The U.S. Experience with a Federal Central Bank System

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How does a decentralized central bank work? The events of September 11 put the Federal Reserve System, the central bank of the United States, to the test and highlighted the benefits of its geographic diversification. In his quarterly message, President Santomero presents an overview of the Federal Reserve's design and explains how it helps the Fed carry out its various roles, including formulating monetary policy, regulating financial institutions, and keeping the payments system running.

The events of September 11, and the days and weeks that followed, put many aspects of the U.S. financial system to the test and demonstrated its resiliency. At the Federal Reserve, our response to those events was a coordinated effort across all areas of responsibility and across the entire Fed System. We kept the payments system operating, provided access to credit for affected banking institutions, and implemented aggressive monetary expansion. The Fed's ability to feel the pulse of financial activity across the country, operate in multiple locations, and coordinate its efforts to ensure financial stability is a testimony to its present, geographically diversified organizational design. In this message, I'd like to present an overview of that design and explain how it helps the Federal Reserve perform its roles as the central bank of the United States.

As the central bank, the Federal Reserve controls the monetary base of the economy to affect interest rates and inflation; it provides liquidity in times of crisis; and it ensures the general integrity of our financial system. I believe the Federal Reserve's decentralized structure has been a positive force in the U.S. economy. It has proved a vital, and indeed very practical, structure for our central bank. Throughout the Fed's history, decentralization has provided the local context and contact necessary for effective policymaking.

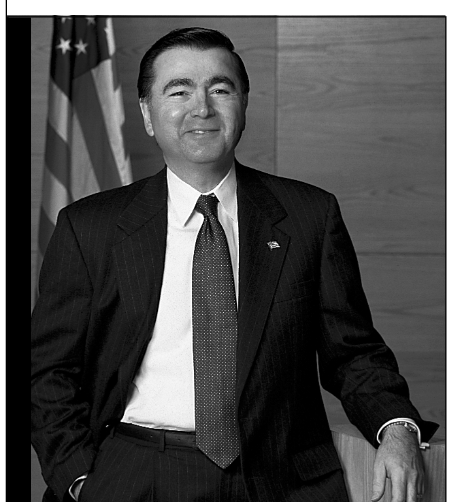
A key to the success of our decentralized structure is its flexibility. To be sure, there is no single model that works everywhere or all of the time. In fact, it is just the opposite. The structure of a central bank must fit the economic and political realities of the time, or it will not survive. It must evolve in response to the unique features of the economy it serves. This adaptation is a constant challenge with new twists and turns along the way.

THE ESTABLISHMENT OF DECENTRALIZED CENTRAL BANKING IN THE U.S.

In 1913, the U.S. Congress established the Federal Reserve System to serve as the central bank. The System comprised 12 independently incorporated Reserve Banks spread across the United States, operating under the supervision of a Board of Governors in Washington, D.C.

Why did the central bank come along so late in the economic history of the United States? Moreover, why was it given such a decentralized structure?

The answers to these questions are interconnected. In fact, the United States had made two previous attempts to establish a central bank. The First Bank of the United States was established in 1791, and the Second Bank of the United States was established in 1816. Congress gave each an initial 20-year charter. Yet, neither was able to



Anthony M. Santomero, President, Federal Reserve Bank of Philadelphia muster the political support to have its charter renewed. Therefore, the United States spent most of the 19th century without a central bank.

By the early 20th century, a series of financial panics and economic recessions further demonstrated the need for a central bank. It became widely recognized that the nation required a more elastic supply of money and credit to meet the fluctuating demands of the marketplace. It also needed a more efficient infrastructure for transferring funds and making payments in the everyday course of business, particularly by check.

While the need for a central bank was clear, so were the reasons to be wary of one. Many people, particularly small-business owners and farmers across the South and West, were concerned that a central bank headquartered "back East," in either the financial center of New York City or the political center of Washington, D.C., would not be responsive to their economic needs.

In some sense, this was a replay of the broader governance issue the United States wrestled with from the beginning of its short national history. The 13 colonies saw the need to bind together and form a nation, but they were wary of ceding power to a national government. It was out of that tension that the federal government of the United States was forged in Philadelphia with the establishment of the U.S. Constitution.

The Constitution provided for the establishment of a federal government that acknowledged and preserved the rights of the states, and a system of checks and balances within the federal government. In this way, power was not unduly concentrated in any one individual or group.

To galvanize the necessary political support to establish a central bank, President Woodrow Wilson and Congress drew on the now familiar model of a federal structure. That structure, embodied in the Federal Reserve Act of 1913, essentially remains intact today.

Overseeing the System is a seven-member Board of Governors appointed by the President of the United States and confirmed by the United States Senate. The 12 Reserve Banks, spread across the country from Boston to San Francisco, each serve a defined geographic area, or District. Each Reserve Bank is overseen by its own local board of directors, with some elected by the local District banks and some appointed by the Board of Governors in Washington. Each Reserve Bank's board of directors selects a president, in consultation with the Board of Governors, who serves as CEO and chief operating officer.

