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**THE ROLE OF THE REGIONAL FEDERAL RESERVE BANKS**

Remarks by  
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I appreciate this opportunity to talk to you about the role of the regional Federal Reserve Banks and their contributions to the Federal Reserve System. In my judgment, the job of the Federal Reserve or, for that matter, the central bank in any large, diverse economy is not very well understood, either by the public or even some of those close to the policymaking process. It follows that the role of the regional Federal Reserve Banks, which are just a part of our central bank, is probably less well understood. For that reason, my talk will focus on the nature of the regional Federal Reserve Banks and how they contribute to the maintenance of a smoothly operating financial system and to the development of a well-informed, carefully thought-out monetary policy.

The Federal Reserve System, the central bank of the United States, is at its core a public agency, headed by the Board of Governors in Washington and its current chairman, Alan Greenspan. The Board is surrounded by 12 quasi-public Reserve Banks, which represent the country's 12 Federal Reserve districts. The Federal Reserve Bank of St. Louis serves the Eighth Federal Reserve District and has branches in Little Rock, Louisville and Memphis. Generally, the Board of Governors focuses on policy matters, while the regional banks concentrate on implementing those policies. One exception to this characterization is monetary policymaking, in which the regional banks participate both in recommending discount rate changes and directing open market operations.

Because this structure is admittedly complicated, a brief historical overview and a discussion of the overall role of the central bank are essential to understand the contributions of the regional banks to the Federal Reserve System. So let me turn now to the question of how the structure of the Federal Reserve evolved.

For most of the 19th century, central banking was a crucial issue in American politics, and considerable political wrangling foreshadowed the founding of the Federal Reserve. At the turn of the century, commercial banking was a political hot potato, in part because interest rates were higher in the West than in the East. Some groups, especially farmers, were thought not to have representation in matters of financial policy. Big city banks, on the other hand, were thought to have too much power and an arrogance in not serving the needs of commerce in rural areas or the Western states. For these essentially populist reasons, regional representation was an important issue in the Congressional debate surrounding the Federal Reserve Act's passage in 1913.

At its founding, then, the Federal Reserve represented a compromise of competing interests with its structure of 12 relatively autonomous regional banks serving the needs of their districts, and a Board in Washington, D.C., performing a supervisory role. The Secretary of the Treasury and the Comptroller of the Currency sat on the Board as *ex-officio* members. The regional banks were located in major centers of economic activity across the country and thus could gather

important information about the state of the markets and the economy generally. This regionally oriented information played an important role in the early policymaking process, a role it continues to play today.

Faced with the Great Depression, Congress recognized that open market operations--the purchase and sale of federal government securities by Reserve Banks--had important implications for the economy. Accordingly, it altered the Federal Reserve's structure with the Banking Act of 1935. The Federal Reserve System was given greater autonomy from the executive branch, as the Treasury Secretary and the Comptroller of the Currency were removed from the Board of Governors. In addition, the Board was generally given greater authority over appointments at the regional banks, including those of the presidents and first vice presidents. The responsibility for open market operations, which had resided primarily with the New York Fed, was given to the Federal Open Market Committee, or FOMC. The FOMC consisted of all seven Board members and the 12 regional bank presidents, with only five of the presidents voting on policy at any one time. This arrangement gave the Board of Governors a permanent majority on the FOMC.

In a 1986 case, a U.S. District Court called this compromise "an exquisitely balanced approach to an extremely difficult problem." The autonomy of the Reserve Banks was retained in providing regional services and offering diverse input to the discussion of monetary policy. Control over

national policy was centralized in Washington, yet at the same time was made more independent of changing political winds by the removal of executive branch officials from the Board. This realignment successfully preserved the best elements of the previous system and created a remarkably durable structure--so much so that the same structure is in place today, more than 50 years later.

As this brief history illustrates, the structure of the Federal Reserve is based on a careful consideration of the nation's central banking needs. It represents a delicate balance of regional representation, political insulation and centralized control. This balance allows the System to execute its functions properly. With this in mind, I would like to move on to what I see is the role of the Federal Reserve System today.

Certainly the best known of the Federal Reserve's functions is that of monetary policymaking. Control over open market operations, the Fed's key policymaking tool, rests with the FOMC. The meetings of this Committee, of which I am currently a voting member, are covered extensively by the financial press and watched closely by politicians and the public. Many today consider monetary policymaking to be the central bank's most important function. But it is not the only function.

