

"A Businessman Looks at the Fed -- Up Close"

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Highly successful organizations in all walks of life share one common characteristic, which is that they all have a clear understanding of exactly what constitutes the heart of their mission. They build out logically from there with a network of policies, products, relationships, and most of all, human skills which are all focused on fulfilling the core mission through excellence in performance and mutual reinforcement. Here is one person's view of the Federal Reserve System from that perspective.

As I observed the Fed from afar over my private sector years, it was not always clear to me that the institution met these specifications. In recent years as I have become much more knowledgeable about what the Fed really is and does, I have come to have considerable comfort that the essentials for successful performance are in place. I have considerable discomfort, however, that many opinion- and policy-makers do not adequately understand the central bank, as I did not, and that this could lead to a lack of public support which could, over time, undermine the institution's

strength. Such an eventuality would be deeply unfortunate for the country.

In my view, the Fed internally has a firm grasp of its mission. That purpose is to undergird the financial system of this country by providing stability and reliability to the nation's monetary unit - the dollar - and to the flows of funds that lubricate the everyday operations of the economy. Over the years the System has structured itself tightly around this core mission and its policies, products, procedures and people are very focused on excellence and mutual reinforcement in fulfilling the mission. The System operates through three interactive and interdependent groups of activities: direct responsibility for monetary policy, key leadership in the payment system, and extensive participation in the supervision and regulation of depository institutions. They are three parts to a single theme, a trilogy, and together they provide the thrust that is needed to achieve the mission.

As a longtime outsider suddenly provided with an insider's view, let me share with you what I would like to have understood years ago about each of these mission elements, and then comment

on certain factors critical to sustained success in the future.

My objective in this is to contribute to an enhanced understanding of the nation's central bank.

Many view the conduct of monetary policy as the job of the central bank and some see it as the decisive element in determining the nation's economic performance. Others see it as increasingly impotent and irrelevant. It is neither. Monetary policy can obviously influence short-term nominal interest rates and through them may influence the near-term pace of the economy. Only indirectly can it influence long-term interest rates, which are far more economically significant. If misused in the short-run, monetary policy may be counter-productive in the long-run. In the long-run, policy cannot create jobs or otherwise positively influence the nation's economic progress in any way other than by fostering a climate of confidence in the stability of the financial system. This specifically includes price level stability. That is a critically important contribution, of course, basic to a successful economy. But that's it. To expect monetary policy to produce results beyond its scope is to assure criticism and negativism that could easily

result in impeding the central bank's ability to do what it can and must do in the nation's long-term interest. Monetary policy is a highly significant, but limited, instrument of macro-economic management.

Our payment system, which the Federal Reserve anchors and in which thousands of depositories participate, is also vital to our financial system. It is a vast and complex public utility, analogous to our electrical power grid, that moves mind-boggling quantities of funds around the country and the world in settlement of financial obligations. Clearly, a modern industrial economy must perform this function well and nobody does it better than, or on so vast a scale as, the United States. Its operation consumes a significant amount of our most sophisticated human and physical resources and with the very rapid evolution of communications capabilities, computer technology, and the structure of the financial services industry, it is in a period of dramatic change. If it should seize up, which it will not, the economy would be seriously disrupted, to say the least. Yet, this essential public service resource is taken completely for granted and rolls along unknown and unrecognized

by almost everyone not directly involved. That's a shame. One can only hope that a day never comes when some unforeseeable issue requires a level of public understanding and support that might not be available.

Extensive participation in the supervision and regulation of depository institutions is the third aspect of the trilogy of activities through which the Fed fulfills its mission. These activities are clearly important, but how do they fit into the trilogy? It's necessary to look back at the first two. Monetary policy is delivered to the economy through the conduit of depositories and it is depositories which operate the payment system. Further, a crisis in the payment system requiring the Federal Reserve's powers of lender-of-last-resort would involve depositories as part of the solution as well as, most likely, part of the problem. For these reasons and more, the central bank must be active everyday in a hands-on manner in the work of this vital industry. There is no other way to understand in depth, and in real time, what is going on. Supervision, which involves the detailed study of individual institutions, and regulation, which involves deciding upon and

setting forth the rules of the game, provides that required hands-on activity.

Let me turn now to several factors central to the Fed's ability to fulfill its mission. The first factor has been weaving through much of what has already been discussed, namely the interdependency and mutually reinforcing nature of the trilogy of monetary policy, payment system participation and supervision and regulation. Monetary policy is implemented through the depository operated payment system and is enriched in turn by the flow of real time financial intelligence that is generated in the process of supervising and regulating depository institutions, and participating in the payment system. In the long run, a sound payment system depends on sound policy. As mentioned above, supervision and regulation strengthens both of the other two by strengthening the depository system, especially through its effective participation in crisis resolution. It is, in turn, itself strengthened in its work by exposure to the concerns of monetary policy and the payment system. The point here is that each of these three activities is necessary to the full effectiveness of the other and, hence, to the

central bank's ability to fulfill its mission at the highest possible level.

A second key factor is the Fed's unique public-private structure, whereby a policy making government body, the Federal Reserve Board, oversees the activities of the quasi-privately managed twelve district Reserve Banks. The United States is a very large country, with a highly diverse and complex economy, and a decentralized central banking system is clearly appropriate. The quasi-private nature of the District Banks has the highly desirable result of providing a carefully tailored and skilled management attuned to each area, and enabling the Board to stay in intimate touch with economic conditions and developments in all of their rich variety across the country. In all three elements of the trilogy, it works superbly. There are those who do not feel that this extent of private participation in public business is proper, and various proposals have been advanced in Congress to change the setup. From my vantage point, I see a highly effective organization operating with total dedication to the public interest and the core missions of the System. It is far from "broke," and great caution

should be exercised before trying to "fix" it. The nation could be a big loser in the attempt.

Congress is the third key factor. Congress created the Federal Reserve, delegates to it whatever powers it may exercise, and can alter it as desired. Although the Congress has granted the Federal Reserve a considerable degree of independence, especially in monetary policy, all of the Fed's activities are subject to Congressional oversight. And there are many areas well worth ongoing public scrutiny. Stability of prices, adequacy of the payment system, stewardship of resources, fairness of competition in payment services, maintaining an apolitical and disinterested public service orientation, and banking regulation to name just a few.

A matter of concern involves the clear articulation of the System's assigned mission as part of the nation's economic management. Congress is quite clear that our basic national economic goal is maximum sustainable economic growth, but it sends out mixed signals as to its attitude toward inflation as a factor in the policy mix. Economists and the public generally

agree inflation is an economic evil. Many governments have instructed their central banks to suppress it, and others are moving into this posture. For its part, the Fed is dedicated to price level stability as a prerequisite to realizing the goal of maximum sustainable economic growth. While I am unaware of any political leader actively supporting inflation on its merits, some do from time-to-time advocate policies which have clear pro-inflation potential. This confuses our public and other governments as to the attitude of the United States, thereby immeasurably complicating the Fed's battle. It would be most helpful if our national leadership would express itself unequivocally, and explicitly instruct the central bank accordingly.

Permit me a personal observation as a final key basic factor in assessing this institution. An unmitigatedly positive one. The Federal Reserve System, over its near eighty-year history, has acquired a corporate culture of unique quality. It has taken on a tradition of excellence of performance, disinterested public service, and integrity in the most complete sense. The long staggered terms of its appointed Governors and long tenure of career staff provide

a depth of sophistication and an institutional memory of central banking that is a priceless national asset. A rare set of qualities.

When you find it, cherish it.