St. Louis Fed's Bullard Discusses the U.S. Economy: A Report from Main Street

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MEMPHIS, Tenn. — In remarks today to the Economic Club of Memphis, St. Louis Fed President James Bullard discussed the historical context and deliberate design of the Federal Reserve System. He called for regulatory reform that strengthens—not weakens—the Fed's ability to head off future financial crises. Bullard also addressed the U.S. economic recovery now under way and cautioned that inflationary expectations appear to be on the rise.

Main Street, Wall Street, and Washington, D.C.

In his presentation, "The U.S. Economy: A Report from Main Street," Bullard addressed the history and design of the current Federal Reserve System and how its decentralized structure has provided strong checks and balances to keep power from being too concentrated in Washington, D.C., or New York City.

Bullard reminded the audience that today's Federal Reserve is actually the nation's third central bank. The first two, the First Bank of the United States (1791-1811) and the Second Bank of the United States (1817-1837), ended up being discontinued.

"The nation had no central bank during much of the 19th century," he noted. "The evidence from the 19th century is generally regarded as unfavorable—there was far too much financial instability. This led to the founding of the Fed following the panic of 1907."

The current Federal Reserve System was structured on the fundamental principle of keeping monetary policy at arm's length from the political process. To accomplish this, the System was designed with three distinct but complementary parts: the Board of Governors in Washington, D.C.; a Federal Reserve Bank in New York City, long regarded as the nation's financial capital; and 11 regional Reserve banks to represent the voice of Main Street across the rest of the nation.

"This regional structure was designed to keep some power out of New York and Washington and to ensure input on key policy questions from around the U.S.A.," Bullard explained. "It is this structure that has allowed the Federal Reserve System to be successful for nearly a century.

"Ultimate authority still remains in Washington," he said. "Members of the Board of Governors are appointed by the president of the United States and confirmed by the Senate for a term of 14 years. This length of tenure enables Board members to make decisions at arm's length from the political process and away from election cycles."

This is similar to the reasoning behind the lifetime tenures provided to justices of the Supreme Court.

“Allowing short-term politics to mix too closely with monetary policy leads to poor economic outcomes,” Bullard said. “This has occurred frequently in the developing world over the last 50 years.”

He further explained that, “The Board of Governors has oversight authority for the Federal Reserve System, including budgets and key appointments. This includes regional bank presidents and first vice presidents, as well as the chair and vice chair of the boards of directors at each bank.” There is considerable accountability in the Federal Reserve System.

He pointed out that the Fed is extensively audited, a practice established long before recent calls to “audit the Fed.”

“Our rough estimate is that about 425,000 hours are spent each year on audits. This is accomplished through internal audits, Board of Governors oversight and an external auditor,” Bullard said. “The Fed is also subject to auditing by the General Accounting Office (GAO), the investigative arm of Congress,” although these hours are not publicly available.

“Additional audits are welcome, so long as they do not constitute political meddling,” Bullard said.

Another way to help ensure good economic outcomes, Bullard said, is through open discussions and debates. “Monetary policy is vigorously debated every day, both inside and outside the Fed,” Bullard said.

Regulatory Reform: The Case for More Fed Authority, Not Less

In the aftermath of the financial crisis, some have called for diminished Fed regulatory authority. Bullard said that it is instead time for the Fed to have broader authority.

“The clear lesson is that the Fed had insufficient access to information about the financial landscape going into the crisis, meaning that it did not have a full understanding of the potential for feedback between the financial sector and the rest of the economy,” Bullard said.

He added, “As the crisis began, all eyes turned to the Fed as the lender of last resort. This always happens in a crisis—only the central bank can play the lender-of-last-resort role,” Bullard said. “Going forward, the Fed will also be at the center of all future crises because of this lender-of-last-resort role. Therefore, reforms should provide the Fed with direct access to detailed information across the entire financial landscape.”

“The Fed had detailed knowledge about only a small part of the financial landscape: the banking institutions for which it had supervisory authority. Prior to the crisis of 2007, this represented only about 12 percent of total U.S. banks,” he said. The remaining banks were overseen by the Fed’s sister regulatory agencies, the Federal Deposit Insurance Corp. (FDIC), the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), as well as state bank regulators.

“Banks are only one part of the financial landscape,” he explained. “Non-bank financial firms turned out to be the most troublesome entities in this crisis.” The Fed had no oversight authority over these firms.

“A future Fed, with an appropriately broad regulatory responsibility, may be able to head off a future crisis,” he added.

The State of the U.S. Economy and Monetary Policy

Turning to the state of the economy, Bullard said, “The recession in the U.S. was severe, but the economic recovery is on track.” He pointed to the past two consecutive quarters of positive GDP growth but noted the recovery from this severe and very deep recession has a long way to go.

“Labor markets remain weak and are at best stabilizing,” he said. “Job losses were much more severe than at any other time in recent history.” He noted that the number of hours worked is stabilizing, adding that this is typical behavior during the early phases of a recovery.

Other positive signs include the increase in U.S. housing starts and housing permits since the spring of 2009. “The housing sector is stabilizing,” Bullard said.

“In addition, financial market stress has abated substantially since the fourth quarter of 2008,” Bullard said.

However, inflation expectations are rising, he said, pointing to increasing spreads between Treasury Inflation Protected Securities (TIPS) and Treasury bonds.

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