The Federal Reserve is also responsible for bank supervision and regulation. The Federal Reserve Act gave the Fed regulatory and supervisory authority over state-chartered

member banks, an authority that has been expanded considerably over the years. Although bank regulation in the United States involves three federal and 50 state agencies, the Fed essentially retains primary responsibility for the regulation and supervision of all bank holding companies and state-chartered banks that are members of the Federal Reserve System.

A third role the Federal Reserve plays is that of financial services provider for financial institutions and the U.S. Treasury. A key part of this function is operating an interbank payments mechanism. The Fed's payment services include collecting and settling checks among banks across the country, and handling large value payments and recurring payments through our nation-wide electronic communications network. Our services to the Treasury include handling electronic social security payments, government checks and the like. District banks and Treasury agencies maintain accounts with local Reserve Banks to clear these payments. To give you some idea of the significance of Fed payment services, more than \$2 trillion flow through these accounts on a typical day.

Finally, and this list is not exhaustive, the Fed has an umbrella responsibility to uphold the strength and stability of the nation's financial system. When a financial crisis looms, it is the Fed that provides liquidity and maintains the integrity of the payments system, thus allowing the real economy to continue to perform efficiently. One way that

liquidity can be provided is through discount window lending to banks by the regional Feds.

Perhaps these functions could be fulfilled by a bureaucracy in Washington. But I believe there are good reasons why the Congress retained an important role for the regional banks as the Fed's structure evolved. Most of these reasons have to do with the System's performance in attaining its objectives. So let me now turn to the contributions that the regional Reserve Banks make to the System.

The most visible regional bank contributions probably occur in the monetary policy arena, with both district bank presidents and research departments providing input. This channel has a long history at the Federal Reserve Bank of St. Louis. Thirty-five years ago, our Bank was producing better monetary statistics than the Board of Governors in Washington. In large measure this was because changes in the money supply were viewed by most economists to be largely irrelevant to discussions of monetary policy--interest rates were the important thing.

Because of the diversity that is possible in a decentralized system, the St. Louis Reserve Bank promoted an alternative theory and supported it with empirical evidence. The Bank's point of view went from being heretical in 1959 to the hottest controversy in economics in 1969 to the actual policy course that put us on the path to controlling runaway inflation in 1979. This change in the way economists think about money was a result of the publication of raw data

combined with sophisticated statistical work that showed important relationships between the quantity of money, nominal GNP and inflation.

In fact, the ideas embodied in monetarism are so pervasive today that it is the 1959 mainstream view that now seems out of place. Monetary aggregates, for instance, play an important role in FOMC policymaking and in the policymaking of central banks worldwide, whereas 20 or 30 years ago they played almost no role. Likewise, the idea that money growth and inflation are closely related in the long run, once an extreme view, now dominates discussions in both academic and policymaking circles. Doubts about the efficacy of short-run fine-tuning of the economy, long voiced by the St. Louis research staff, have crept into the views of many economists and policymakers. In short, once-radical ideas spawned by the early monetarists now seem mundane.

The experience of the St. Louis Fed in influencing monetary policy speaks volumes for the advantages of decentralizing research activity. Examples of the influence of other regional banks on this score can be cited, but I think the point is clear: a decentralized system permits and promotes a free competition of ideas.

But the advantages of the Fed's decentralized approach are not limited to economic research. The regional banks also bring a vital local perspective to deliberations at the FOMC. Each bank tracks economic developments in its own region and reports on them at every FOMC meeting. Without question, this



type of regional input provides important information about the economy that the national numbers miss. In particular, the national statistics are released with a lag, followed by numerous revisions. During the time it takes to compile aggregate figures, information gleaned from direct contacts with businesses, labor, consumers and others around the country can be a valuable and far more timely aid to decision making.

Putting the benefits of this information aside, there is a lot to be said for regional input on issues of as much national importance as monetary policy. In our lifetimes, we have all seen the decision making of some Washington bureaucracy go awry, having lost touch with the public. In my view, this has been less of a problem at the Federal Reserve, where the regional banks have regular contact with the people and institutions that make up the American economy. The regional Feds help the System keep a finger on the pulse of national economic activity, and deliver a real world perspective to monetary policy discussions.

