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The Role of a Central Bank in a Democracy

First of all I'd like to thank the Chicago Council on Foreign Relations for inviting me to speak tonight. As you've just heard, I've served as deputy United States trade representative and worked for fourteen years with a number of companies with extensive worldwide operations. So I have an ongoing active interest in the international arena. I think the Council provides an extremely valuable service by encouraging discussion on some very timely and relevant issues.

I'm particularly happy to be here tonight for this combined gathering of the Council and Northwestern University alumni. I thoroughly enjoyed my year teaching at Northwestern. The students, the faculty, and the administrators are all first rate. And the Kellogg Graduate School of Management is truly an outstanding institution. Northwestern President Arnie Weber and Kellogg Dean Don Jacobs have done an excellent job providing leadership for this great university.

While leaving Northwestern was painful, I couldn't pass up the opportunity to work at the Federal Reserve Bank of Chicago. There were several aspects of the job that made it especially intriguing. In particular, it provides a unique opportunity to stay in Chicago and be involved in economic policy at the national level. In fact, my new position may have been the only job that could have enticed me from Northwestern.

The Fed's structure

I'd like to talk tonight about the role of a central bank in a democracy. I think this topic is particularly appropriate as it's almost eighty years ago to the day that the Chicago Fed first opened its doors on November 16, 1914. As I thought about my topic, and about the Bank's 80-year history, I came to a somewhat unexpected conclusion: I come tonight to praise Congress.

Congress, and government in general, have taken a lot of heat lately. I'd hazard a guess that somewhere, someone is discussing the global economy, the accelerating pace of change, and even the socio-economic implications of the merger and possible break-up of Michael Jackson and Lisa Marie Presley. But I may be the only one with a kind word for Congress. Nevertheless, I think it's entirely appropriate to praise Congress. Or to be more precise, I'm here to praise Congress' wisdom over the years in endowing the Federal Reserve with its current structure.

What's noteworthy about the Fed's structure, and why should we care? The Federal Reserve is unusual, perhaps unique, among central banks in its decentralized, regional design with a mixture of public and private attributes. To my mind, this is important because this structure fosters effective, **long-term** monetary policy.

My perspective in examining the Federal Reserve is that of a recent immigrant — an outsider who recently became an insider. This may be more appropriate than you think. Certainly, assembling the proper ingredients for effective policy is an internal process, but it's also a process that's nourished with input from the outside. People commonly think of Fed policy as emanating from Washington — and that's true. But only in the sense that the decisions are made at meetings that take place there. The decisionmaking process does not proceed from inside the Beltway — from the inside looking out; instead, ideas and opinions flow to the Fed and are distilled into policy.

Fed History

First, I'd like to give some background on the Fed's beginnings. The Federal Reserve is an unmistakable creation of our political process — it's very much an American version of a central bank. The United States conducted two previous experiments in central banking — neither one made it past its original 20-year charter. In each case the central bank was doomed by a very deep and typically American suspicion of concentrated power, especially money power. Americans didn't feel confident in giving the government unchecked power to issue notes. But at the same time, many did not think that private parties should control the money supply. The issue of the proper role of a central bank in a democracy hung in the balance.

Despite these continuing controversies, the question of whether the U.S. should have a central bank was answered again in the affirmative by the early 1900s. The crucial question was how to structure the bank. On one side were those who favored a centralized institution with a strong private sector orientation, preferably located in New York. On the other side were those who wanted a regional structure dominated by the government.

The organization that resulted was a finely wrought compromise, an intricately structured balance between the public and the private, the central and the decentralized. To achieve this balance, in 1913 President Wilson and Congress created a system of 12 regional banks and a coordinating board of governors in Washington, D.C. The regional Reserve Banks would have a mix of public and private features. The governing board would consist of public officials appointed by the President and approved by the Senate.

One of the keys was to insulate the central bank from day-to-day political pressures. It's generally acknowledged that it can be difficult for an elected representative to resist the temptation to "gun" the economy periodically. Stimulating the economy may, of course, be appropriate at times. However, doing so in response to the election year cycle is not likely to make for effective economic policy. The central issue is balancing short-term gains against long-term considerations.

This is the conclusion of economists and others who have studied central banking. But more importantly, it's the conclusion of Congress. Nobody is more aware of short-term political pressures than those subjected to it. This is nothing new. I think a report issued in 1830 by the House Ways and Means Committee put it well. In explaining its reluctance to have the government directly involved in issuing notes, the Committee stated (and I quote) "...the temptation to supply the Federal Treasury by the easy process of bank issues, rather than resorting to the unpopular process of internal taxation, would be too fascinating to resist."

To help the Federal Reserve resist this fascinating temptation, Congress provided fourteen year terms for the Board of Governors.

