Charles I Plosser: An appreciation of the Fed's 12 banks

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, to the Union League of Philadelphia, Philadelphia, Pennsylvania, 17 February 2015.

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The views expressed are my own and not necessarily those of the Federal Reserve System or the FOMC.

Highlights

- President Plosser highlights the history of the Federal Reserve and why he believes our central bank's unique structure has withstood the test of time.
- He believes a key strength of the Federal Reserve is the vibrant role the 12 independent Reserve Banks maintain in operations and policymaking.
- President Plosser defends central bank independence. He discusses the importance of the central bank in making monetary policy decisions without fear of direct political interference.
- He explains that he does not support the "audit the Fed" movement because he believes it would lead to greater political interference in monetary policy decisions. He states this proposal would reduce the independence of the central bank through the threat of a political action in real time.

Introduction

Thank you, Dr. (Karen) Lawson, for that kind introduction and thanks to the Union League's Public Affairs Committee and the Business Leaders Forum for inviting me here today for what will be my final public speech as president of the Federal Reserve Bank of Philadelphia. For more than eight years, I have had the honor of working alongside many talented colleagues here in Philadelphia and throughout the Federal Reserve System during an extraordinary period in this nation's economic history.

I came to Philadelphia in 2006 after more than three decades in academia, where much of my research and teaching centered on the subjects of macroeconomics, monetary theory, and finance. Serving as president of the Philadelphia Fed has given me a rare opportunity to combine three roles: first, to lead an extraordinary organization, as I did as dean of the Simon School of Business in Rochester; second, to serve as a monetary policymaker, and third, to continue a lifelong role as an educator, through speeches like this one today, to help people understand the economy, monetary policy, and the role of the Fed.

It has been a fascinating yet challenging time to serve. As I look back, I had about a year to settle in before facing a global financial crisis, the ensuing recession, and more than five years of a slow, but steady, climb back to normalcy.

Today, I would like to take a step back from the day-to-day economic picture and give you a personal appreciation of America's decentralized, central bank, made up of 12 independently chartered Federal Reserve Banks and the Board of Governors in Washington, D.C. It is customary to mention that these views do not necessarily reflect those of the Federal Reserve System or my colleagues on the Federal Open Market Committee (FOMC). But it won't be long until such a caveat will no longer be necessary.

Historical roots

It is not unusual to hear questions like, “Why are there 12 Federal Reserve Banks and do we really need so many?” “Why are the 12 presidents involved in monetary policy?” “Wouldn’t policy be more effective if it was delivered without the “cacophony” of so many voices expressing different views?” While I understand these perspectives, I think these arguments miss the fundamental point driving the Federal Reserve’s governance structure.

Americans have a long history of suspicion toward the concentration of authority. So, our uniquely American form of a central bank seeks to strike a balance between centralization and decentralization, between the public and private sectors, and among Washington, Wall Street, and Main Street. This balancing is critical to ensuring accountability and reducing the risk that the institution would be captured by private or political interests.

To understand how it came to be, it is useful to review a little history. Just a few blocks from the Philadelphia Fed stand the vestiges of our country’s two earlier attempts at a central bank, dating back to the early years of our nation when Philadelphia was the major financial and political center of the country.

The first institution was the brainchild of our first Treasury secretary Alexander Hamilton. His efforts led to the creation of the First Bank of the United States, which was awarded a 20-year charter by Congress in 1791.

Although the First Bank’s charter was not renewed, the inflation and economic turmoil following the War of 1812 convinced Congress to establish the Second Bank of the United States. It was also given a 20-year charter and operated from 1816 to 1836. However, its charter was not renewed – Congress could not override the veto of President Andrew Jackson, who led the opposition to the central bank. Public distrust of centralized power was an important factor in the demise of both banks. Both became entangled in politics, and both failed to gain the public’s confidence to serve our vast and diverse country of bakers and bankers, farmers and financiers, and manufacturers and merchants.

It took Congress nearly 80 years to try again to establish a central bank. After the severe bank panic in 1907, Congress began several years of study to come up with a model that would work. When Congress finally passed the Federal Reserve Act of 1913, it included a unique political compromise. It established a system of semi-independent Federal Reserve Banks around the country with oversight provided by a public Federal Reserve Board in Washington, D.C. Many in Washington and on Wall Street favored a more centralized central bank, either dominated by bankers or politicians, but Congress passed the law requiring a decentralized organization with eight to 12 reserve banks to disperse authority. That tension between centralization and decentralization has waxed and waned over the past 100 years and continues even today.