The quasi-public nature of Reserve Banks is also a strength of the Fed's structure. The members of the boards of directors of the regional banks are drawn from the private sector, with due regard for the public responsibilities of the institution. Employees of the Fed are not part of the civil service. Operational management at Reserve Banks which emulates the private sector has paid handsome dividends. An internal study comparing the spending patterns of the federal

government as a whole with those of the Federal Reserve Banks reached a stunning conclusion. When placed on a comparable basis, the Reserve Banks proved far superior in containing costs as they significantly expanded their activity. From 1983 to 1989, federal government spending increased at a rate six times that of the Federal Reserve Banks. This sort of cost control is something I think we would all appreciate elsewhere in the public sector.

Though regional Reserve Bank boards of directors come from the private sector and name bank presidents, such as myself, these actions must be approved by the Board of Governors. This arrangement puts the regional banks at arm's length from the political process and offers a degree of insulation from the daily goings-on in Washington. This is what was intended in the original compromise creating the Federal Reserve System, and it incorporates a high degree of public accountability. The members of the Board of Governors are appointed by the President of the United States and confirmed by the Senate. The Board reviews all aspects of regional bank performance. Presidents of Reserve Banks can be removed from office by the Board of Governors. Furthermore, presidents must obtain appropriate security clearance and observe the same standards of conduct expected of public officials. In my opinion, there is no doubt that the regional banks are held directly accountable not only to their boards of directors, but also to the Board of Governors, and ultimately to Congress and the public.

Finally, I want to turn to the integration of the various functions of the Federal Reserve that is realized at the regional banks and how important this integration is in a financial crisis. While these functions--implementation of monetary policy, bank supervision and financial services--may initially seem separable, they are in fact closely related. Banks are the principal channel of monetary policy actions. The detailed knowledge of banking gained through our supervision activities is critical in assessing the impact of these actions. A recent example of this is the so-called credit crunch and its effect on the behavior of broader monetary aggregates used to guide policy.

Evaluating the condition of banks, in turn, is enhanced by our participation in financial services and the first-hand knowledge we have in understanding the risks that arise in payments systems. On a broader scale, our focus on general macroeconomic developments in monetary policymaking helps us assess risks affecting banks as well. Finally, our detailed knowledge of the financial condition of banks and other depository institutions gained from bank supervision helps us to minimize our own credit risk, and hence the risk to taxpayers, in providing financial services.

This reinforcement of one of our functions by other Federal Reserve activities is certainly desirable under normal, day-to-day operating circumstances. But it becomes critical in a financial crisis where the smooth and efficient functioning of the payments system is threatened. Imagine a

situation in which a major bank participant in the payments system is hit by the sudden failure of a large customer and is thus unable to meet its immediate obligations on a timely basis. Imagine further that other banks are counting on payment from the first bank to fully meet their obligations. These circumstances describe very simply what is meant by payment system risk--the potential for problems of one institution to affect the liquidity of other institutions in an interdependent payment mechanism. Not only can liquidity problems spread, but there is a chance that the entire system could seize up.

This is where the Federal Reserve, through a regional Reserve Bank with monetary policy, bank supervision and financial services expertise under one roof, comes into play. A Reserve Bank's financial services area might extend the operating hours of certain payments systems to permit the first bank to raise liquidity and meet its obligations. The bank supervision area might work with the credit discount function to determine the first bank's solvency and whether the Reserve Bank can prudently extend discount window credit for liquidity. The open-market desk located in New York, in consultation with the Fed chairman, might provide extra liquidity to the banking system as a whole for some time period. The point is, all the requisite skills are on hand in each Reserve Bank to respond quickly, thoughtfully and at the local level to a financial crisis. It is hard to imagine that in the United States, with its large geographic area and

fragmented banking arrangements, that a centralized system could respond as effectively, particularly if it did not embrace the full range of functions represented in Reserve Banks today.

In closing, I want to reiterate my view that the structure of the Fed is indeed an "exquisite balance" of independence, regional representation and accountability. I think that those who drew up the current system showed remarkable foresight in designing a structure that has stood the test of time. The regional banks provide the System with a number of advantages, including independence of thought on monetary policy, specialized regional information as an input to the policymaking process and hands-on expertise that must be tapped in times of crisis. This structure has served us well for many decades, and the regional banks have made many contributions to the Federal Reserve System as a whole. Accordingly, I expect that it is a structure which will continue to serve us well in the future.