Donald D. Hester

The Evolution of Monetary Policy and Banking in the US

Springer

Preface

In the forty years that I taught courses in finance and macroeconomics at Yale University and the University of Wisconsin, I have been amazed by the spectacular innovations that have occurred in finance and by the failure of textbooks and treatises to address this dynamism. This short volume describes what led to changes and what the changes mean for the conduct of monetary policy and financial markets. Change and innovation are unending and should always be the principal focus of financial institutions, regulators, and portfolio managers.

The first part of this monograph, chapters one through eight, describes the evolution of U.S. monetary policy from 1945 through 2007. In 1945 the portfolios of U.S. banks were heavily invested in government securities and interest rates were kept low by the Federal Reserve, because of a pledge to help finance the Second World War. In the ensuing years banks steadily shifted from securities to loans, and interest rates and the rate of inflation were volatile. Between 1955 and 1960, restrictive monetary policy and competitive pressures forced banks and other institutions to begin to develop new techniques in order serve their clients. In the following years the frequency of innovations and their complexity increased, which led to many changes in the formulation, sophistication, and conduct of monetary policy. Innovations continue to threaten the effectiveness of monetary policy and also the stability of financial markets, which in turn challenge regulatory policies that apply to financial institutions.

The second part of the monograph, chapters nine through eleven, examine changes in the practices of financial institutions in greater detail and analyze how innovations have affected flows of funds through financial markets and the distribution of income, risk, and wealth in the U.S.

My interest in banks dates from my undergraduate days at Yale when I worked as a research assistant for James Tobin. My dissertation on bank lending at Yale was partly supported by a Stonier Fellowship from the American Bankers Association. My first book was an empirical study of Indian banks that appeared in 1964. A later book, coauthored with James L. Pierce, Bank Management and Portfolio Behavior (Yale 1975), was a large empirical study of commercial and mutual savings banks in the U.S. After it appeared and a year spent as an academic visitor at the Federal Reserve Board, I have been generally working on financial market innovations and their consequences. In recent years, I have been particularly interested in changes in Italian banking, work that is summarized in Banking Changes in the European Union: An Italian Perspective (Carocci 2002), coauthored with Giorgio Calcagnini.

Monetary policy has always been a major focus of my research and teaching. My interest in a larger study of the effects of financial innovations can be traced to a conference organized by the International School on the History of Banking and Finance at the University of Siena and Professor Marcello De Cecco in 1989. Early drafts of chapters 9 and 10 of the present monograph were originally lectures at that conference. An early version of Chapter 6 has appeared as Chapter 1 in Monetary Policy and Institutions: Essays in Memory of Mario Arcelli (LUISS 2006). Comments that I have received on lectures given at the University of Siena, LUISS, the University of Ancona and the University of Bologna have been very helpful in sharpening my arguments. I am also grateful to my many colleagues and students at the University of Wisconsin – Madison for encouragement and invaluable interactions and suggestions over the years.

I am indebted to Niels Thomas of Springer Verlag who made several organizational suggestions that improved this book's appearance and accessibility. Dawn Duren very ably transformed my Word text into Springer's final template. Last, but certainly not least, this book could never have appeared without the unending encouragement and support of my wife, Karen. She read the penultimate draft and her suggestions vastly improved my exposition. I remain solely responsible for any remaining errors.

Madison, Wisconsin Donald D. Hester
February 5, 2008

Contents