CHECKS AND BALANCES

Delivered by
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Checks and Balances

This is the Golden Anniversary of the Federal Reserve System. The System is not identical with what it was originally. An important ingredient of any viable, living institution is that it be flexible enough to meet changing conditions. During the past 50 years the System has undergone considerable change -- both through an evolutionary process from within and as a result of legislation.

Since early this year a congressional subcommittee has been examining the structure of the system and its conduct of monetary policy. This is not a new experience. During recent times it seems that similar reviews have been conducted every 2 to 4 years. Nor is it inappropriate -- because the System performs important public functions and the people are entitled to know what its central bank is doing.

On the other hand, it is not worthwhile to innovate simply for the sake of innovation. Moreover, the structure of the Federal Reserve System embodies principles which are rooted in American concepts of checks and balances and which have been hammered out through experience.

However, enactment of some bills now pending in Congress would fundamentally change the structure of the System.

So today I would like to discuss some of the characteristics of the System and, by way of background, to outline briefly the way monetary policy is formulated and implemented.

The Federal Reserve Banks have been described as Bankers' Banks and, in a sense, this is fair because we perform a number of services for commercial banks similar to those which the commercial banks perform for you and me. Reserve Banks hold deposits of their member banks, collect checks, supply currency and coin, and hold securities in safekeeping.

We have also been referred to as Government Banks and, in a sense, this is accurate for we hold a large portion of Uncle Sam's checking account and aid the United States Treasury in the issuance and redemption of Government securities.

The System collectively is also known as a Central Bank. This we certainly are because of our statutory authority over monetary policy.

A few years ago in an informal conversation the Governor of the Bank of England made the observation that the Federal Reserve System cannot work -- but it does -- and very well. What he meant was, from his point of view, our central banking organization was cumbersome and complicated. This is not a surprising view for a non-American.

In all economically advanced countries the guiding power over money is a Central Bank. In most instances, including England, Canada, Germany and France, this power is concentrated in a single institution which is strictly a governmental agency and ordinarily subordinate to the Treasury.

Our Central Bank, on the other hand, is a System of five component parts, each having certain powers and responsibilities.

(1) Board of Governors

(2) Twelve Federal Reserve Banks and twenty-four branches

(3) Open Market Committee

(4) 6,000 member banks

(5) Federal Advisory Committee

The Board of Governors in Washington is composed of seven members, each of whom is appointed by the President confirmed by the Senate for 14-year terms. This Board supervises and coordinates the entire System's operations.

The twelve Federal Reserve Banks and twenty-four branches reflect the regional flavor of the System. They have more than 250 directors who come from many walks of life. Each of the twelve head offices has nine directors; three are appointed by the Board of Governors and six are elected by the member banks.

The Reserve Banks function in the public interest and are instrumentalities of the Government. On the other hand, they have a private nature as evidenced by the fact that the officers and employees of the banks are not under Civil Service and the expenses of the System are paid out of the operating revenues of the banks, with no funds for System operations appropriated by the Congress.

The Federal Advisory Council has twelve members, one from each Reserve District and appointed by the Board of Directors of the Reserve Bank. The Council is simply what the name implies. It confers with the Board of Governors and makes only advisory recommendations.

There are a little better than 6,000 member banks. These, too, are an important part of the System. It is through these banks that the Federal Reserve carries out many of its responsibilities and implements its decisions regarding monetary policy.

The Open Market Committee is particularly significant and I would like to refer to it later. However, at this point I am sure you are aware that the powers and responsibilities of the System are decentralized by the mechanics of organization.

The System's principal concerns are to contribute to sustainable growth in our economy with reasonable stability in prices and a workable balance in our international payments position. This we attempt to do by providing reserves to the member banks. In less technical terms, our actions can be described as increasing or decreasing the supply of money.

The System, through monetary policy, cannot accomplish all things. Other factors, such as fiscal policy and taxation, are equally important. The System does, however, play an important role. During periods of inflation the problem is excess demand in relation to the supply of goods and services. This demand can be dampened by reducing available credit and money. In times of recession the need is for greater demand or stimulation. This can be encouraged by increasing the availability of credit and money.

The three principal tools used to stimulate or limit demand are:

(1) Reserve requirements. The Board of Governors has the power to raise and lower the proportion of their deposits that member banks must keep on deposit with the Federal Reserve. By raising the

requirements, funds are, in effect, taken from the market and the availability of credit is reduced. Conversely by lowering requirements, reserves are released to the member banks, thereby making credit more readily available.

(2) Discount rate. This is the rate of interest charged member banks for loans made to them by the Federal Reserve Bank. These rates are established by the Board of Directors of the Reserve Banks subject to the approval of the Board of Governors. Increases in the discount rate tend to restrict member bank borrowing and, consequently, the availability of credit. Lower rates would tend to have the opposite effect.

(3) Open Market Operations. This term refers to the System's purchases and sales of Government securities. As I have indicated, these purchases and sales are made for the purpose of affecting the amount of bank reserves. If, in the judgment of the Open Market Committee, more funds should be supplied, the Committee would buy bonds in the open market. On the other hand, if it would appear appropriate to tighten policy, i.e., reduce reserves, bonds would be sold.

