The Twenty-Second Annual Economic Policy Conference of the Federal Reserve Bank of St. Louis, held October 16-17, 1997, touched on all three of the fundamental responsibilities that Congress assigned to the Federal Reserve System. These responsibilities include conducting monetary policy, supervising and regulating banking organizations, and protecting the payments system. Throughout its history, the Fed has approached all of these vital responsibilities with one broad objective in mind—that is, to provide a stable monetary environment in which the economy can achieve its maximum sustainable rate of growth. Inflation, bank failures, and unreliable payment mechanisms all distort the public’s financial decisions and prevent the economy from achieving its full potential.

Not surprisingly, the Fed’s responsibilities are closely linked in an operational sense. Changes in the Fed’s monetary liabilities—currency in circulation and bank reserves—reflect monetary policy actions. At the same time, these central bank liabilities constitute the sole means of settling transactions with finality. Because only commercial banks and other depository institutions have access to real-time, irrevocable interbank settlement provided by the Federal Reserve, they alone are able to extend these services directly to their customers. Accordingly, depository institutions are regulated not only to protect consumer deposits, but also to ensure the integrity of our nation’s payments system.

Our economy might function without a central bank. Although the Treasury and various private banks assumed some central bank functions during the first century-and-a-half after our nation’s founding, the United States did not have a formal central bank until 1914. However, many observers of financial history conclude that a lender of last resort coupled with a payments provider of last resort—in essence, a central bank—provides the solid foundations upon which the rest of the nation’s financial structure can safely be constructed.

As we approach the twenty-first century, rapidly evolving technology, financial innovation, and financial globalization have created new problems for monetary policy and financial regulation. But many of the issues involved in these challenges are not new. The payments system is rapidly entering the electronic age, for example. The questions of security, efficiency, and integrity that arise as we move away from paper-based payments, however, are really no different from those associated with private banknote issuance or interbank settlement among correspondent bank networks in the nineteenth century.

History's potential for informing current policy extends far beyond the regulation of new payment instruments. It may also shed light on the broader questions about the activities in which banks should be permitted to compete, the impact of financial innovation or institutional changes on the conduct of monetary policy, and the appropriate role of a central bank in providing payment services.

Consider some recent history involving banking and monetary policy. Much of today’s bank regulatory structure originated in the Great Depression. Although this structure seemed to work well for many years, the inflationary environment of the 1970s gave rise to financial innovations outside the banking industry that increased competitive pressures on banks and other depository institutions. These pressures led eventually to decontrol of deposit interest rates and deregulation of S&Ls. At the same time, federal deposit insurance was expanded.

The subsequent rise in bank and S&L failures taught us several lessons. One lesson is the danger of piecemeal regulatory change: Policymakers must be mindful that a change in one regulation can produce unintended consequences from other regulations. Another lesson is that mismanaged monetary policy—policy that causes substantial fluctuations in the price level—can initiate or amplify instability in the nation’s financial structure. Depository institutions...
might still have felt increasing pressures in the 1970s and 1980s had the price level been stable, but surely the situation was made worse by high and variable inflation. Some reforms have since followed—tighter limits on deposit insurance, for example. Other proposed reforms, such as repeal of the Glass-Steagall restrictions on the permissible activities of banks, await action in Congress. With the regulatory environment currently in a state of flux, now is an important time to consider the role of banks with an eye toward understanding the appropriate role and form of regulation. I am thus especially pleased that the opening session of our conference focused directly on the special place of banks in the financial system.

Next, we broadened our focus to consider issues of financial-market development and monetary policy regimes. Although depository institutions receive a special supervisory and regulatory focus, the stability of the financial system as a whole is crucial to the integrity of the payments system and hence to the functioning of our nation’s economy.

The total volume of all payments made in an average business day in the United States is approximately $2 trillion, and payments to effect transactions in financial instruments constitute a lion’s share—perhaps 90 percent—of this volume. By comparison, the M2 money stock is roughly $4 trillion, and U.S. commercial bank assets total some $4.5 trillion. Because all large-dollar payments flow through the banking system, a widespread financial-market collapse could have serious repercussions for banks and the payments system. It is thus imperative that the Fed monitor financial-market developments, supervise the financial-market activities of banks, and ensure that monetary and regulatory policies do not contribute to financial instability.

Finally, the conference turned explicitly to the payments system and the central bank’s role in it. As a member of a Federal Reserve System committee headed by Governor Alice Rivlin, I recently was involved personally in a re-examination of the Fed’s retail payments system operations, including the clearing of paper checks and the provision of ACH services. For a number of years, I also chaired a standing committee concerned with setting the strategic direction of Federal Reserve financial services and coordinating those activities among the Reserve Banks. I thus found especially interesting our final conference session, which considered the implications of central bank provision of payment services on the efficiency of the payments system.

My colleagues assembled an all-star lineup of financial historians. I am sure that you will find informative and insightful the articles they prepared for the conference and this proceedings issue of the Review. The articles address timely issues that lie at the heart of what the Federal Reserve is all about.

Thomas C. Melzer*
Federal Reserve Bank of St. Louis

* Thomas C. Melzer was president of the Federal Reserve Bank of St. Louis at the time of the 1997 Conference. He resigned from the Bank at the end of January 1998.