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Money and Banking in the 21st Century

We're here to discuss money and central banking in the 21st century. That's not an easy assignment. Anytime you look into the future, your vision can be blurred. For example, Popular Mechanics predicted in 1949 that "Computers in the future may weigh no more than 1.5 tons"

They're not alone in making less-than-accurate predictions. In Chicago we're still smarting from the prediction that Ernie Broglio would help the Cubs win the pennant and that Lou Brock was just another ball player.

Nevertheless, we're here today to address the question: "Will the Federal Reserve System, designed in the early 1900s, still be effective and relevant in the 21st century?" To me, this isn't a tough call. It shouldn't surprise anyone here, but I feel safe in predicting that the answer is "yes"

To support my answer, I'd like to discuss how the Fed's decentralized, regional structure helps us formulate effective, long-term monetary policy. To do this, I'll start by giving a brief historical overview of the Federal Reserve. Then I'd like to provide a specific example of some regional analysis that's taking place at the Chicago Fed.

Fed Structure

The Fed System was set up by Congress in 1913. It's been a unique organization from the beginning because of its mix of the public and the private, the centralized and the decentralized.

The United States tried two previous experiments in central banking—both failed. The first bank lasted from 1791 to 1811; the second from 1816 to 1836. Each bank closed after its 20-year charter expired …

largely because of a basic American distrust of concentrated power, especially money power. We then faced a 77-year period with no central bank. Most other industrialized nations had central banks; we were behind the times.

By the early 1900s, it became clear that the U.S. needed a central bank. The crucial question was how to structure it. Some favored a centralized institution with a strong private-sector orientation. Others preferred a regional structure dominated by the government.

The organization that resulted was a compromise. The Fed was created with an intricately structured balance between the public and the private, the central and the decentralized. It's a balance that still exists. The 12 regional Reserve Banks throughout the country have a mix of public and private features. The Banks are overseen by a governing board in Washington, D.C., which consists of seven officials appointed by the President and approved by the Senate. It's interesting to note that European Union central banks are trying to establish a structure and a process we've been fine-tuning for decades.

The Fed's regional, decentralized structure helps to insulate it from day-to-day political pressures. To this end, Congress provided staggered, 14-year terms for the seven members of the Board of Governors. Reserve Bank presidents are appointed by the board of directors of each Fed Bank, with the approval of the Board of Governors in Washington. We also don't depend on the appropriations process to meet our expenses. I should add, though, that Congress does review our budget. And the vast majority of our earnings is turned over to the U.S. Treasury. Out ability to fund our own operations is a public trust … it's a responsibility we take very seriously. The Federal Reserve is insulated from short-term political pressures, but we're ultimately accountable to Congress and the American people. This delicate balance is sometimes referred to as being "independent within government" We're tied to government, but we're also insulated from it.

Why do we need this insulation? It can be difficult for an elected representative to " resist the temptation to gun the economy periodically. That's the conclusion of many students of central banking, including Congress. Nobody's more aware of short-term political pressures than those who experience it every day. This is nothing new—back in 1830 the House Ways and Means Committee expressed its reluctance to have the government directly involved in issuing money, stating, (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."

Federal Open Market Committee

The Federal Open Market Committee, or FOMC, is the most intricate example of the Fed's checks and balances. It's the Fed's most important policymaking body, which decides the course of monetary policy. The FOMC meetings combine the seven members of the Board of Governors and the 12 Reserve Bank presidents, five of whom vote on a rotating basis. It's admittedly a complex system—but it works.

At the FOMC meetings, decisions are usually made by consensus, and there's rarely a close vote. Regional input is crucial. We get grass-roots, up-to-the minute information that we're able to glean from a variety of regional sources. This helps us understand the story behind the numbers.

The board of directors at each Federal Reserve Bank and Branch play a key role in the information-gathering process. The boards consist of leading private citizens representing a number of economic sectors and interests such as banking, industry, retail, labor, and agriculture. They provide us with a first-hand view of the latest developments in the economy.

Importantly, the Reserve Banks add a regional perspective and a broad range of ideas to the policy process. The Bank presidents ensure a constant flow of input from beyond the Washington "beltway." So our regional structure not only insulates us from narrow influences, it also helps us obtain a broad range of information and ideas from people living and working throughout the country.

Midwest Study

So far I've talked in general terms about the advantages of a regional structure. Now I'd like to give a specific example of a project that helps to illustrate these advantages. Specifically, I'd like to talk about a long-term, Chicago Fed project to study the renaissance of the Midwest economy. The study focuses on the Seventh District states of Illinois, Indiana, Wisconsin, Michigan, and Iowa. But I think it raises issues that are of interest to people in the Midwest more broadly defined.

As you know, it wasn't that many years ago that the Midwest was commonly referred to as the rustbelt. And you couldn't find many people predicting that good times were ahead. The Midwest bottomed out during the early 1980s. It received a wake-up call; it just wasn't competitive.

