A Case for Monetary Reform

By JAMES L. PIERCE*

Any paper on *U.S.* monetary reform must consider reform of the Federal Reserve System. This paper considers reforms of the Federal Reserve that should enhance the quality of monetary policy. Two kinds of reforms are considered: 1) changes in the internal institutional structure of the Federal Reserve that should enhance the quality of its monetary policy decisions; 2) changes in the powers of the Federal Reserve to impose reserve requirements that should enhance the efficacy of the policies themselves.

I. Internal Reorganization

On July 17, 1978, Senator William Proxmire released, during hearings of the Senate Banking Committee, the contents of a letter written to him in March by David M. Lilly, a former member of the Board of Governors. In that letter, Mr. Lilly described four specific areas in which he thought the Fed should be reorganized. The contents of the letter provide an excellent vehicle for discussing organizational reform of the Fed. In fact, to have the Lilly letter made public is an important reform itself; former governors of the Fed have been remarkably silent about flaws in that institution. Mr. Lilly's observations will be quoted, and then I shall offer my own comments on those observations.

1) *Organization of the Open Market Committee*

"I think that the presidents of the Federal Reserve banks should have the same accountability that applies to members of the Board as regards the Open Market Committee. The Reserve Bank presidents are neither appointed by the President of the United States nor by the Board of Governors,—yet they serve on the Open Market Committee and have input into monetary policy and on a rotating schedule vote on decisions that are crucial to the nation's well-being."

"Furthermore, with regard to monetary policy they are not accountable to the Board of Directors of their Reserve banks. Those Boards are excluded from monetary policy discussions connected with the OMC. Thus, in my view the Reserve Bank presidents are not responsible to anyone for their votes. The accountability of the Reserve Bank presidents should be established if they are to continue to have a say in monetary policy."

The Federal Open Market Committee (*FOMC*), or OMC as Mr. Lilly calls it, is the primary vehicle for monetary policy in the United States. It makes all the decisions concerning the execution of open-market operations. These operations in turn are directed toward affecting the growth of money and credit, the level of interest rates and, ultimately, the level of economic activity in the United States. Changes in reserve requirements and in the discount rate, which are determined by the Federal Reserve Board, are distinctly secondary to open market operations in the conduct of *U.S.* monetary policy.

The *FOMC* has twelve voting members: the seven governors of the Federal Reserve, the president of the Federal Reserve Bank of New York, and four presidents of the remaining eleven Reserve Banks; these four presidents serve on a complex rotating basis. All twelve Reserve Bank presidents take part in *FOMC* meetings but only five vote on policy. Of the twelve votes on the *FOMC* only the seven from the Board of Governors are cast by individuals who receive presidential appointments and Senate confirmations. Reserve Bank presidents are not appointed by any public official. Rather, they are appointed by the private directors of their Reserve Banks with the appointment confirmed by the Federal Reserve Board. The Bank directors are private citizens; one third of whom are bankers, one third are individuals selected by

*University of California-Berkeley.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

bankers, and one third are selected by the Federal Reserve Board.

Mr. Lilly observes that Federal Reserve Bank presidents are accountable to their boards of directors, but these directors are not privy to monetary policy discussions or decisions. Thus, because the directors are not aware of what the bank president said in *FOMC* meetings and only learn of his vote after a significant time delay, the Reserve Bank presidents actually are accountable to no one. He argues that their accountability should be established. I agree, but changing the nature of appointment is not sufficient to establish accountability.

Many proposals have been made over the years to increase the accountability of the Fed and the *FOMC*. There are two elements in this accountability: who appoints the decision makers and to whom must they explain their actions once appointed. Mr. Lilly only addresses the first element. It will be discussed briefly here before turning to the second element.

The question of who appoints the members of the *FOMC* is the less important of the two elements. Nevertheless, most observers would agree that the private directors of Reserve Banks have no business appointing members of the *FOMC*. Many proposals have been made over the years to rectify the situation. Some would restrict the *FOMC* to Federal Reserve Board members, others would retain the participation of Bank presidents on the *FOMC* but require either presidential or Federal Reserve Board appointment of the presidents with Senate confirmation in either case. Since I prefer restricting the *FOMC* to Federal Reserve Board members, I should like to point out some of the difficulties involved in having Reserve Bank presidents sit on the *FOMC*.

The Federal Reserve Board currently can exert a powerful influence over selection of Reserve Bank presidents by confirming or rejecting names supplied to it by the bank directors. Further, and perhaps more important, the Federal Reserve Board approves the budgets of the Reserve Banks. The Board and/or its chairman can make life very unpleasant for a Bank president who causes too much trouble at *FOMC* meetings. Thus, even if Bank presidents were appointed by the president of the United States and confirmed by the Senate, they would not be free agents so long as the Board controls their budgets. There are Bank presidents who act independently of the Board, but by-and-large, Reserve Bank presidents go along with the Board.

