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Testimony by

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I appreciate this opportunity to discuss the important issues raised by recent legislative initiatives to alter the structure of the Federal Reserve System I will begin my remarks this morning by placing these issues in some historical perspective, before commenting specifically on provisions that would change the status of Reserve Bank presidents, broaden the authority of the General Accounting Office to audit the Federal Reserve, and mandate additional disclosure of monetary policy decisions and discussions

The appropriate role of a central bank in a democratic society is an important and controversial issue The performance of such an institution has profound implications for the nation's economy and the people's standard of living Americans have pondered the question of the appropriate role and structure for the central bank at length, beginning with the debate over the First Bank of the United States, which George Washington signed into existence in 1791

Echoing the earlier discussions surrounding the chartering of the First and Second Banks of the United States, extended debate and compromise preceded the establishment of the Federal Reserve System Much of the focus of the debate was on the balance that should be struck between public and private authorities in governing the central bank

In 1908, in response to the periodic financial crises that had plagued the country in the latter part of the nineteenth century and in the early years of the twentieth, a National Monetary Commission, consisting entirely of members of Congress, was established by legislation Four years later, the Commission, in submitting its report to Congress, called for the creation of a National Reserve Association to provide stability to our financial system Both the Commission's plan and an alternative, proposed by President Woodrow Wilson, envisioned the central bank as containing public and private elements President Wilson's plan won the approval of Congress and established the Federal Reserve System as our nation's central bank Over the intervening years, Congress has initiated many reviews of the System's structure, but with rare exceptions has chosen to leave the basic structure intact

The major piece of legislation affecting the Federal Reserve's organization since its inception in 1913 was the Banking Act of 1935, which established the Federal Open Market Committee (FOMC) in its current form as the central decisionmaking body for monetary policy When it was clear by the 1930s that the buying and selling of securities by the Federal Reserve was a crucial monetary policy instrument, there was again debate in Congress over whether it should be carried out entirely by government appointees or whether the Reserve Bank presidents, who were not politically appointed, should share in that policymaking role In the 1935 act, Congress reaffirmed that the Reserve Bank presidents should have a substantive voice in policy They were granted five of the twelve positions on the FOMC, while the seven members of the Board constituted the majority

The wisdom of Congress in setting up the structure of the System has stood the test of time Federal District Court Judge Harold Greene, in commenting in 1986 on the constitutionality of the FOMC, noted that, "The current system[,] the product of an unusual degree of debate and reflection[,] represents an exquisitely balanced approach to an extremely difficult problem "

The role of a central bank in a democratic society requires a very subtle balancing of priorities between the need for sound, far-sighted monetary policy and the imperative of effective accountability by policymakers Accountability and control by the electorate are vital, the nation cannot allow any instrument of government to operate unchecked The central bank, just like other governmental institutions in a democracy, must ultimately be subject to the will of the people

In this regard, the Federal Reserve's activities are constantly scrutinized by this Committee and others in Congress The Federal Reserve Board reports semiannually both to the House of Representatives and to the Senate pursuant to the Humphrey-Hawkins Act, and we regularly respond to other congressional requests for testimony We recognize our obligation to do so and appreciate the importance of maintaining open communication with the nation's elected representatives We also provide a great deal of information about our operations directly to the public And we consult frequently with those responsible for economic and financial policy in the Administration

We have to be sensitive to the appropriate degree of accountability accorded a central bank in a democratic society If accountability is achieved by putting the conduct of monetary policy under the close influence of politicians subject to short-term election-cycle pressures, the resulting policy would likely prove disappointing over time That is the conclusion of financial analysts, of economists and others who have studied the experiences of central banks around the globe, and of the legislators who built the Federal Reserve

The lure of short-run gains from gunning the economy can loom large in the context of an election cycle, but the process of reaching for such gains can have costly consequences for the nation's economic performance and standards of living over the longer term The temptation is to step on the monetary accelerator, or at least to avoid the monetary brake, until after the next election Giving in to such temptations is likely to impart an inflationary bias to the economy and could lead to instability, recession, and economic stagnation Interest rates would be higher, and productivity and living standards lower, than if monetary policy were freer to approach the nation's economic goals with a longer-term perspective

