

The Fed's Role in Community Development

Rays of Hope: A New Day for America's Distressed Urban Areas Conference
Co-sponsored by the Community Affairs Department of the Federal Reserve Bank of St. Louis
and the University of Illinois East St. Louis Action Research Project
Jackie Joyner-Kersee Center
East St. Louis, Illinois
October 23, 2002

The conference proceedings yesterday made clear that there are a number of individuals, organizations, and government agencies working hard to find solutions to the problems facing cities throughout our country. And they are as varied as the citizens and neighborhoods they serve.

What I want to do is to talk for just a few minutes about the appropriate Federal Reserve role. But before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, but I retain full responsibility for errors.

One of the organizations working to address urban problems is the East St. Louis Action Research Project, or ESLARP, our partner in sponsoring this conference. Other participants in this effort are faculty and students from the University of Illinois at Urbana-Champaign who collaborate with East St. Louis neighborhood groups on projects that address the immediate and long-term needs of some of the city's most distressed communities. Community residents identify and prioritize tasks to be worked on. Individuals from the campus learn from community residents and, in exchange, work on projects that enhance and build the community.

There are numerous nonprofit housing developers, like Beyond Housing in St. Louis, which provide affordable rental housing or homeownership opportunities. In addition, thousands of community development corporations, large

and small, work in their neighborhoods to provide job training, credit counseling, and small business loans.

The Federal Reserve also plays a role through its community affairs offices. The community affairs staff provides leadership and information on successful approaches to community development. In that role, the Federal Reserve Bank of St. Louis is pleased to sponsor this conference in East St. Louis. The attendees here today—from banks, community-based organizations, government agencies, universities, and others—are representative of the many partners the St. Louis Fed's community affairs staff works with daily.

But a question often arises—why doesn't the Federal Reserve also use monetary policy to help neighborhoods in locations such as East St. Louis and urban areas across the country? After all, monetary policy is one of the most powerful forces in the economy.

Almost everyone knows that the Fed influences demand for goods and services in the economy by managing short-term interest rates. Interest rates affect people's decisions about consuming or saving and firms' decisions about expanding production or laying people off. Monetary policy can help lift the economy out of recession, and it can be used to keep inflation low so that the country can achieve its maximum sustainable rate of economic growth and employment.

Why, then, doesn't the Federal Reserve flex its monetary policy muscle in neighborhoods all across the United States that need an economic boost?

MISCELLANEOUS

Interestingly, the founders of the Federal Reserve established a structure for the System that assumed that each Federal Reserve Bank could set its own discount rate appropriate for the needs of its region. But even in 1914, when the System commenced operation, this view was outmoded. The U.S. financial markets were well integrated by that time, and powerful market forces equalized interest rates across the country. A Treasury bond, for example, had the same yield in St. Louis as in New York, the financial capital of the country.

The market forces at work then and now are easy to understand. Anyone wanting to buy a Treasury bond will want to buy at the lowest possible price, and anyone wanting to sell will want to sell at the highest possible price. The willingness and ability of buyers and sellers to take their orders to the market with the most favorable prices brings actual transactions prices for Treasury securities to equality in all markets, except possibly for very minor differences.

Securities issued by private borrowers, or local government borrowers, will also tend to trade at identical prices where the securities have identical characteristics. The dimensions of the characteristics include risk, maturity, tax status, liquidity, and perhaps others. Securities with a more favorable mix of characteristics will tend to trade at higher prices, or equivalently, lower yields, than securities with a less favorable mix of characteristics.

The Federal Reserve, in administering national monetary policy, has much to do with determining interest rates on Treasury securities but nothing to do with determining the mix of characteristics of various other securities. Thus, the Fed's job is to set the target level of the federal funds interest rate, which influences Treasury rates, appropriate for the needs of the economy as a whole. It is the responsibility of private and governmental issuers to determine their needs for funds and how best to make their securities attractive to the market.

A striking fact of our dynamic economy is that the fortunes of particular regions and industries are vastly different. Even when the overall

economy is booming, some regions and industries are left behind; when the overall economy is in recession, some regions and industries are nevertheless doing quite well. Today, for example, the overall economy is growing modestly, recovering all too slowly from last year's recession. Economic conditions vary substantially across regions and industries; the housing industry, for example, is extremely strong at present but the airline industry is in considerable trouble. Industries and regions also vary greatly over time. Many high-tech firms went from extreme boom three years ago to enormous difficulty today, including even bankruptcy. It would be easy to multiply these examples many times over in our recent and not so recent history.

The U.S. system of organizing and directing economic activity is a mixed one, with highly decentralized and highly centralized mechanisms existing side by side. Moreover, the degree of centralization evolves over time, in response to changing conditions and changing understanding of what works well. There is general agreement, after the failure of Soviet-style economies, that extreme centralization is a terrible mistake.

Perhaps less well appreciated by the general public is the advantage of maintaining the current arrangement for managing monetary policy. The Federal Reserve is a specialized institution, with responsibility for monetary policy, shared responsibility with other government agencies for bank supervision and regulation, and shared responsibility with private market competitors for financial services such as electronic funds transfer and check processing.

