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THE ROLE OF THE REGIONAL FEDERAL RESERVE BANKS

Remarks by
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Mayor Bosley said it best a few weeks ago when he told the Post Dispatch, "St. Louis is on a roll."

Good things are happening in St. Louis:

The Rams are coming, the Blues are back on the ice, construction has started on the new $194 million federal courthouse, the city has a $46 million HUD grant to redevelop an area south of downtown, and there's a plan for Laclede Town and a study that suggests exciting ideas for Cupples Station.

The retooled GM plant in Wentzville will open in March, Chrysler's plant No. 1 in Fenton is scheduled to start producing new minivans this spring, and Ford's retooling in Hazelwood will be complete next year.

Factories throughout the area are going full tilt and available workers are getting scarce. In fact, unemployment in St. Louis is at a 20-year low of 3.9 percent.

Of course, not all of the news is good, which is what you would expect in a dynamic market economy. There will always be a need for mergers, downsizings and the like. These developments can be painful, but they make businesses stronger and more competitive, contributing to long-term growth in the U.S. standard of living.

On balance, the news for St. Louis is very good. Sometimes people think the Fed doesn't like good news, but nothing could be further from the truth. I suppose that's hard to believe when short-term interest rates have been allowed to increase seven times in the last 12 months. Nonetheless, we do celebrate prosperity and growth, and the

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Fed doesn't like high interest rates any better than you do. We simply want to avoid the hard times that follow when the trend in inflation is allowed to move up and economic expansion inevitably comes to a screeching halt.

Formulating monetary policies that foster sustainable growth is the most important goal of the Federal Reserve System. And monetary policymaking is certainly our most visible role--it's the one people think of first when they think about the Fed.

Today, I will talk about monetary policymaking. I will also describe some of the other roles the Fed plays because they, too, have great influence on how well the banking system, financial markets and, ultimately, the economy function.

The Federal Reserve System has two major responsibilities in addition to monetary policymaking. We provide safe, reliable financial services to depository institutions so that cash, checks, and electronic payments can flow smoothly among these institutions and their customers. And, we supervise and regulate banks to ensure they are financially sound and aren't putting customers' funds, and ultimately the U.S. taxpayer, at undue risk. The three functions work together to protect the strength and stability of the nation's financial system.

You may be aware that there are 12 Federal Reserve Districts nationwide. As I talk about each of the Fed's responsibilities today, I'll also emphasize the role of these regional Reserve Banks.

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The Federal Reserve System is structured to provide the advantages of decentralized operations through the regional Reserve Banks, while maintaining the benefits of central oversight and political accountability through the Board of Governors in Washington. This delicate balance between the Board of Governors and the 12 regional Reserve Banks is key to the Fed's success.

As we go along today, I think you'll see that the Fed is an excellent model for how national policy can be coordinated in Washington, but operations can be left to regional organizations that are smaller, closer to the communities they serve and managed like private sector enterprises.

Let's talk first about monetary policy which is carried out through the Federal Reserve's purchase and sale of government securities, or what we call open market operations. These activities are directed by the Federal Open Market Committee, or FOMC, which is comprised of Federal Reserve governors and Reserve Bank presidents. Open market operations affect the amount of funds commercial banks have to make loans and other investments, and ultimately, determine the nation's money supply. They also affect various interest rates, especially short-term ones, including the federal funds rate. This is the interest rate that banks charge one another for overnight loans.

But all interest rates are, ultimately, determined by market forces which affect the supply and demand for credit. The Fed has much less direct influence than it is attributed,

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especially on long-term interest rates such as those for Treasury bonds or mortgages. These interest rates typically include a large premium to compensate for estimated future inflation and uncertainty with respect to that estimate.

One might think the Fed could push interest rates as low as it wanted simply by increasing the amount of money supplied to the economy. The consequences of such a policy, however, would be to generate inflation--excessive money growth causing prices to rise. After a time, the effort to lower interest rates would backfire and end up producing higher interest rates instead. Sooner or later, the public would recognize that the Fed was pursuing an inflationary policy and demand higher nominal interest rates to compensate for higher inflation. In this way, inflation is like a tax that, among other things, erodes the purchasing power of those who save or invest.

The principal way that monetary policy can hold down long-term interest rates is by holding down expectations of future inflation. A policy that seeks to maintain price stability over time will minimize inflation expectations and, therefore, produce lower long-term interest rates. Keep inflation down, and long-term interest rates will be low. Of course, interest rates will rise and fall to some extent--even when there is no inflation--but rates will be lower in the absence of inflation.