Our founders' original vision was that the "central" in the central bank would be minimized. That is, the Reserve Banks would be relatively autonomous bankers' banks providing a full array of services to the banks operating in their Districts. The Reserve Bank would extend credit directly to District banks with short-term liquidity needs on a collateralized basis through rediscounting. Banks would also maintain reserve accounts at their Federal Reserve Bank and use those accounts to clear checks, move funds, and obtain currency for their customers.

Of course, the original vision of self-contained regional banks began to erode almost as quickly as the System was established. Technological change and the dynamics of the marketplace were driving the U.S. economy, particularly its financial and payments systems, into a more fully integrated entity. The Federal Reserve System would have to integrate the activities of its various components as well. Indeed, this is exactly what has happened in the Fed over the course of its history and what continues to happen today.

This integration has occurred on all levels, from making policy decisions to managing backroom operations. It occurs through all of our central bank lines of business — monetary policy, bank supervision and regulation, and payment system support.

Yet, the integration continues to evolve within the context of the "federal" structure established almost 90 years ago. I consider this a testament to the Federal Reserve's flexibility and also to the value of its structure in achieving the Fed's mission.

Let me be specific about how the Fed has evolved its decentralized structure in each area of its operations.

MONETARY POLICY

When the Fed was founded, the notion was that local economic conditions generated local credit conditions and regional Reserve Banks would help the regional banks address them. Meanwhile, with the nation on the gold standard, the overall supply of money — and, hence, the long-run price level — was out of the central bank's hands.

Today, we think of monetary policy as an independent tool at the central bank's disposal to help stabilize overall economic performance. The establishment of the Federal Open Market Committee was the pivotal event in the Fed's evolution to an independent, activist, monetary policymaking body with national macroeconomic objectives.

Although the FOMC was not formally established until 1935, its history begins in the 1920s, when regional Banks began looking for a source of revenue to cover their operating costs. As you may know, the Fed does not receive an appropriation from Congress. Instead, it funds itself from the return on its portfolio. In fact, it was with the intention of funding their operations that the Federal Reserve Banks began to purchase government securities. Eventually, these assets were managed collectively by the Federal Reserve Bank of New York. This portfolio became the System Open Market Account, through which the Fed now conducts open market operations.

Gradually, it was recognized that the Fed's open market securities transactions had a powerful and immediate impact on short-term interest rates and the supply of money and credit. Over time, open market operations became the central tool for carrying out monetary policy.

Congress created the structure of the FOMC in the midst of the Great Depression. The FOMC consists of the seven members of the Board of Governors and the 12 Reserve Bank presidents. Because it is a mix of presidential appointees, the members of the Board of Governors, and Reserve Bank presidents, who are selected by their respective boards of directors, the FOMC is a blend of national and regional input of both public and private interests.

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The fundamental insight is this: While there can be only one national monetary policy, making the right policy decision is the product of sharing perspectives from different regions of the country.

The Reserve Bank presidents provide both valuable up-to-date intelligence about economic conditions and the perspective of business people about prospects for the future. They glean these from their meetings with their Banks' boards of directors and advisory councils, through informal "town meetings" around their Districts, as well as through the contacts they make in the everyday course of operating a Reserve Bank.

Some of this finds its way into our regional reviews, the so-called Beige Book, but even this suffers from time lags and a formulaic approach to gathering intelligence. Our real-time grassroots perspective is valuable for helping to overcome the fundamental challenge to monetary policy — the effects of long and variable lags on its impact.

Beyond this, the Reserve Bank presidents can also bring broader perspectives on monetary policy. On a theoretical level, differences can coexist on the structure of the economy and the role of monetary policy. Some well-known examples include the monetarist perspective championed by the St. Louis Fed and the real-business-cycle perspective supported by research at the Minneapolis Fed. On a more practical level, differences still exist in the geographic distribution of industries across our nation. The perspective of some regions gives particularly useful insight into certain parts of our economy, for example, San Francisco's technology focus and Chicago's heavy industry concentration.

Decisions are usually made by consensus, so unanimous decisions are usually the rule rather than the exception. Nonetheless, we do have a voting procedure. The 12 voting members make the formal decision of the FOMC. All seven Governors vote at all times, while only five of the 12 presidents vote, on a rotating basis. Philadelphia happens to be a voting member in 2002. In any case, we all participate on equal terms in the discussion and consensus building that leads to the formal policy vote.

Once the FOMC has made its decision on the appropriate target level for the federal funds rate, it is up to the Fed's trading Desk located at the Federal Reserve Bank of New York to achieve the objective. To facilitate that process, a policy directive is drafted requesting the appropriate action by the

New York Desk to achieve the overnight borrowing rate target.

Time has shown that the structure of the FOMC uses the decentralized Federal Reserve to its best advantage. This structure allows for the generation of well-informed monetary policy decisions at the national level, plus an ability to communicate decisions and rationale to various parts of the nation. This two-way exchange of information enhances the Fed's ability to monitor the economy and build consensus for the needed policy action.