Through its discount window, the Federal Reserve makes fully collateralized loans to banks, a power that is extremely important to the Fed in fulfilling its responsibilities to maintain financial stability. But the Fed does not make loans to others. This restriction on the range of its lending activities is an important component of a successful monetary policy. The Federal Reserve creates money, which is a power subject to great potential abuse because it can so easily appear that no one has to pay when newly created money is used to finance various good causes. In fact, newly

created money is the functional equivalent of revenue raised through taxation. It is far better that public funds be allocated through the political process than through a hidden mechanism involving the central bank.

Our economic system, then, displays a division of labor in which the Federal Reserve is assigned the responsibility for overall monetary policy but not for financing particular enterprises or organizations. Individual entities, whether for-profit or not-for-profit firms or governments, are financed through a mixture of market, charitable, and tax-supported mechanisms. This division of labor has worked well over the years; countries that used to have central banks heavily involved in providing credit have for the most part moved away from such activities as a consequence of adverse effects on overall monetary policy and inadequate political control over the application of public funds.

While monetary policy, then, is the wrong tool for the Fed to use to target the problems in particular sectors of the economy, whether those of agricultural regions, the coal regions of Appalachia in an earlier era, or those of lower-income communities today, the Fed does not ignore opportunities to contribute where it can. The Fed plays a significant role as enforcers and promoters of the Community Reinvestment Act and related fair lending laws. And, as mentioned earlier, the community affairs departments at Federal Reserve Banks across the country continue to inform, educate, and assist banks and community organizations in areas critical to community and economic development.

Let me mention briefly several examples of Fed activities in this area:

- **Academic Research Conferences**—In March 2003, the Federal Reserve System's community affairs offices will sponsor its third academic research conference in Washington, D.C. These conferences bring together economists and scholars from the Federal Reserve System, colleges and universities, and major research institutions to present research on effective community

economic development tools, programs, and strategies. Papers selected for presentation during this third conference offer an evaluation of credit counseling and financial literacy, CRA's impact, sustainable community development partnerships, housing development, public policy interventions, and international approaches to community development.

- **Specialized Information**

1) *Community Development Financing*: In addition to community development finance workshops, the Federal Reserve Bank of St. Louis recently published a self-study version of the guide to community development financing: *Coming Up with the Money: Community Development Financing*. So far, we have received requests for copies of the guide from 43 states and four other countries. One session this afternoon will be a *Coming Up with the Money* workshop, and participants will receive a copy of the guide. Conference attendees also are welcome to order a free copy of this self-study guide.

2) *Perspectives on Credit Scoring and Fair Mortgage Lending*: Several Federal Reserve Banks worked together to produce a series of articles in which industry, concerned groups, and individuals addressed issues surrounding credit scoring and its potential impact on mortgage applicants.

- **A Quarterly Newsletter**—Our community affairs newsletter, *Bridges*, is published quarterly to highlight timely information and emerging issues, such as predatory lending, financial literacy, and serving immigrant populations.

For the markets to work, everyone has to have all of the information free of bias. That is why I believe that our role as a provider of essential information, through efforts such as these, is critical to strengthening and expanding the array of tools to provide all citizens with better opportunities for jobs, housing, and wealth creation.

MISCELLANEOUS

We thank you for your participation in this conference, and trust you will find today's sessions informative. Like yesterday's program, we have excellent panelists joining us today to share their expertise.

CONCLUDING REMARKS

I will finish with a few highly personal remarks.

Everyone in this room knows how difficult the problems of distressed areas are. We are dealing with crime, substance abuse, poor educational opportunities, and a long list of other issues. Our conference title is highly appropriate for the situation: We can see rays of hope, but we do not see the bright sunshine of unbridled success. And I'll predict that we will be engaged in a process of renewal for the indefinite future. We will not see a job finished that we can then walk away from.

It is too easy to become disillusioned. We know that the cultures of distressed areas are dysfunctional. People often engage in behavior that is self-destructive and destructive to others. It is not easy to change behavior; in fact, all we can do is to help people realize the advantages of changing their own behavior, and we can help them to do so by providing hope, improved education, and steady support.

Let me speak directly to those from the East St. Louis community. The Federal Reserve has an institutional commitment to do what it can. But I know that an institutional commitment means nothing without personal commitment. I want those of you from this community to come to us—to help us understand what we can do to assist you in your work. It is often said that the first reason people don't receive help is that they don't ask. So I am inviting you to ask us—tell us what information we can provide, what research we can do. Tell us who we can bring together to facilitate discussions to resolve problems. We have no vested interests; we are politically neutral.

I've been at the St. Louis Fed for a little over four years now. I've come to know people at the Bank and the Bank's culture of community service. The Eighth Federal Reserve District includes some areas of very deep distress—urban areas, major parts of the Mississippi Delta, and others. We want those of you who are working to address the issues of these areas to call on us—tell us what we can do to help. The Federal Reserve has a responsibility, but more important, each of us as citizens has a responsibility.

Contact community affairs at the Bank, contact me. We're here—Don't be bashful about writing, calling, or e-mailing us.