The recognition that monetary policies that are in the best long-run interest of the nation may not always be popular in the short run has led not only the United States but also most other developed nations to limit the degree of immediate control that legislatures and administrations have over their central banks More and more countries have been taking actions to increase the amount of separation between monetary policy and the political sphere

In this nation, several aspects of the current set-up promote the central bank's distance from the political fray The fourteen-year terms of the governors on the Federal Reserve Board are one of those elements, with only two vacancies scheduled to occur during the four years of any single Presidential term Once in office, those governors cannot be removed by the President over a policy dispute In addition, regional Reserve Bank presidents -- who are selected at some remove from political channels -- are included on the FOMC To prevent political pressure from being applied on monetary policymakers via the power of the purse, the Federal Reserve is not required to depend upon appropriated funds to meet its expenses

H R 28, The Federal Reserve System Accountability Act of 1993, would remove some of that insulation I would view the enactment of legislation of this type as a major mistake Provisions that, in effect, increase political leverage on Federal Reserve decisionmaking amount to assaults on the defenses that Congress has consciously put in place to ensure the appropriate degree of central bank independence. Weaken those defenses and, I firmly believe, the economy is at risk The Federal Reserve must be free to focus on advancing the nation's ultimate economic goals

In an amendment to the Federal Reserve Act, Congress has charged the central bank with furthering the goals of "maximum employment, stable prices, and moderate long-term interest rates" To promote those objectives, the Federal Reserve must take a long-run perspective

In that vein, as I have indicated to this Committee on previous occasions, the determination of the effectiveness of a federal agency has to be based, in the end, on whether it has carried out the objectives Congress has set for it In discharging its tasks over the years, the Federal Reserve has faced a variety of challenges, our economy has been buffeted by swings in fiscal policy and by strong external forces, including oil price shocks and wars In often difficult economic circumstances, the Federal Reserve has implemented policies aimed at promoting the nation's economic health We have not always been entirely successful, but we have learned from experience what monetary policy can do and what it cannot do

In my view, current Federal Reserve policy is promoting conditions vital to maximizing the productive potential of the U S economy Monetary policy is, and will continue to be, directed toward fostering sustained growth in economic output and employment

As the nation's central bank, the Federal Reserve stands at the nexus of monetary policy, supervisory policy, and the payments system Part of our task is to minimize the risk of systemic crises while endeavoring to implement a macroeconomic policy that supports maximum sustainable economic growth When, for example, threats to the nation's financial system loomed large in the wake of the 1987 stock market crash, the Federal Reserve effectively contained the secondary consequences of the crash with prompt but prudent injections of liquidity and with constant consultations with depository institutions during the crisis The bulk of our efforts in this area, however, of necessity garners considerably less publicity, as it is directed at ongoing efforts to fend off financial-sector problems before those problems emerge as full-blown crises that could threaten American jobs and living standards. Much of our success over the years, therefore, reflects crises that did <u>not</u> happen. In working with other regulatory agencies, the Federal Reserve also has brought its broad perspective to bear on supervisory actions that could have had macroeconomic or monetary policy implications.

In practice, the central bank of the United States works, and it works well. On paper, however, its structure can appear unwieldy -- an amalgam of regional and centralized authority, and of public and private interests. If we were constructing a central bank for the United States now, starting from scratch, would it be identical to the Federal Reserve System described in current law? Perhaps not. But the Federal Reserve has evolved to be well suited to today's policy tasks.

One of the reasons that the Federal Reserve is effective is that its basic structure has been in place for a long time. The institution has been able to take that framework as a given and to adapt and build on it during decades of invaluable experience in the financial and economic setting of this country.