It is difficult to overstate the power that the Board of Governors, and particularly its chairman, has in the *FOMC*. Perhaps a few examples will make the point. The Board controls (or at least it did under the previous chairman) all staff material presented at the *FOMC*, and only Board staff members make verbal presentations at *FOMC* meetings. Reserve Bank presidents usually seek Board approval prior to agreeing to testify before Congress. Reserve Bank presidents typically have their testimony reviewed by Board staff and the Board itself prior to delivery. Board members do not check their testimony with Bank presidents prior to delivery. Finally, Bank presidents do not form coalitions within the *FOMC* but the Board often represents such a coalition. It is unlikely that a presidential appointment would make Reserve Bank presidents much more willing to buck the Board and its chairman.

There appear to be two solutions to the nonindependence of Reserve Bank presidents. The first would simply accept the reality of the situation and exclude Reserve Bank presidents from the *FOMC* and monetary policy decisions. This solution would have the virtue of fixing responsibility directly with the Board of Governors. It would have the deficiency of depriving monetary policy deliberations of regional influences and knowledge. The second solution would retain the Bank presidents on the *FOMC*, require presidential appointments with Senate confirmation *and* take the budget control over the Banks away from the Federal Reserve Board. About the only feasible way that budget control can be taken from the Board is to change the entire budgetary treatment of the Federal Reserve System, including the Board. This could be accomplished by placing all Fed expenditures within the federal budget. Such a change

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

would entail congressional authorization for Federal Reserve expenditures, both of the Board and the twelve district Banks.

Reform of appointment of members of the *FOMC* would enhance the accountability of that body. The most important improvement in accountability, however, must come from greater disclosure of decisions by the *FOMC*. Disclosure was not mentioned in Mr. Lilly's letter, but it is the key to accountability. The Fed cannot be held accountable until it is forced to announce what its policies are, how it selected them rather than others, what effects it expects to have with the policies and how it will modify them if events do not materialize as expected. In accountability, it is crucial to distinguish objectives and the methods selected to achieve them from honest policy mistakes that result from an uncertain environment. Disclosure is the only method of making this distinction. Some progress has been made to increase disclosure, first in the form of House Concurrent Resolution 133 and later in an amendment to the Federal Reserve Act which made most of the elements of the Resolution permanent. The Fed does announce its money growth targets, but it refuses to name objectives for the economy and to divulge its forecasts and policy alternatives. True accountability will occur only when these factors are disclosed.

2) *Board of Directors of the Reserve Banks*

"Only the three Class C directors are chosen by the Board of Governors. The Class A and B directors are chosen by the member banks. This ostensibly gives the member banks a larger voice in the running of the Reserve banks than the Board of Governors. In light of the reforms made with regard to the interests to be represented by members of Board of Directors made by Public Law 95-188, I believe it would be desirable to have both Class B and Class C directors selected by the Board of Governors in Washington."

Currently, two-thirds of the directors of Reserve Banks are chosen by member banks in the district and one-third are selected by the Federal Reserve Board. Recent changes in the law (P.L. 95-188) impose antidiscrimination standards on selection of directors and liberalize slightly the standards for selection. Despite these minor changes, the majority of Reserve Bank directors is still selected by member banks in the district. Mr. Lilly would like to have all directors chosen by the Board of Governors in Washington.

It is easy to make too much of the issue of Reserve Bank directors. They really exert no influence on monetary policy; their primary function is to advise the Bank president on internal operations and to provide community involvement with the Federal Reserve. Bank directors might appear to have a policy role because requests for changes in the discount rate must come from Reserve Banks, but the Board of Governors is free to ignore these requests and usually does. The discount rate function does lead to economic briefings of the board of directors so that possible submissions of discount rate changes can be considered. Because the Board in Washington must approve these requests and because most requests are not even considered, the role of the bank directors is not important. The Board almost always has a menu of previously proposed changes in the discount rate available, should it wish to change the rate. If there is nothing on the menu that the Board likes, a phone call solves the problem.

Central banking is a governmental function and it is inappropriate to have private individuals serving as directors of Reserve Banks. Central banking functions are no more important to bankers than to anyone else, yet the selection of directors is dominated by bankers. Mr. Lilly would like to have the bank directors selected by the Board in Washington; I would like to see them eliminated altogether. If a Reserve Bank president wants help with internal operations, then let him appoint an advisory group.

3) *Deferral of Open Market Committee Directive*

"I see no reason why the release of the policy directive of the OMC needs to be delayed. Everyone should have the same access to the decisions made by the OMC. Currently, only those brokers and dealers with large staffs monitoring Federal Reserve policy on a daily, and in some cases hourly,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

basis can know what monetary policies the OMC is pursuing. This is discriminatory and gives brokers and dealers an advantage over the ordinary citizen."