Once in office, appointees cannot be removed over a policy dispute but only for cause. In fact, to my knowledge, a governor has never been removed from office. Additionally, the Federal Reserve does not have to depend on the appropriations process to meet its expenses. I should add, though, that Congress does carefully review the Fed's budget and that the vast majority of our earnings is turned over to the U.S. Treasury.

While the Federal Reserve is insulated from short-term political pressures, we're ultimately accountable to Congress and the electorate. We report to Congress twice a year regarding our policy objectives and appear regularly to testify on a myriad of subjects. In addition, we consult frequently with Administration officials responsible for economic and financial policy. We also supply a great deal of information about our operations directly to the public. In keeping with this ongoing effort, the Federal Reserve in recent months has provided a more immediate announcement of its monetary policy decisions. This is an action that I strongly support as I believe we should be as open as possible unless it impedes our ability to formulate and implement policy.

The Reserve Banks

The 12 regional Reserve Banks are an integral component of this system of checks and balances woven into the fabric of the Fed. The Reserve Banks include a number of features that are typical of private companies. For example, each Reserve Bank and branch has a board of directors consisting of leading private citizens from the region. In addition, member commercial banks hold shares of stock in the Reserve Banks. And the Reserve Banks sell a variety of financial services in the marketplace, such as check clearing and electronic funds transfers.

However, the Reserve Banks are, in a tangible sense, owned by the government. In the unlikely event that the Banks were liquidated, the accumulated surplus would be turned over to the Treasury. And while member banks own stock, they don't have the usual stockholder attributes of control and financial interest.

The member banks do elect six of the nine Reserve Bank directors – three are bankers and three are representatives of other economic sectors such as agriculture, industry, labor, and consumers. The remaining three directors are appointed by the Federal Reserve Board in Washington to represent the public. The Federal Reserve Board selects the chairman and deputy chairman from among its three appointees.

Our directors have a general governance responsibility for the Bank's operations and provide advice and counsel on the state of the economy. Also important obviously from my perspective, the directors are responsible for selecting the Bank's president, subject to the approval of the Federal Reserve Board.

This selection process, of course, is different than that used for the Federal Reserve governors, who are appointed by the President and confirmed by the Senate. The apolitical selection of the Reserve Bank presidents adds another important layer to the Fed's insulation from short-term political pressures. In addition, by virtue of their location at watchposts across the country, the presidents help to ensure a constant flow of information and ideas from beyond the Washington "beltway." So our regional structure not only insulates us from narrow influences, it also facilitates our access to a broad range of input, information, and ideas.

Federal Reserve's responsibilities

It's said that form follows function, so I'd like to briefly describe our activities. The Fed's mission, of course, is to foster a healthy, growing economy and a safe and stable financial system. More specifically, the Fed formulates monetary policy; supervises and regulates banks and bank holding companies; and provides financial services to depository institutions and the U.S. government. To carry out these activities in our five-state region, we have a head office in Chicago, a branch in Detroit, and offices in Des Moines, Milwaukee, and Indianapolis.

Each of these activities relates to our overall mission. By participating in supervision and regulation, the Fed has accumulated valuable knowledge of the banking system — the lever that we utilize to affect the flow of money and credit. Through the process of providing financial services, we help to ensure that the payments mechanism operates in a safe and efficient manner.

All of these elements can come into play during a crisis. During the stock market crash of 1987, for example, the Fed announced that it would provide liquidity as needed; consulted constantly with banks; and extended its hours on Fedwire, our large-dollar wire transfer network. I should add that the Chicago Fed played an important role in this crisis because of its specialized knowledge of the futures markets in Chicago.

Most important, however, is the fact that the Fed's day-to-day involvement in these areas helps to prevent a crisis from happening in the first place. The Fed's important role includes the prevention as well as the resolution of a crisis situation.

Given our involvement in all of these areas, we have a fairly complex and diverse organization. Our activities range from the analytical and abstract study of the economy to the high-volume, time- critical processing of checks. This makes for an interesting combination, with elements of the private sector, government, and academia all in one organization.

The diverse nature of the Bank places strong demands on our staff. I'd like to note that I've found the employees at the Chicago Fed to be outstanding. I heard before I accepted this position that the Federal Reserve was a first-rate organization. I'm very pleased that this information proved to be correct. We have about $5 billion in our vaults but our most valuable assets are the accumulated talents, knowledge, skills, and commitment of our employees.