There's been a dramatic turnaround since then. The Midwest has been outperforming the rest of the nation in recent years. One indication is that unemployment rates in Seventh District states have been *below* the national average by about one percent. Back in 1982, unemployment rates for the Midwest were three percentage points *above* the national average.

So the region's done well. The big question is why? And how do we sustain the comeback? It's important to look at public policy options that will help the region prosper in the future. As a regional institution, the Chicago Fed is uniquely positioned to study the Midwest and communicate information to policymakers. And through these efforts, information flows back to us — and helps us do a better job in contributing to national monetary policy. We've obtained a better understanding of the Midwest economy—how it's likely to develop and how the region may be affected by specific factors such as NAFTA or new welfare legislation.

During the past year, we've held six workshops focusing on a wide range of topics, We've looked at global linkages to the Midwest economy; the labor force and education policy; the rural economy; tax and regulatory policies; the performance of metropolitan areas; and changes in the manufacturing sector.

We're also working with an advisory group, which includes the governors of the five Seventh District states as honorary members. Each of the governors has a representative on the group. The group also includes six university presidents as well as representatives from business, labor, and not-for-profit organizations.

We'll be issuing a report in April. Then we'll begin a major effort to distribute the findings of the study to policymakers and community and business leaders.

Study results

I'd like to take a few minutes to give you a flavor of what we're finding. A number of interesting issues have emerged.

One thing that's very clear is the Midwest's transformation from over-the-hill to the king of the hill ... from rustbelt to robust. The old image of a gutted-out region overflowing with obsolete manufacturing plants is a thing of the past.

We did go through some tough times. For example, the Midwest lost three percentage points of its share of national manufacturing employment from 1977 to 1983, But since 1983, we've *gained two* percentage points of national manufacturing employment. And we've seen major manufacturing industries, such as steel and autos, reconcentrate in the Midwest.

The other mainstay of the Midwest economy is agriculture. Here we've seen increased output, primarily due to exports. And, surprisingly, we've also seen an increase in manufacturing employment in rural areas.

The stronger economy has attracted people. The Midwest's old image included a mass migration to warmer, more successful states. But again, the facts belie the image, In fact, tight labor markets in recent years have led to an inflow of people to the region. This trend has been most pronounced in rural areas. Froin 1980 to 1990, the population in rural counties declined by 2.2 percent. But since 1990, the population has increased and wiped out those losses.

We've seen an increase in population in metropolitan areas too. Many of these areas losses, have undergone an economic transformation. The Chicagoland area, for example, has transformed from a manufacturing center to a service center, specializing in business services, trade, travel, and financial services.

Why did all this happen? We're all aware of some external factors that have benefitted the Midwest ... declining energy prices; the stronger dollar; and cuts in defense spending. That last trend helped the Midwest because defense spending historically has been concentrated on the East and West coasts.

But these external factors don't completely explain the turnaround in the Midwest. The key to the Midwest's success, I believe, is that the region's industries have changed how they conduct their businesses. The Midwest has not dramatically changed its lines of business. It continues to be more concentrated than the nation in its mainstay industries — durable manufacturing and agriculture.

So, the Midwest is doing the same thing — it's just doing it better. The region has changed the way it does business — its organization; mode of operation; and use of technology. The region has been a leader in implementing best manufacturing practices, such as lcan manufacturing. Each industry has found ways to be competitive.

A study by Chicago Fed economists highlights the competitiveness of the Midwest economy. According to common wisdom, the Midwest benefitted quite a bit from the declining dollar, which made its exports cheaper for overseas buyers. This is a logical conclusion, given the results of studies that have looked at the value of the dollar and the nation's major trading partners. Our economists took a different approach—a regional approach—and looked at the value of the dollar and it's effect on the Midwest's major trading partners. They found that the dollar did not decline in those countries. In other words, the Midwest did not have a built-in price advantage. It appears that the Midwest succeeded because of better products and prices, not just because of external factors such as the performance of the dollar.

That's just a brief indication of what we're finding in the study. It's been a very useful process for the Chicago Fed because it's enhanced our understanding of the regional economy…It's encouraged us to take a more innovative approach in our analysis and helped us obtain a better understanding, of the numbers.

I hope our study also will be a useful tool for Midwest policymakers. The Midwest has rebounded… but that's no guarantee for the future. The region doesn't have an abundance of natural advantages. And we don't see any external trends that will sustain the region. The Midwest needs to look at policies that can keep prosperity going. Our goal is to be a catalyst for the development of effective regional policy… policy that will contribute to a healthy,,growing economy.

Conclusion

To sum up, the Fed's regional system offers a number of important advantages. Certainly, the Fed needs to respond to a changing environment, and we are doing that, as indicated by colleagues' comments.

It's important to keep in mind, though, that our regional system facilitates the development of effective, long-term policy. It provides insulation from day-to-day political pressures. It helps us keep track of the very latest developments in the economy, before they show up in the numbers. And it encourages a flow of ideas and in ut from "beyond the beltway." It's a system that's worked well for many years, and, I predict, will continue to do so in the 21st century.