PAYMENTS INFRASTRUCTURE

Monetary policy is the role for which central banks are best known. But the Fed also plays an integral role in the U.S. payments system. In fact, payments processing is the largest component of Fed operations. System-wide, the Federal Reserve Banks employ over 23,000 people. Of these, about 12,000 — roughly half — are involved in payments.

Over the years, the Fed's decentralized structure has given us an advantage in supporting the payments system. The U.S. has long been a nation of many small banks serving relatively limited geographic areas. Establishing a network for the efficient movement of money among them is one reason the Fed was founded. One of the Fed's first projects was setting up a check-clearing system. In that system, each Reserve Bank provided the banks in its District with a local clearinghouse and access to a national clearing network through its sister Reserve Banks.

As early as 1918, the Reserve Banks also gave banks in their Districts convenient access to a national electronic funds transfer network — Fedwire. At that time, the transfers were via telegraph connection among the Reserve Banks.

The traditional paper-based forms of payment — cash and check — still require a decentralized delivery network. However, over time, the movements toward electronic payments and mergers in the U.S. banking industry have been driving the Fed toward greater coordination and consolidation of payments services. Accordingly, the Fed has reorganized to provide nationally managed services through the decentralized structure of the regional Reserve Banks.

First, at the strategic level, the Federal Reserve has established the Payments System Policy Advisory Committee (PSPAC). Its mission is to set the direction for Fed payments activities System-wide. Like the FOMC, PSPAC is a committee of Fed Governors and Reserve Bank presidents.

Second, at the operational level, the Reserve Banks coordinate their payments operations through national product offices, reporting to the Financial Services Policy Committee. By this means, each payments product is centrally managed by one Reserve Bank and delivered, as appropriate, through the Reserve Bank distribution network.

SUPERVISION AND REGULATION

I have discussed the benefits of the Federal Reserve's decentralized structure on the monetary policy decision process, as well as on its evolving role in the nation's payment system. This structure has also served us well in our third area of responsibility, bank supervision and regulation.

As I noted earlier, the U.S. has long been a nation of many small banks, serving local communities in narrow geographic areas and offering relatively limited product lines. This was primarily the result of government regulation. Long-standing state laws prohibited banks from branching across state lines and frequently other political boundaries as well. Then, in reaction to the Great Depression, the U.S. Congress passed legislation prohibiting commercial banks from engaging in investment banking or insurance activities.

During that period in our history, under delegated authority, local Reserve Banks kept a close watch on the safety and soundness of the local banks under their jurisdiction.

But, recently, in the U.S. and around the globe, a wave of deregulation has cut away the thicket of limitations on banks' activities. Now technology and the marketplace are driving banking organizations to expand their geographic reach and diversify their array of product offerings. The result has been the growth of larger and more complex banking organizations with national or international scale and scope.

Through this process of change, the Federal Reserve's role in the regulatory structure has been expanding. Congress first entrusted the Fed with the responsibility of regulating all bank holding companies. More recently, the Fed has been assigned the additional role of "umbrella supervisor" for newly formed financial holding companies. As such, the Fed aggregates the assessments of other regulators of the financial services industry to form an enterprise-wide view of risk and protect depository institutions.

Since its creation almost 90 years ago, the Federal Reserve has survived, and succeeded, by evolving.

To fulfill its responsibilities in this new environment, the Federal Reserve has been transforming its supervision and regulation function. Our focus has shifted from point-in-time financial statement reviews to continuous risk-based assessments; from on-site examinations to early warning systems; from strictly financial evaluations to ones that include increased emphasis on community lending and technology. Furthermore, in light of the shift toward broad financial holding companies, we are working in closer cooperation with other regulators in the banking and financial industry.

In addition, to properly oversee larger, more complex organizations, we have employed new and more sophisticated analytical tools and have consolidated examination reports from geographically dispersed subsidiaries into overall financial profiles.

Our approach has been the System-wide coordination of bank supervision to achieve efficiency in staff deployment, yet still gain the benefits of specialized knowledge. Still, we have maintained face-to-face contact with the regulated institutions, as well as the use of on-site examinations. In the end, even with all the changes in the financial services industry, there is no substitute for first-hand knowledge of the organization and its leadership. The Reserve Bank network allows the Fed to have geographic proximity, which substantially improves its ability to know the institutions it regulates.

CONCLUSION

Since its creation almost 90 years ago, the Federal Reserve has survived, and succeeded, by evolving. Through congressional mandates and its own internal restructuring, the Fed has proved an ever-changing entity, decentralized yet coordinated. The trends in the financial sector imply a continuation of the move toward a single national market, with a growing number of national and international players. As a result, further coordination and consolidation of activity is inevitable.

Yet, even as we develop into a more fully integrated organization to better address our central bank responsibilities, we continue to extract value from our decentralized structure. Today, as we have seen in both normal times and times of crisis, the regional structure of the Federal Reserve System is one of its greatest strengths.