Monetary Policy

Our foremost responsibility, of course, is formulating and implementing monetary policy. The Federal Open Market Committee is the Fed's most important policymaking body. The Committee is perhaps the most intricate example of the checks and balances that characterize the Fed System. The voters at any particular FOMC meeting consist of the seven members of the Board of Governors and 5 of the 12 Reserve Bank presidents. But all of the presidents attend all of the meetings and take part in the discussions, regardless of their voting status. As president of the Chicago Fed, I'm a voting member every other year, alternating with Jerry Jordan, president of the Cleveland Fed.

The participation of the Reserve Bank presidents in policymaking has been a sometimes controversial topic. However, when Congress established the structure of the FOMC in the Banking Act of 1935, it clearly intended for the presidents to actively participate in the policy process. This is very much in keeping with the intent of the Federal Reserve Act to include a degree of regional autonomy in the Fed's structure and augments its non-political character.

I also believe that the presidents add an important voice to policy deliberations because of their locations throughout the country. As you may know, one of the difficult aspects of determining monetary policy is allowing for lags. What's happening in the economy today won't be reflected in the statistics for several months. And our policy actions won't work their influence on the economy for months to come. So we're faced with the difficult task of trying to influence the future using information that may be outdated by the time it's released.

I don't mean to imply that determining policy is an impossible undertaking. I think the record of the Federal Reserve during the 1980s and 1990s belies that notion. But it's just not possible to simply look at the latest national statistics and obtain an up-to-the-minute and realistic overview of the economy. Our economy is so dynamic and complex that we need to examine the regional economies and even specific industries to obtain a true picture. One of our most effective tools for accomplishing this goal is the grass-roots, up-to-the minute information that we're able to glean from a variety of regional sources.

The directors of the Reserve Banks and branches are an important aspect of this process. By law, the boards represent a variety of locations and economic sectors. Our directors in Chicago and at our Detroit Branch provide us with a unique opportunity to obtain the thinking of a cross-section of well-informed individuals from a variety of backgrounds and regions.

Perhaps most importantly, our board of directors in Chicago provides direct input into policy by voting on the discount rate every two weeks. The directors' recommendation to change the rate or keep it the same is forwarded to the Federal Reserve Board, which may decide to act on a recommendation or table it for possible future action.

I'd like to add that the directors are providing a significant public service. I was interested to learn that eighty years ago the Bank's original directors were each paid $20 per meeting. I think it's safe to say that the current fee has not kept up with inflation — this is one area where the Fed has not had to be vigilant about emerging wage pressures. My point here is to emphasize that the directors are very giving of their time and expertise, and I think they should be commended for taking on the responsibility and performing an important public service.

FOMC Process

During my brief tenure, I've had an opportunity to attend two FOMC meetings. Obviously I can't relate specific discussions, but I'd like to describe briefly how the meetings are conducted as I think it will help to give you a feel for the policy process.

The FOMC meets every six to eight weeks in Washington, but for me the policy process is an ongoing endeavor and starts at the Chicago Fed. On a continuous basis, our staff conducts research on a variety of macroeconomic and regional topics. In addition, we have ongoing contact with a variety of people living and working in the District. Our directors in Chicago and at the Detroit Branch play a very important role, as I've mentioned. We also have advisory councils on agriculture and small business as well as industrial roundtables, which are groups of economists and business leaders familiar with emerging developments that meet throughout the District. As the FOMC meeting approaches, we tap these sources and many others to shape an informed view of the latest economic developments. Some of this information is contained in the Beige Book, the summary of regional conditions released a couple of weeks prior to the FOMC meeting.

Prior to the FOMC session, I meet with our Research staff to discuss the District and U.S. economy as well as special issues. An analysis of the national economy developed by the staff at the Federal Reserve Board — known as the Green Book — provides our staff with a basis of comparison.

Typically a day or two before the FOMC meeting — we receive what's known as the Blue Book from the Federal Reserve Board. The book contains the Board staff's analysis of money and credit conditions, bank reserves, and interest rates as well as several possible approaches to monetary policy, known as Alternatives A, B, C, etc. These alternatives provide a starting point for discussion at the FOMC meeting.

The FOMC meets at the Federal Reserve Board in Washington, typically on a Tuesday. The meetings last one day, although the sessions may extend to a second day in July and February when we set our long-term annual goals.

Because there are a relatively large number of participants, the meetings are fairly formal. There's a strong sense of discipline among the participants. We're careful to avoid straying from the subject and don't spend a lot of time reviewing the reports because everybody is already familiar with the material.

During each meeting there are two go-rounds. During the first go-round, the presidents give a concise 5-minute briefing of conditions in their Districts. The Governors then report on information they have obtained from their contacts throughout the nation. Because everybody is familiar with the published statistics, our reports tend to include special information about our districts and anecdotal information obtained just before the meeting. All of the participants also give their views of the national economic outlook, emphasizing any areas where there's disagreement with the Board staff outlook.