I believe that no one wants a monetary policy that reacts excessively to the latest economic news, or one that revs up

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the engine of the economy one year, then slams on the brakes the next.

The gains in production or employment that may come from a highly stimulative monetary policy tend to be short-lived. The increased inflation this policy generates will last much longer and ultimately require painful measures to restrain it. Our own experience, along with that of other countries, has taught us that orienting monetary policy toward inflation control is the best way to promote low long-term interest rates and sustainable economic growth.

That means a policy which seeks price stability is actually a pro-growth policy. And that's the policy the Fed has been committed to since early last year.

Through participation in the FOMC, regional Reserve Banks help assure that monetary policy is well-informed and carefully thought-out. A dramatic example of this occurred thirty-five years ago when the St. Louis Reserve Bank was producing better monetary statistics than anyone else in the Fed System. At the time, changes in the money supply were considered largely irrelevant by most economists. Interest rates were the important thing.

Economists at 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 thinking about money was a

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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.

The once radical ideas of the early monetarists are well-accepted today. 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.

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.

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

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are released with a lag, followed by numerous revisions. During the time it takes to compile accurate national figures, information gleaned from direct contacts with businesses, labor representatives, consumers and others around the country can be a valuable and far more timely aid to decisionmaking.

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 decisionmaking 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.

A real world perspective also is essential to the Fed's two other major functions. Let's talk about each of these briefly and then look at how all three work together when a crisis threatens the banking system.

The second major role of the Federal Reserve is to provide financial services for depository financial institutions and the U.S. Treasury.

Regional Reserve Banks collect and settle checks among financial institutions and handle large value wire transfers and recurring payments through our nationwide electronic communications network. We also distribute currency and coin to financial institutions. Our services to the Treasury as

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fiscal agent include handling electronic social security payments, government checks and the like. Commercial banks, thrifts and the Treasury maintain accounts with local Reserve Banks to clear these payments. The nationwide network of Reserve Bank offices ensures that financial institutions of all sizes have access to efficient, reliable payment services.

To give you some idea of the significance of Fed payment services, more than $2 trillion flow through these accounts on a typical day.

As part of our mandate to foster a sound banking system, the Federal Reserve also supervises and regulates financial institutions. This is our third major function.

The Fed regulates and supervises all bank holding companies and state-chartered banks that are members of the Federal Reserve System. The Board of Governors sets policy, then delegates direct oversight of the banking organizations in each district to the local Reserve Bank.

Our objective is to enforce banking laws and regulations, prevent bank failures when we can, and give the public confidence that our nation's banks are operating in a prudent manner.

These three functions -- monetary policy, financial services and banking supervision -- work together 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

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efficiently. One way 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 Congress retained this important role for the regional Reserve Banks.

Imagine a situation where a major bank is hit by the sudden failure of a large customer and is unable to meet its immediate obligations. Imagine further that other banks are counting on payment from the first bank to fully meet their obligations. As the liquidity problems spread, 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's 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 at the New York Reserve Bank, in consultation with the Fed chairman, might provide extra liquidity to the banking system as a whole for some time period.

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The point is, all the requisite skills are on hand at each Reserve Bank to respond quickly, thoughtfully and locally 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.

The quasi-public nature of Reserve Banks is also a strength of the Fed's structure. The members of their boards of directors 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 emulates the private sector and has paid handsome dividends. An internal study comparing the spending patterns of the federal government, as a whole, with those of the Reserve Banks reached a stunning conclusion. When placed on a comparable basis, the Reserve Banks proved far superior in containing costs while significantly expanding their activity. In the five years studied, 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 throughout the public sector.

Though regional Reserve Bank boards of directors come from the private sector and select bank presidents, such as myself, these actions must also be approved by the Board of Governors. This arrangement puts the regional Banks at arm's

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length from the political process and offers a degree of insulation from the daily goings-on in Washington. Yet, political accountability is maintained through the Board of Governors.

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 individuals who drew up the current system showed remarkable foresight. The regional Banks provide independent points of view on monetary policy, specialized regional economic information for policymaking and hands-on expertise in times of crisis. Overall, we ensure the integrity and successful operation of the nation's financial system. That's the role we play in assuring that good things can happen in St. Louis and communities all across the nation.

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