each year.

The Fed is critical to payments processing because it is the supplier of final settlement. That is a quintessential central bank function, one shared by all central banks. But the Reserve Banks also compete with private providers at every level of payments service provision, from processing checks to transferring large electronic transactions--a unique level of hands-on participation by a central bank in the payments system.

Far from being just a mechanical process, a responsive and reliable payments system is critical to economic growth. There are many types of risk inherent in the system, which is why the Fed has been involved since its inception. The Fed serves as a safety valve, and helps maintain order in the midst of problems. We in Boston have an abiding memory of the Rhode Island thrift crisis, when doubt that Social Security payments could be made on a regular basis threatened not just the uninsured thrifts in Rhode Island, but the deposits at thrifts across the border in Massachusetts as well, and even national public confidence in the electronic check clearing system. The Boston Fed arranged alternate receivers of Social Security deposits, and supported them operationally.

That situation illustrates the central bank's deep interest in ensuring even small-value payments are made and providing stability when problems occur. Stress in the payment system is one of the manifestations of financial crisis, and the Fed's practical expertise in this area has been essential to handling various banking and financial problems over the past decades.

Of course, as with other regulated industries such as telecommunications and electricity, there is vigorous debate about the appropriate mix of private and public participation in the payments system. Reserve Banks price the services they provide, and over the period since 1980 when this was first required, have managed to cover payment system to an electronic system. The need to process and collect approximately 65 billion paper checks a year has been estimated to cost nearly 1 percent of GDP. The banking industry historically has had difficulty coordinating changes in the paper check system. This is not surprising, since that payment mechanism is a complex network, requiring a substantial degree of standardization among participants, and operating with significant economies of scale. Similarly, it took decades for nationwide credit card and ATM networks to evolve.

The Federal Reserve System has a long track record in espousing and implementing change in the payment system, through participation in the process, through regulation, and through conducting innovative research and product development. Commercial banks realize much can and should be done to reduce paper and improve efficiency in the payments system, and we in the Reserve Banks are assisting in this process.

I've covered a lot of ground here in highlighting the Fed's role, and some of the key debates, in monetary policy, bank regulation and supervision, and the payments system. In each area, market forces and technological change are driving rapid innovation. Yet with all this change, the primary need to foster stable economic growth remains. There is a record of success here, and that success in my view, is at least in part a result of the Federal Reserve System's continuing attention to three critical and interrelated areas --price stability, safe and sound banking systems, and safe, secure and reliable payment systems. The genius of the Federal Reserve System, I believe, is that these three highly interrelated functions are viewed together. Other countries do these processes differently, but the U.S. approach has and should continue to serve us well over time.