Economic Commentary

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The Federal Reserve in the 1980s: Damage Control in the Southwest

[Editor's Note: On Jan. 31, Robert H. Boykin will retire after serving more than 37 years with the Federal Reserve Bank of Dallas. He became the Bank's ninth president in 1981.]

The decade of the 1980s was unquestionably one that required extraordinary adaptations and adjustments to change by those of us who lived in the Southwest. During my tenure as president of the Federal Reserve Bank of Dallas, I witnessed firsthand many who possessed this capability. Given our spectacular growth in the 1970s, who could have imagined the difficulties the region's states would face in the 1980s? Who foresaw the precipitous plunge in oil prices and the ensuing deterioration in property values? Moreover, a decade ago, could anyone have predicted that some of the Southwest's largest and oldest banks would fail or need outside assistance?

These incidents forced those of us in the Southwest to fundamentally reassess our ways of thinking and doing business. Because of our trials and tribulations, however, I think we succeeded in transforming our economy into one that, through diversification, is now more resilient.

Normally, our free and democratic society relies on private markets to adjust to these types of economic shocks and to redirect resources to their best uses. But the shocks the Southwest underwent were so severe and of such enormous magnitude and duration that an orderly, market-driven transition was in jeopardy—too much change, too fast, threatened to push our economy into a much deeper recession than that which actually occurred. Fortunately, society is well aware of the potential for market failures and creates special public or quasi-public institutions, in part, to help overcome these disruptions and to restore the effective operation of markets. The Federal Reserve is a prime example of such an entity.

With the crisis in the region's banks, the Federal Reserve played an important part in helping Southwestern businesses and individuals survive this crisis by providing a risk-free way to clear payments. During this banking crisis, the need for an efficient payments mechanism expanded as failures of large correspondent banks—banks that clear payments for other institutions—initiated a breakdown of established clearing arrangements. Because the Federal Reserve offered an alternative means of clearing, the Southwest avoided the disruption in the flow of payments and the chaotic consequences such a disruption might have caused.

Another way the Federal Reserve offered assistance was by providing liquidity to failing banks during the process of resolution by the Federal Deposit Insurance Corp. (FDIC). In doing so, the Federal Reserve helped to check the serious repercussions that the failure of one bank could have on other financial institutions and the system overall. The Fed's ability to quickly establish control over a bank's collateral in order to extend loans at the discount window was crucial in isolating the problems resulting from the failure of a single bank. Because of the Federal Reserve's quick response, the closures and sales of failed banks were conducted in an orderly manner.

Enhancing the Federal Reserve's ability to respond promptly and effectively to the crisis was its quasi-independent status. The Fed can implement necessary actions immediately, unencumbered by debates over the pros and cons of various policy responses. Although such policy discussions are an important and even fundamental part of a democratic society, there are times and places for such debates. In times of crisis, however, actions, not debates, are appropriate, especially when the health of a large portion of the nation's financial system is at stake. Thus, the preservation of the Fed's independence is important to minimize the impact of potentially devastating economic and financial shocks.

In addition to its independent status, the Fed's regional organizational structure contributed to the Dallas Fed's ability to deal with the economic crisis in the Southwest. Without regionally based Federal Reserve Banks—each with its own board of directors representing a broad cross section of business, financial and public interests—it is doubtful that the Federal Reserve could have responded as quickly and as intensively to the financial stresses and economic demands of this region. It is to the credit of the framers of the original Federal Reserve Act, written in 1913, that they created an institution with the ability to respond appropriately to the region's economic problems of the 1980s. During the past decade, the Federal Reserve System, as the nation's central bank, was put to the test. As a result, we have learned that the complete role of the Federal Reserve includes, as essential elements, its responsibilities for an efficient, safe and smoothly functioning payments system and its role as the lender of last resort.

Institutions such as the Federal Reserve assist our government in alleviating problems that might otherwise threaten the well-being of society in general. Through its payments-system operations and through its responsibilities in the areas of monetary policy and regulatory oversight, the Federal Reserve System successfully achieves its government-mandated charge—to promote a smoothly functioning economy and to safeguard against crises. I am proud to have served such a beneficial institution for so many years.