In the end, Congress and the Reserve Bank Organizing Committee opted for 12 Districts. Their size was based on the number of banks in their Districts and their relative size in the economy. Since the organizers wanted the 12 Districts to begin with roughly similar capital bases, the Districts in the East, where more capital was concentrated, were geographically smaller than the Districts in the West, where capital was more dispersed.

Congress has debated and changed the governance structure from time to time, including the 1927 decision to give the 12 Federal Reserve Banks permanent charters rather than 20-year charters. Following the Great Depression, the passage of the Banking Acts of 1933 and 1935 brought about the biggest changes in governance. The Banking Act of 1935, in particular, renamed the Federal Reserve Board the Board of Governors and granted the Washington-based entity greater powers. It specified that the Board of Governors should have seven members appointed by the U.S. president and confirmed by the Senate.[1] Governors could serve 14-year terms to insulate them from short-term political pressures and to encourage a long-term perspective on the economy and the financial system.

The 12 Federal Reserve Banks, of course, were, and still are, independently chartered institutions. They each have a nine-member board of directors drawn from citizens in their respective Districts to represent a cross-section of banking, commercial, and community interests. Three directors represent the banking community. Six other directors, all nonbankers by law, come from a wide variety of backgrounds and perspectives. These directors not only fulfill the traditional governance role of overseeing the Bank's performance but also provide valuable insights into economic and financial conditions in the District and the nation. One recent change in the directors' roles came under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010: Only the six nonbank directors on each board may vote to select a Reserve Bank president, subject to the approval of the Board of Governors.

Operational advantages

When the Fed was first established, the U.S. and much of the developed world operated on a gold standard. The primary objective of the new central bank was to provide an "elastic currency" so that banks could meet the cash demands of businesses and consumers. Before the Federal Reserve, circulating cash was predominately in the form of private bank notes, which could become scarce in times of panic. The Reserve Banks were given the authority to issue Federal Reserve Notes that were declared legal tender and so they could meet these cash needs by short-term lending to banks against collateral. Thus, for the most part, the Board in Washington had little role to play in the primary responsibilities of the Federal Reserve System.

The Reserve Banks remain the operating arm of the Federal Reserve System. It is the 12 Banks and not the Board of Governors that distribute currency, act as a bankers' bank, and generally perform the functions of a central bank. This includes serving as the bank for the U.S. Treasury. It is the Reserve Banks that have assets and a balance sheet. The earnings on these assets fund the operations of the 12 Banks as well as the operations of the Board of Governors to give the Federal Reserve System independence from the Congressional appropriations process. In fact, the System turns over any excess earnings above the cost of its operations to the U.S. Treasury.

So, from the beginning, the Reserve Banks have played an integral role in their regions' economies. In addition to providing currency and coin services to banks, the Reserve Banks handle other basic payment services, such as wire transfers and clearing checks. In fact, if you look at the development of payment systems in America, many of the innovations in electronic funds transfer have been led by the 12 Federal Reserve Banks, including championing the passage of the Check Clearing for the 21st Century Act in 2003, which has accelerated the migration from paper checks to electronic check images and electronic payments. So, rather than having 45 check-processing locations at its peak, the Federal Reserve has just one location today for paper checks and one for electronic payments.

While supervisory and regulatory authority for many banks and bank holding companies rests with the Board of Governors by statute, not the Reserve Banks, the Board delegates authority to the staff in the 12 Reserve Banks to provide the boots on the ground for effective supervision of the covered institutions in their Districts.

1 As of February 17, 2015, there were five Governors serving, with one more nominee awaiting Senate confirmation.

The Reserve Banks also act as the bank for the U.S. Treasury. They work closely with the Treasury to develop payment processes, such as making payments on the public debt, distributing payments to Social Security recipients, and so forth.

The Banks also support community development activities, including research and engaging organizations to find effective and impactful development solutions that promote the Federal Reserve System's economic growth objectives in low- and moderate-income communities.

Setting monetary policy

Of course, most people think of the Federal Reserve as being responsible for setting and executing monetary policy. Here, too, the Reserve Banks play an important role. In the early decades of operations, the Reserve Banks came to learn that buying and selling assets on the open market had an influence on the money supply. In fact, they found that if they didn't coordinate their actions, they could encounter unintended consequences as they may act at cross purposes. So, in 1923, early leaders, such as Benjamin Strong in New York and George Norris here in Philadelphia, helped organize a committee to coordinate open market operations. This eventually led Congress to formally create the Federal Open Market Committee, or FOMC, as the formal body within the Fed responsible for monetary policy.