As the Federal Reserve has evolved over the years, it has been permeated by a culture of competence and dedication to public service. As a consequence, the Federal Reserve has attracted highly skilled analysts, technicians, and policymakers. While we might imagine a different initial structure for our central bank, implementing a major change at this stage could, for all intents and purposes, destroy the exceptionally valuable culture that has evolved over time and that continues to serve this nation well. And there is always the risk that changing a complex organization, even with the laudable goal of improving one or more parts of it, may well have unforeseen and unfortunate consequences elsewhere in the structure

Nonetheless, the Federal Reserve recognizes that an organization that does not appropriately respond to changes in the environment in which it functions will soon become ineffectual Accordingly, the Federal Reserve has suggested, initiated, and instituted a number of measured changes over the years When confronted with a new development requiring change, we advocate change For example, not long ago we recognized, as did this Committee, an apparent weakness in the way the discount window could be used in the case of insured failing institutions, a condition which we had rarely before experienced We saw change as a constructive response, and, while we were prepared to implement the change by adapting our regulations, we cooperated with this Committee which chose to amend our discount window procedures as part of FDICIA

I hope, and I expect, the Federal Reserve will continue to change, but always prudently -- in response to clearly identified problems -- and only for the better One area in which I see major need for change is the inadequate pace at which women and minorities have moved into the top echelons of the Federal Reserve We share your concerns in this regard and are working diligently to improve opportunities for women and minorities throughout the System

In the remainder of my remarks this morning, I would like to address three specific issues, under the more general topic of Federal Reserve accountability These are, first, the status of the Reserve Bank presidents on the FOMC, then the General Accounting Office's purview in auditing the Federal Reserve System, and finally the disclosure of FOMC deliberations and decisions

The Status of Reserve Bank Presidents

The Federal Reserve Banks represent a unique blend of the public and private sectors I believe that those who label the Reserve Bank presidents as representatives of the banking interests, as opposed to the public interest, misunderstand the position of the presidents -- and the Reserve Banks -- in the Federal Reserve System

The Federal Reserve Banks are instrumentalities of the United States government organized on a regional basis They are in a tangible sense "owned" by the federal government The bulk of their net income is handed over to the government each year Their accumulated surplus, were they to be liquidated, would revert to the U S Treasury And while a portion of the capital of the Reserve Banks represents contributions by member commercial banks, those member banks are not free to withdraw the capital, their dividends are fixed by statute, and their capital stake in no way affords them the usual attributes of control and financial interest

The member commercial banks do select the majority of the directors of their local Reserve Bank But the Federal Reserve Board chooses the remaining directors, and, among those, designates a chairman and a deputy chairman The directors, in turn, select the Reserve Bank's president, but their selection is subject to the Board's approval

Those Reserve Bank presidents then receive top-secret clearances from our government and are subject to the federal conflict-of-interest statute They can be removed by the Federal Reserve Board, and it is the Board that sets their pay Upon joining the FOMC, they take an oath of office to uphold the Constitution of the United States, and -- uniformly in my experience -- they are dedicated to the service of our country

However, regardless of whether the presidents of the Reserve Banks are viewed as more public than private or more private than public, the real question remains, does their participation on the FOMC make for better monetary policy? I can assure you that it does

The input of Reserve Bank presidents who reside in and represent the various regions of the country has been an extremely useful element in the deliberations of the FOMC By virtue of their day-to-day location and their ongoing ties to regions and communities outside of the nation's capital, the presidents see and understand developments that we in Washington can overlook They consult routinely with a wide variety of sources within their districts, drawing information from manufacturing concerns, retail establishments, agricultural interests, financial institutions, consumer groups, labor and community leaders, and others Moreover, because their selection is apolitical, they tend to bring different skills and perspectives to the policymaking process

The public-private and regional makeup of the Federal Reserve System was chosen by Congress, in preference to a unitary public central bank, only after long and careful debate The system was designed to avoid an excessive concentration of authority in federal hands and to ensure responsiveness to local needs Nonetheless, then as now, the operations of the Reserve Banks were placed under the general supervision of the Board of Governors When the FOMC was given its current form in 1935, five Reserve Bank presidents were placed on that Committee, but their presence was outweighed by the seven Presidentially appointed members of the Board

This blending of public and quasi-public institutions has a long history in this country and has been reaffirmed repeatedly in Congress Nonetheless, the presence of Reserve Bank presidents on the FOMC periodically resurfaces as an issue This occurs despite the long and successful history of the presidents' membership on the

FOMC, which counters a similarly lengthy history of claims that their participation would be detrimental to our nation The involvement of quasi-government officials in monetary policymaking has survived a series of challenges over the years It has survived the test of time One must wonder why we would wish to tinker with a unique partnership of the public and the private that has worked well for more than half a century