Again, I am sure that you have noted that the tools of power are in separate hands.

The Committee, which is provided for by statute, is composed of 12 members, including the 7 members of the Board of Governors and 5 Presidents of Federal Reserve Banks. The President of the Federal Reserve Bank of New York is a permanent member of the Committee while the other 4 presidential positions are supplied on a rotating basis from the other Federal Reserve Banks. Your Reserve Bank is grouped with that of Dallas and Atlanta. Currently, the President of the St. Louis Bank is a member of the Committee.

The formulation of policy by the Open Market Committee is not done in a vacuum nor on the spur of the moment nor by any one or two people. The members of the Board of Governors and the presidents of each of the 12 Federal Reserve Banks are continually studying reports, statistics, and all available information in an effort to keep up with developments nationally and internationally. Each of the banks and the Board of Governors is supported in this undertaking by staffs who are specialists in their fields. These staffs are regularly engaged in gathering statistics, making surveys, analyzing reports and formulating views and considerations for their respective principals.

In addition, the Directors of the Reserve Banks also are important sources, not only of current business and statistical information, but also of grassroot, practical understanding and judgment.

The Open Market Committee meets at the offices of the Board of Governors of the Federal Reserve System in Washington, D. C. approximately each three weeks and more often when it is advisable. These meetings are attended by the 7 members of the Board of Governors and the 12 presidents of the Federal Reserve Banks. In addition, selected and key members of the staffs of the Banks and the Board are present.

The Chairman of the Committee opens the meeting and calls on members of the staff of the Board of Governors for reports. These include information on the general economic situation, the banking and financial picture, and regarding our balance of payments. This is followed by a report made by the Manager of the Open Market Account who is the staff member responsible for carrying out the policies established by the Open Market Committee for the purchase and sale of government securities. Another report on international activities and operations is submitted by the Special Manager for foreign currency operations for the Account.

Following the staff reports, the President of the Federal Reserve Bank of New York makes a report and concludes by making a statement with respect to what he thinks monetary policy should be. The Chairman then calls on each President and each member of the Board of Governors for his comments and statement. The President of each Federal Reserve Bank comments specifically on the economic and financial situation in his district in addition to making such other observations as he may choose, and also makes a statement as to what, if any, changes should be made in monetary policy. The last observations are made by the Chairman of the Committee.

If a consensus for monetary policy is apparent, this becomes the Committee policy. If there is no consensus and a difference of opinion exists, the Chairman calls for a vote and the majority view is established as the current monetary policy. The Committee then formulates a written directive addressed to the Manager of the Open Market Account which guides him in the administration and operation of the Open Market Account until that policy is changed at a subsequent meeting of the Committee. An account of the deliberations of the Federal Open Market Committee appears each year in the annual report of the Borad of Governors of the Federal Reserve System.

This arrangement, which appeared complex to the Governor of the Bank of England, is typically American. It is a unique blending of the public and private participation, and of both local and central views in an important Governmental function.

Out of bitter experience the Founders of our form of Government were suspicious of every form of all-powerful central control. They sought to guarantee that such a government would never exist in this country by setting up a Federal System established with a separation of powers and with checks and balances. One-hundred-twenty-four years following the ratification of our Constitution these same fundamental concepts were in the mind of the Congress when, under the leadership of Woodrow Wilson, Carter Glass, and Robert Owen, it delegated responsibility for monetary policy to an independent Federal Reserve System. Independent within the Government and not independent of Government. For Congress created the System and can, of course, modify or change it.

Pending Legislation

As I have indicated proposed legislation would fundamentally change the structure of the System.

(1) One provision of a pending bill would increase the membership of the Board of Governors to 12 and reduce the term of office from 14 to 4 years.

The purpose of the 14-year term was to remove the monetary policy decision making process from the mercurial changes in day-to-day political pressures -- which in my judgment is a desirable aim.

(2) Another provision would make the Secretary of the Treasury a member and Chairman of the Board of Governors. At one time the

Secretary was a member of the Board. Along with other changes in our banking laws in the 30's, the Secretary was removed from the Board. It was recognized at that time that his important position in the administration interfered with the ability of the Central Bank to make an independent judgment.

(3) Still another provision would require the System to obtain annual appropriations from Congress to meet its expenses.

(4) It is proposed that the Federal Reserve Banks and the Board of Governors be audited by the General Accounting Office.

Prior to the 1930's the Board of Governors was subject to such an audit, though the banks never have been. In the 1930's, Congress changed the law to remove the Board from this procedure.

This is not to say that the banks and the Board ought not be subject to audit. On the contrary, the Banks are not only subject to continuous internal audit but are also examined annually by the staff of the Board of Governors. The Board is also audited annually by an independent audit firm.

(5) Proposed legislation would abolish the Open Market Committee and transfer its powers and duties to the Board.

As I have indicated, there have been changes in the System during the past 50 years. But the changes which have been made have preserved and strengthened the basic principles of the responsibility of the System to formulate and implement monetary policy on the basis of its own independent judgment and not on the basis of hopes or wishes, pressures or politics.

No doubt there will be changes in the future -- for change is life -- but in my judgment any changes should continue to be made in the light of the high value of checks and balances and separation of power.