The deferral of release of the *FOMC* directive has been a hotly debated issue for sometime. Some people, many of whom are in the Fed, argue that speedy release of the directive would be harmful because it would encourage speculation. It is difficult to find merit in this argument. Insiders such as government security dealers know very quickly when the Fed has changed policy. After all, the Fed executes policy through open market operations with these dealers. Other large operators in the money market employ Fed watchers who have become very good at divining when the Fed has changed policy. It is difficult to understand why the rest of the public must wait thirty days to learn of Fed policy.

There appears to be a belief within the Federal Reserve that secrecy and confusion about current policy enhances the effectiveness of that policy. I know of no basis for this belief. The sooner the public knows what monetary policy is, the better. The public cannot decide what to do with information until it has it.

I believe that the real reason the Fed defers release of the directive is its penchant for secrecy, which in turn is a desire to avoid accountability. If the Fed truly had its way, I doubt that it would ever release the directive, it would usually produce only platitudinous statements about the "thrust" of policy.

Speedy release of the directive is clearly called for. While I think it is helpful to have policy debates in private in order to invite free interchange of ideas, once decisions are made they should be announced immediately.

4) *Monetary Policy Responsibilities of the Board of Governors*

"I accepted the position on the Board because I viewed, and still do, the Board's monetary policy responsibility to be of utmost importance to the nation. Unfortunately, there are many other matters that come before the Board that are time consuming, and these detract from this major responsibility."

Contrary to popular opinion, the Federal Reserve Board and Reserve Bank presidents spend most of their time on matters other than monetary policy. The Federal Reserve Board spends most of its time on bank and holding company regulation. The Reserve Bank presidents are concerned not only with regulation but also check clearing, funds transfer, and other operating activities. It seems reasonable to assert that monetary policy is a full-time job and policymakers should not be distracted by other matters.

The Federal Reserve is on both sides of this issue. On the one hand, many Board members have felt the frustration indicated by Mr. Lilly over the relatively small amounts of time available for monetary policy. On the other hand, the Board has resisted efforts to reduce its regulatory burdens. When faced with the prospect of seeing its regulatory functions go to other agencies, the Fed evidences a strong desire to protect its turf.

The Fed has argued strenuously that it needs regulatory functions in order to help it execute monetary policy. I know of no case in which monetary policy was helped by having the Fed in the regulatory business. I know of many cases in which regulatory responsibilities got in the way of monetary policy. The Federal Reserve needs data on what is happening with respect to banks and in financial markets in general. It does not need to regulate in order to obtain these data. I believe monetary policy would be significantly improved if the Fed ceased being a regulator.

II. Some Further Considerations

Mr. Lilly's complaints seem well founded. They all spring from the same institutional source. The basic problem lies with viewing the Federal Reserve as a banking agency. A central bank is not a private bank; it plays its role by affecting the nation's monetary base.

The current structure of the Fed has its roots in history, not in good economics. It was history that produced Reserve Banks that were set up like private banks with stockholders (member banks) and boards of directors.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The stock of the Reserve Banks should be retired (purchased from member banks) and the boards of directors eliminated. Reserve Banks should become purely governmental entities.

It was also history that made membership and regulations by the Fed come with reserve requirements. It is important to divorce reserve requirements from Fed membership and regulation. Required reserves held at the Fed are helpful to monetary policy. Reserve requirements should have nothing to do with the type of charter an institution has or with who regulates it. If reserve requirements should be imposed on a particular kind of liability for purposes of monetary policy, then they should be imposed on any institution that accepts that liability: member bank, non-member bank, savings and loan, mutual savings bank, or credit union.

The Federal Reserve has found itself with declining membership primarily because many banks have found required reserves onerous. It has used all sorts of schemes to attract members. The Fed doesn't need members, it needs authority to impose reserve requirements.

While there is no evidence that declining membership has injured monetary policy, there is evidence that the Fed's Rube Goldberg graduated reserve scheme has harmed monetary control. There is also reason to believe that with automatic transfer accounts starting in November, and with nationwide *NOW* accounts (or their equivalent) waiting in the wings, there could be explosive growth in transactions accounts offered by institutions that do not have reserve requirements imposed against them. If this explosion occurs, the Fed could find its monetary policy control slipping. The solution appears to lie with imposing reserve requirements against all transactions accounts and allowing all institutions that offer them to have full access to Fed services including the discount window. The answer does not lie with forcing these institutions to be members of the Fed. If all institutions have access to Fed services, there will be no incentive to be members and the Fed's regulatory burdens should die a natural death. This reform would solve many of Mr. Lilly's problems.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis