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REFORMING THE FEDERAL RESERVE

Proposals range from reducing the Fed's role in consumer financial protection, to adding the power to supervise non-bank financial firms, to allowing audits of monetary policy decisions by the Fed.

A look back shows valid reasons for the current system.

Charles I. Plosser
is president and CEO of the Federal Reserve Bank of Philadelphia

In June, the administration proposed financial reforms that could change some of the Federal Reserve's roles and responsibilities. Congress is considering these and other proposals. Those considering the future of the Federal Reserve would do well to revisit the past. Here in Philadelphia are vestiges of our nation's two earlier attempts at a central bank. Both became entangled in politics and failed to find the balance and independence needed to serve our vast and diverse country.

The First Bank of the United States lasted from 1791 to 1811, and the Second operated from 1816 to 1836. Distrust of centralized power led Congress to vote against renewing the First Bank's 20-year charter and led President Andrew Jackson to successfully veto the recharter of the Second Bank. The nation went almost 80 years before trying again. When President Woodrow Wilson signed the Federal Reserve Act in 1913, it included an ingenious compromise — a decentralized central banking system.

Congress created 12 regional Reserve Banks, overseen by a board of governors in Washington, to provide checks and balances — between centralization and decentralization, public and private sectors, and Wall Street and Main Street — all to ensure that policy decisions are balanced and independent.

Legislators wanted a central bank accountable to Congress, yet free from short-term political influences. So Congress made the Fed independent from Treasury. Fed governors are appointed by the president and confirmed by the Senate to 14-year terms to enable them to take a long-term perspective, unencumbered by the short-term political cycle. Each of the 12 Reserve Banks has its own board of directors. Among directors' important responsibilities is selecting the Reserve Bank president, subject to the board of governors' approval. To further preserve the Fed's political independence, its employees, officers, and directors are generally restricted from engaging in political activities.

This structure serves to ensure that national policy discussions reflect a healthy and diverse set of views. It also helps protect the independent status of monetary policy and preserve the public's trust in the policy process. By bringing an independent view and a regional perspective from Main Street to Washington, the 12 regional Reserve Bank presidents contribute to maintaining a balance in the decision-making process, improving policy and economic outcomes on behalf of the entire country.

Indeed, research has shown that countries with independent central banks have lower rates of inflation on average, and generally better economic performance. One reason independence is essential is that monetary-policy decisions affect the economy with a long lag, sometimes many quarters. This requires central bankers to look beyond current economic conditions and near-term political considerations. Independence also reduces the risk the central bank will be pressured to "monetize" the fiscal debt, which often results in high inflation.

But independent does not mean unaccountable. The Fed is accountable to Congress and to the American people and, ultimately, the Fed must be judged on how it meets the goals set by Congress. That is why the Fed has steadily improved transparency about its actions. The Federal Open Market Committee — the Fed's monetary policymaking body — issues a statement after each meeting and detailed minutes three weeks later. Verbatim transcripts are available after five years.