Some who agree that the Reserve Bank presidents provide a unique perspective would nonetheless argue that such input could still be obtained by reducing the Reserve Bank presidents' role to an advisory one I doubt that, for two reasons First, let us not delude ourselves Anyone permanently denied a vote sees his or her influence diminish markedly Not only would the presidents' varied experiences and regional perspectives likely become less well reflected in policy decisions, but their ability to solicit real-time information from their communities would be diminished as well Second, I believe that a fair number of my colleagues who serve as presidents of the Reserve Banks would have declined that office had voting rights on the FOMC not attached to it These are people who do not lack for opportunities If the Reserve Bank presidents were denied votes, we could not attract individuals of the same caliber to these jobs that we do today As a result, the advice received would be adversely affected, and FOMC deliberations would be less productive

A different proposal would retain the Reserve Bank presidents on the FOMC, but would have them appointed by the President of the United States Such a proposal is not new It was considered and rejected by this Committee as recently as 1976 The clearest drawback to this suggestion is one that I have already mentioned, that is, the potential for increased partisanship that would erode the quality of policy, as the central bank was drawn more closely into the ambit of daily political concerns In addition, however, such an arrangement would create significant managerial problems for the Federal Reserve System as an organization

Under current law, Reserve Bank presidents are directly accountable to the Board for their performance in carrying out Systemwide policies in such areas as bank supervision, payments systems responsibilities, and discount window administration The Board's ultimate defense against a Bank president who is either incompetent or purposely obstructing the effective implementation of System policy is our power to remove that person from office

If the heads of the Reserve Banks were instead Presidentially appointed, we presume that they could be removed constitutionally only by the President In that circumstance, Systemwide coordination of policies and inter-bank cooperation could be seriously impaired

In sum, if the sole duty of Reserve Bank presidents were to vote on the FOMC, granting the President of the United States the power to appoint and remove them would be unwise on only one count -- that of adversely affecting the conduct of the nation's monetary policy However, Reserve Bank presidents also run large organizations charged with such tasks as collecting data, processing currency, operating the book-entry system, and auctioning Treasury bills The twelve Banks must operate as one in these various areas, and Congress has given the Board general oversight of the Banks to ensure that they do A proposal that divested the Board of the power to remove a Reserve Bank president from office would subtly but significantly undermine the ability of the Board to manage the Federal Reserve System

<u>Scope of GAO Audits</u>

As you know, the passage in 1978 of the Federal Banking Agency Audit Act made most of the operations of both the Federal Reserve Board and the Federal Reserve Banks subject to review by the General Accounting Office Since then, the GAO has completed more than 100 reports on various aspects of System operations, as well as numerous others that involved us less directly At present, the GAO has roughly 25 audits of the Federal Reserve under way and maintains several of its staff in residence at the Board and at selected Reserve Banks

The GAO has free rein to audit the System, with the explicit exemption of only three functions Those are deliberations, decisions, or actions on monetary policy matters, transactions made under the direction of the FOMC, and transactions with, or for, foreign official entities By excluding these areas, the 1978 Act represented another effort to balance, on the one hand, the public accountability of the Federal Reserve with, on the other, its ability to perform its policy functions most effectively

The benefits, if any, of broadening the GAO's authority into the monetary policy and FOMC areas would be small, in part because a GAO audit would tend to duplicate functions that are already performed With regard to purely financial audits, the Federal Reserve Act already requires that the Board conduct an annual financial examination of each Reserve Bank, including open market and international operations And these exams are complemented by other Board reviews of Reserve Bank effectiveness and efficiency, as well as by comprehensive audits conducted by each Reserve Bank's independent internal audit function In order to provide the Board with additional assurance of the quality and comprehensiveness of the Board's audit process, complete financial audits are currently being conducted by nationally recognized independent accounting firms at Reserve Banks Two such audits were conducted this year The results of these audits to date have confirmed the integrity and quality of the System's audit process In addition, the Board itself is audited annually by an independent public accounting firm, and the results of those audits are furnished regularly to Congress