Since the Banking Act of 1935, the composition of the FOMC has included the seven Governors in Washington, D.C., the president of the New York Fed, and the presidents of four other Reserve Banks, who serve one-year terms as members on a rotating basis. These rotations ensure that all regions are represented in the formation of monetary policy. The composition gives the Board of Governors the majority of votes.

However, whether we vote or not, all Reserve Bank presidents attend the FOMC meetings, participate in the discussions, and contribute to the Committee's assessment of the economy and policy options. The FOMC has eight regularly scheduled meetings each year to set monetary policy. It discusses economic conditions and, in normal times, decides the path of short-term interest rates to achieve the goals of monetary policy that Congress has set for us in the Federal Reserve Act.

When preparing for the FOMC meetings, participants rely on their economic research departments to brief them on regional and national economic conditions and provide support and insight on appropriate monetary policy. The independent presidents and their research departments also help ensure that a wide variety of perspectives are brought to the table when we make policy. This helps prevent monetary policy from adopting a "groupthink" mentality.

The separate teams of research economists in the Reserve Banks also ensure a useful diversity in academic pursuit. Research teams at the Banks have advanced many economic concepts that have been adopted by the Federal Reserve System, such as the value of inflation targeting or the latest use of economic modeling. This has led to centers of excellence in the Districts, such as the Payment Cards Center and the Real-Time Data Research Center here in Philadelphia.

In addition to economic research, the Reserve Bank presidents also gather information from their boards of directors and advisory councils and through conversations with local and international business leaders. All this helps to contribute to a rich and comprehensive mosaic of the national economy.

Monetary policymaking is conducted by committee by design, and divergent views can and often do exist. As we worked our way through the financial crisis and through the recovery, we found ourselves in uncharted territory dealing with many economic challenges. So, there is little wonder why there are often differences of opinion around the table. Some commentators express the view that dissent causes dissonance and therefore confuses the communications. I disagree. I believe that open dialogue and diversity of views lead to better policy decisions and are the primary means by which new ideas are gradually incorporated into our monetary policy framework.

Thus, I believe diversity of thought is a sign of a thoughtful process. I have often quoted the famous American journalist Walter Lippmann, who said, “Where all men think alike, no one thinks very much.” I think it is healthy for the American public to know that we debate some of the same issues that those outside the Fed debate. Hiding such debate behind a unanimous vote does nothing to promote true transparency. By being open and transparent about these various perspectives, our decentralized model for the Federal Reserve helps strengthen public confidence and preserve its independence.

Defending central bank independence

So, why is central bank independence so important? It strikes many people as odd that in a democratic society we leave monetary policy decisions in the hands of nonelected policymakers who can act with independence. I think this view stems from confusion about what is really meant by central bank independence. Central bank independence means that the central bank can make monetary policy decisions without fear of direct political interference. It does not mean – nor should it – that the central bank is not accountable for its policies.

It is important to remember that the Federal Reserve does not select its own goals. Instead, Congress sets the goals it wants the Fed to pursue with monetary policy. Since 1978, Congress has mandated that the FOMC “shall maintain long run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

The goals of monetary policy are rightly a subject of legitimate debate. I have frequently argued that these goals are too broad, and they risk making the Fed responsible for more than it can actually deliver. That, from my perspective, risks undermining the Fed’s credibility and invites policymakers to lurch from one goal to the next when it seems convenient, thus making it more susceptible to political pressure. As a consequence, I have favored a single mandate for the Fed – price stability – to increase the clarity of the objective and make it easier to hold the Fed accountable.

Nevertheless, given a mandate, what central bank independence means is that Congress has left the decisions of how best to achieve this mandate to Fed policymakers. Why did Congress design the Fed this way? There are two very important reasons. First, monetary policy affects the economy with sometimes long and variable lags, but elected politicians, and even the public, often make decisions with the next month, next quarter, or the next election in mind. Monetary policy actions taken today will often not have their full effect on the economy for at least several quarters and perhaps as long as several years. That is why monetary policy choices today must focus on the intermediate to long term and anticipate what the economy might look like over the next one to three years. Indeed, the mandate itself stresses the long run focus of monetary policy.

Moreover, there can be a conflict between what monetary policy may be able to achieve over the short term versus its impact over the long term. For example, in the short term, it might seem expedient or even desirable to try to spur economic growth and employment by conducting excessively accommodative monetary policy. Yet, this could lead to very bad economic outcomes in the long term, including higher inflation, higher interest rates, and an eventual tightening of policy to control inflation that may be detrimental to the economy. These outcomes would be inconsistent with the long-term goals set by Congress. Delegating the decision-making to an independent central bank that can help focus on long-term policy goals is a way of limiting the temptation for short-term gains at the expense of the future.