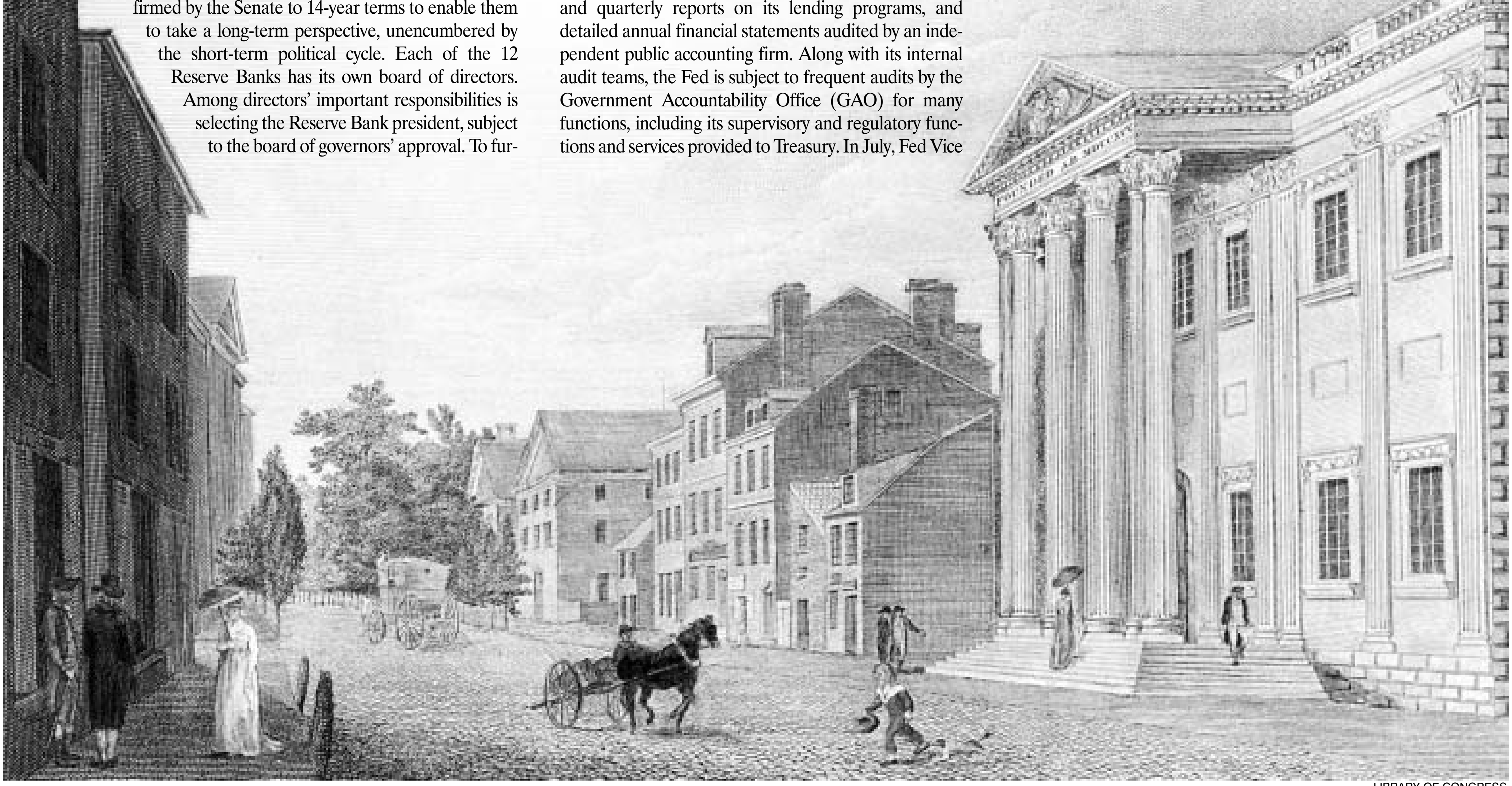
The Fed publishes weekly balance sheets, monthly and quarterly reports on its lending programs, and detailed annual financial statements audited by an independent public accounting firm. Along with its internal audit teams, the Fed is subject to frequent audits by the Government Accountability Office (GAO) for many functions, including its supervisory and regulatory functions and services provided to Treasury. In July, Fed Vice Chairman Donald Kohn testified that since the beginning of 2008, the GAO has completed 26 engagements involving the Federal Reserve and currently has 19 engagements under way, including 14 initiated at the request of the Congress.

What Congress correctly decided, though, is to not have the GAO review monetary-policy decisions. This avoids politicizing those decisions, which would undercut the Fed's ability to achieve the longer-term goals of price stability and maximum employment. Instead, the Fed chairman reports to Congress on monetary policy at least twice each year and Fed officials frequently testify before Congress.

Nearly a century ago, there were valid reasons for creating an independent and decentralized central bank, rather than one based solely in the nation's political or financial capital. Those reasons remain valid today. As we consider reforms, we must preserve these key features. We must also avoid changes that jeopardize the Fed's ability to achieve price stability — the one goal that is uniquely the central bank's responsibility and essential to achieving maximum employment and growth.

E-mail Charles I. Plosser
at Phil.Comments@phil.frb.org.

The Federal Reserve Bank of Philadelphia, top, and others are decentralized versions of the Bank of the United States, shown in 1800 from Third Street. Two incarnations of the central bank lost their charters before the Federal Reserve Bank compromise.



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