More broadly, Congress has, in effect, mandated its own review of monetary policy by requiring semiannual monetary policy reports and by holding hearings In addition, a vast and continuously updated literature of expert evaluations of U S monetary policy exists In this environment, the contribution that a GAO audit would make to the active public discussion of the conduct of monetary policy is not likely to outweigh the negatives

Those negatives would include a potential compromising of Federal Reserve effectiveness, in part because the change could peel away a layer of the central bank's insulation from day-to-day political pressures Even what appears to be a very limited audit of the efficiency of our operations could in fact turn into pressure for a change in monetary policy itself as the 1978 Act understood For example, the question being posed to Comptroller Bowsher in these hearings of whether the magnitude of our open market operations reflects unnecessary buying and selling of government securities is a monetary policy question, not an efficiency question The volume of transactions that the Open Market Desk completes in carrying out the FOMC's directive correlates directly with the substance of the policy in place

GAO scrutiny of policy deliberations, discussions, and actions also could impede the process of formulating policy A free discussion of alternative policies and possible outcomes is essential to minimize the chance of policy errors The prospect of GAO review of formative discussions, background documents, and preliminary conclusions could have an adverse effect on the free interchange and consensus-building that leads to good policy

Transactions made under the direction of the FOMC primarily involve domestic monetary policy operations, but also include foreign exchange operations Expanding GAO audit authority into this latter area would risk impairing our sensitive working relations with foreign central banks and governments Important daily contacts and exchanges of information with foreign monetary authorities now take place in a candid and constructive atmosphere The possibility of a GAO audit of our foreign exchange operations would reduce the willingness of foreign authorities to share information with us and thereby would reduce the effectiveness and efficiency of our operations This caution also applies to the third exempted area -- transactions with or for foreign entities, however, there the principal issue is one of sensitive proprietary information about foreign governments, foreign central banks, and international organizations

In sum, I believe that the current structure of internal controls and audits, and congressional review strikes the right balance between public accountability and policy effectiveness

FOMC Disclosure

The issue of fuller or more immediate disclosure of FOMC discussions and decisions has been a controversial one historically In Congress, the financial markets, and academia, this topic has been debated repeatedly over the years The FOMC itself has reviewed policies and procedures in this area frequently and has revised its practices several times At the heart of this issue is, again, balance The appropriate degree of openness comes from striking the right balance between the public's right to know and the need for effective policymaking and implementation

In a democratic society, all public policymaking should be in the open, except where such a forum impedes the primary function assigned to an institution by law Accordingly, the Federal Reserve makes its decisions public immediately, except when doing so could undercut the efficacy of policy or compromise the integrity of the policy process When we change the discount rate or reserve requirements, those decisions are announced at once When we establish new ranges for money and credit growth, those ranges are set forth promptly in our reports to Congress And when Congress requests our views, we come before this Committee and others to testify Moreover, we publish our balance sheet every week with just a one-day lag, enabling analysts to review our operations in considerable detail

What we do not disclose immediately are the implementing decisions with respect to our open market operations However, any changes in our objectives in reserve markets are quickly and publicly signalled by our open market operations We publish a lengthy record of the policy deliberations and decisions from each FOMC meeting shortly after the next regular meeting has taken place

Nevertheless, the Federal Reserve has a reputation, along with other central banks, of being secretive I suspect this is largely a result of the nature of a central bank's mission The operations of central banks have a direct impact on financial and exchange markets, therefore, these institutions often find themselves in the position where premature openness and disclosure could inhibit or even thwart the implementation of their public purpose

Suppose, for example, a central bank that operated by targeting the foreign exchange rate decided that it might be appropriate to change the target rate at a given point in the future Or, to bring the discussion closer to home, say that the central bank phrased its policies in terms of contingency plans -- that is, if a given economic or financial event occurs, a particular policy action would ensue If those decisions were made public, markets would tend to incorporate the changes immediately, preventing the policies from being effectively carried out as planned

More broadly, immediate disclosure of these types of contingencies would tend to produce increased volatility in financial markets, as market participants reacted not only to actual Federal Reserve actions but also to possible Federal Reserve actions It is often the case that the FOMC places a bias toward change into its directive to the Open Market Desk, without any change in instrument settings in fact resulting In such circumstances, the release of those directives during the period they are in force would only add to fluctuations in financial markets, moving rates when no immediate change was intended