The second important reason to give monetary policy decision-making to an independent central bank is to separate the authority of those in government responsible for making the decisions to spend and tax from those responsible for printing the money. This lessens the temptation for the fiscal authority to use the printing press to fund its public spending, thereby substituting a hidden tax of inflation in the future for taxes or spending cuts.

History is replete with examples of what happens when central banks are not independent or become agents for a nation's fiscal policy. Just think of the hyperinflation in Germany between the World Wars of the last century, or in Italy before the euro, or in the numerous financial crises and high inflation rates in Latin American in more recent years, to name just a few. The consequences – higher inflation, currency crises, and economic instability – are not good. This is why so many countries have structured their central banks with a great deal of independence from political interference.

Despite the strong arguments for political independence, there continue to be proposals that would make monetary policy subject to more political interference. In recent years, this effort has manifested itself in the movement in Congress to pass an "Audit the Fed" bill. Since 1978, Congress has specifically exempted monetary policy decisions from such "audits" by the Government Accountability Office, or GAO, with good reason. The bill is not really about an audit in the usual accounting or financial sense of the term, since the Fed's financial statements and indeed its operations in supervision and payment services are already subject to extensive outside audits by the GAO, the Board of Governors' Office of the Inspector General, and an outside public accounting firm. Rather, this proposal to strike that exemption for monetary policy is an attempt to reduce the independence of the central bank through the threat of a political action in real time.

For example, under the provisions of the bill, the GAO could be called on to investigate a monetary policy decision whenever any member of Congress opposes a decision to change interest rates. This possibility would change the dynamics of the FOMC's internal discussions and undermine the Fed's credibility and its ability to conduct monetary policy in the long-term interests of the American public.

Over the past 30 years, many countries have acted to increase the degree of independence of monetary policymaking from short-term political influences. In a democracy, though, independence must be accompanied by accountability. In recent years, the Fed has increased its transparency. The FOMC issues a statement after every meeting. It publishes the minutes three weeks after each meeting. It also reports the economic projections of Committee participants four times a year. These meetings are followed by press conferences with the chair of the FOMC. In 2012, the FOMC issued a statement clarifying our longer-run goals and strategy, including an explicit 2 percent target for inflation. And the economic projections now include information about the policy path assumptions of participants. Finally, after five years, verbatim transcripts are available for every FOMC meeting.

The Reserve Banks' structure also helps increase transparency by communicating economic and monetary policy objectives and actions through educational outreach and speeches such as this one, as well as discussions with their boards of directors and other groups.

I support these ongoing efforts to increase accountability and transparency, but I do not support efforts that would lead to greater political interference in monetary policy decisions. Such efforts include the audit-the-Fed movement but also those efforts that would make Reserve Bank presidents political appointees.

I do not believe the Fed is perfect or that it is infallible. As you know, I have been a vocal critic at times. But I have also been explicit over the years about steps that could be taken to strengthen the Fed as an institution. I have argued for a narrow mandate that is achievable so the Fed can be held accountable. I have stressed the importance of transparency and a systematic approach to policy that reduces uncertainty and makes policy more predictable. These could be helpful in strengthening credibility and the public's trust in the institution. But steps that undermine the Fed's independence or make it more susceptible to political control and influence in the short run are counterproductive.

I also believe that a key strength of the institution is the vibrant role the 12 independent Reserve Banks play in operations and policymaking. They are a safeguard, not a straightjacket. Too much power or authority concentrated in Washington or Wall Street could make the central bank more susceptible to capture by political or private interests.

Conclusion

So, I believe the Federal Reserve System, with 12 Reserve Banks and a central Board of Governors, has withstood the test of time, in part because it has checks and balances to protect and serve our diverse nation. Americans have a long history of suspicion toward the concentration of authority. So, Congress has created a uniquely American form of a central bank to find a middle ground between centralization and decentralization, between the public and private sectors, and among Washington, Wall Street, and Main Street.

My time as president of the Federal Reserve Bank of Philadelphia has deepened my appreciation of our nation's decentralized central bank. I have great respect for the institution and the people who serve here in Philadelphia and around the Federal Reserve System.

I hope that you – and our nation more broadly – come to appreciate the unique role of the 12 Federal Reserve Banks as integral parts of our nation's central bank. Thank you.