I feel I have a particularly important responsibility because of the region we represent. The Seventh Federal Reserve District is large and diverse, covering most of Illinois, Indiana, Wisconsin, and Michigan and all of Iowa. It truly represents a microcosm of our national economy. To give you a quick feel for the economic importance of this region, the District accounts for 45 percent of truck and auto production, 38 percent of steel production, and 19 percent of farm commodity sales. The region has a significant international presence as a major exporter of goods and services, and is home to one of the leading financial centers in the world. Because it both drives and reflects a substantial portion of the U.S. economy, it's especially important that we have a complete understanding of what's taking place in the Seventh District.

While it's important to add a regional perspective, I want to emphasize that policy decisions have to be based on national considerations. The presidents don't attempt to shape policy to benefit a particular region. The second go-round focuses on monetary policy options. To expedite procedures, we tend to use a sort of a monetary policy shorthand. The alternatives contained in the Blue Book provide the basis for the recommendations. So participants may state that they favor "B." Or a participant may prefer a course somewhere between the two alternatives, such as A- or B-.

If there's a clear consensus after the second go-round, Chairman Greenspan may summarize the views and suggest a possible course of action. Or there may be a general discussion until a consensus emerges. Because the discussions are such a vital part of the process, all of the FOMC attendees play an important role, regardless of their voting status. Once a consensus is reached, the Committee finalizes a policy directive, and a vote is taken. The directive adopted will be forwarded to the New York Fed's trading desk where open market operations are conducted to implement the policy decision.

The point I'd like to emphasize is the collegial nature of the process and the importance of providing the latest anecdotal information to supplement published statistics. Given this process, I think that the participation of the Presidents, even those who are not voting members, is a very important component of the FOMC's deliberations. I'd also like to comment on the high quality of the deliberations. My experience in business, government, and academia provides me with a good basis for comparison, and I'm pleased to report that the quality of the analysis and discussion that takes place at the FOMC is very impressive.

Conclusion

As you know, the Federal Reserve recently tightened monetary policy by raising the discount rate and the target for the fed funds rate by 75 basis points. The action was taken against a background of persistent strength in economic activity and high and rising levels of resource utilization.

I believe this action was clearly a case where the Federal Reserve appropriately took a long term view. In my opinion, we had to take action now to contain potential inflation and thus foster sustainable growth. Obviously it's not always easy to take such policy actions, but it's essential that the Federal Reserve consider the longer term view in order to help ensure a healthy, growing economy. Some may argue that there was no need to tighten policy because consumer price measures had not accelerated. However, it is important to bear in mind that inflation responds to the level of economic activity with a significant lag. There is a risk that the recent unusually strong economic growth will, if it persists, lead to increasing inflation. Postponing actions designed to keep inflation in check risk returning to the boom and bust cycles that we all too painfully remember. In my view, our recent policy actions were very much in keeping with our goal to foster sustainable growth with price stability.

Fortunately, Congress structured the Federal Reserve so that it can consider the longer view. While it's difficult to pin down the correlation between central bank independence and a more effective monetary policy, the link has been tested. For example, one study published in 1993 showed higher average inflation rates to be correlated with low degrees of central bank independence. While international comparisons must be interpreted cautiously, the study does highlight the importance of central bank independence.

Certainly, the Federal Reserve must never be so insulated that it turns a deaf ear to the opinions and ideas of others. In ancient Rome when a victorious general returned home to the cheers of the crowd, a man was hired to whisper in the general's ear, "You're mortal; you're mortal." Now I don't think we need to adopt this particular form of checks and balances for the Federal Reserve. For one thing, I don't recall any cheering crowds when I returned from Washington, although my wife seemed happy to see me. But certainly we at the Federal Reserve have a very important public responsibility and need to continue to be as open as possible so that we can encourage a healthy public debate regarding our policy actions. Fortunately, our regional structure helps to ensure a constant two-way flow of information so that we can consider many points of view.

At the same time, however, the Federal Reserve must not twist and turn in response to the short-term gusts and flurries of public opinion. We need to keep our mission in mind and proceed accordingly.

In conclusion, I'd like to re-emphasize that the Fed's unusual structure, with its mixture of the public and private, the central and decentralized, facilitates the flow of information and ideas and helps the Fed to accomplish its mission. Its regional framework and independent stature enable it to account for the broadest range of public interests. The Fed without its current structure would be like Chicago without the lake — it would still function but it wouldn't be the same. Reviewing the organization of our institutions is always appropriate. But we should remember that there's a uniquely American wisdom expressed in the structure of the Federal Reserve. It's a structure that's served us well these past 80 years, and, I trust, will continue to do so for many more to come.

Thank you.