As a consequence, a disclosure requirement would impair the usefulness of the directives, as Committee members, concerned about the announcement effect of a directive biased either toward ease or tightening, would tend to shy away from anything but a vote of immediate change or of no change at the meeting An important element of flexibility in the current procedures would be lost, which can scarcely serve the public interest Immediate disclosure of the directive would change the nature of monetary policymaking, and it would not be a change for the better

Of course, our current policies on information release are grounded on an assumption of confidentiality Any unauthorized, premature release of FOMC decisions is a very serious matter, and it undermines our policies Such leaks are abhorrent As I noted in my recent letter to you, Mr Chairman, leaks of FOMC proceedings are clearly unfair to the public, potentially disruptive of the policymaking process, and undoubtedly destructive of public confidence in the Federal Reserve We have taken steps that we believe will be effective to curb any further unauthorized release of information

To repeat, as a general matter, public institutions are obliged to conduct their business in open forums The Federal Reserve endorses this principle and adheres to it, except when doing so would prevent us from fulfilling our fundamental mission of producing sound public policy

Holding open meetings of the FOMC or releasing a video tape, audio tape, or transcript of them would so seriously constrain the process of formulating policy as to render those meetings nearly unproductive The candid airing of views, the forthright give and take, and the tentative posing of new ideas likely would disappear Monetary policy would suffer, and the economy with it

In open forum, a number of important items currently discussed at FOMC meetings simply could not be mentioned We would no longer have the benefit of sensitive information from foreign central banks and other official institutions or of proprietary information from private-sector sources, as we could not risk the publication of information given us in confidence

Moreover, to avoid creating unnecessary volatility in financial and exchange markets, the FOMC might have to forgo explorations of the full range of policy options Our discussions would, in effect, become self-censored to prevent the voicing of any views that might prove unsettling to the markets Even a lag in releasing a verbatim record of the meetings would not eliminate this problem, but only attenuate it Unconventional policy prescriptions and ruminations about the longer-term outlook for economic and financial market developments might never be surfaced at meetings, for fear of igniting a speculative reaction when the discussion was disclosed

It has been averred that, since the minutes we release do not indicate which individuals voiced which views at the meetings, the FOMC members themselves escape accountability for their actions This is contrary to fact The vote of each FOMC member is recorded, by name, and the reasons for that vote are also recorded In the case of a dissent from the majority, the reasoning behind the vote is generally explained separately In the case of a vote cast with the majority, the members assure themselves that the minutes accurately reflect their views and the reasons for voting as they did

In both the Freedom of Information Act (FOIA) and the Government in the Sunshine Act, Congress explicitly recognized that there were types of information and kinds of meetings that should be protected from dissemination to the public Certain exemptions have been provided in FOIA for information that, for example, is of a confidential financial nature and in the Sunshine Act for meetings that would prompt speculation in financial markets In the exempted areas, it was determined that information release would not be in the public interest As I have indicated, I believe that the consequences of requiring the prompt release of a verbatim record of FOMC meetings would most certainly not be in the nation's best interest

Conclusion

Mr Chairman, you have made it clear that, in your view, this legislation does not represent an attempt to politicize the Federal Reserve or to infringe on its independence I feel I must respond that, whatever its intent, legislation of this type would have precisely that deleterious effect

I take this legislative initiative seriously not only because it would emanate from this Committee, but also because of monetary policy's key position in the nation's overall economic policy At the flashpoint of financial crisis, monetary policy, if mishandled, can pose a threat to our economic system. And in this century we have witnessed inflation -- a monetary phenomenon -- turn virulent in too many nations around the world. To a considerable degree, then, both the earnestness with which we approach our task and the unique position accorded the Federal Reserve in our governmental structure derive from the potential for just such dire consequences of monetary policy mismanagement.

In imposing significant change on the Federal Reserve System, we would run the risk of real damage to the institution's effectiveness from unintended, adverse consequences. The Federal Reserve is not a flawless institution. It is, however, a very good one. In my view, it would be a mistake to legislate structural reform when, as in this case, compelling evidence of the need for change is lacking.