# Central Banking and Its Discontents?

Athenaeum of Philadelphia

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Good evening. It's a pleasure to be here at the Athenaeum of Philadelphia.

Given the excitement of the past few weeks, I'm going to take the opportunity this evening to be a little boring. I'm not going to discuss my outlook or the next rate hike, although I fully expect to be asked about them. Instead, I'm going to take a step back and talk a bit about how the Fed came to be and what it is we do, and what it is we don't do. We're in the birthplace of American central banking this evening, and I like to take every opportunity to talk about this great District, headquartered in this historic, wonderful city.

Even though I'll mostly be addressing the whys and wherefores of the Fed System, I should still deliver the standard Fed disclaimer that the views I express are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

With that out of the way, let me start, as they say, at the beginning.

## A Brief History of Central Banking

The First Bank of the United States was the brainchild of Alexander Hamilton and located right here in Philadelphia when we were still the capital of the country. The bank was established in 1791 to deal with the debt from the Revolutionary War and to ensure the government's financial stability. It looked a lot different than the entity we are today, and it wasn't without controversy. As Broadway has reminded us — at least as it has reminded those who can get tickets — Thomas Jefferson was among those who worried about power that was too strong and too centralized. He even once famously said he found banks to be more dangerous than standing armies.[1] When the bank's charter was up for renewal after its initial 20 years, the measure failed by a vote each in the House and the Senate, and it was dissolved.

Five years later, Congress agreed to a central banking function a second time, and we got the imaginatively named Second Bank of the United States. And 20 years after that, Congress again decided not to renew the charter, again owing to a strain of popular sentiment that didn't trust powerful, centralized institutions.

This makes reasonable sense given many of the founders' philosophical foundations. But it was nowhere near unanimous, and the problem with not having a central bank is that it breeds volatility. The period leading up to the third iteration of American central banking — the Federal Reserve — was marked by currency instability, bank runs, and cycles of boom and bust. At one point, J.P. Morgan actually had to step in to personally bail out the country. Even during the Revolutionary War era, central banking was standard in a democracy, and it remains that way today. Certainly there are no developed economies that don't have it in some form. So, the eventual adoption of our current central bank — in the 1913 Federal Reserve Act — was to some extent inevitable. And the configuration of the Federal Reserve System — a central bank with a decentralized structure — is something of a testament to old-fashioned American compromise.[2] It also reflects the unique demands of the United States and our economy.

**How the Fed Is Organized**

The Federal Reserve System consists of a Board of Governors, which sits in Washington, D.C., and 12 regional Banks located around the country. The Board seats seven governors, including the Chair. Each regional Bank has its own president and board of directors, which is made up of business, banking, and community leaders from the area. Fundamentally, this provides the Fed with a perspective, within each District, of the sectors and issues that make the region tick.

[1] A letter from Thomas Jefferson to John Taylor in May 1816, https://www.monticello.org/site/jefferson/private-banks-quotation

[2] For more information on the Federal Reserve's history, see the History of the Federal Reserve https://www.federalreserveeducation.org/about-the-fed/history.

This is an important aspect of the Fed that most other countries don't have. We're making national policy, but we're doing it for an enormous country, and the averages of economic data can obscure realities on the ground. Conditions look very different in Philadelphia or Camden than they do in Dallas or Salt Lake City. This system gives, in my view, a voice to a range of localities and sectors. It also allows us to focus on regional issues within each Bank's District.

The United States has a unique set of needs. It's easy to forget that we're an outlier because we're such a massive country: Only Russia and Canada are bigger geographically, only China and India have larger populations, and no one country has a bigger economy. And that economy is vast, spreading across sectors and natural resources in a way that most other nations' just don't.

So, it makes sense that we have a system that feeds back information from around the country.

The other difference from most central banks is that the Fed has a dual mandate rather than a single goal; that is, we're charged with both maximum employment and price stability. Most just focus on one.

"Maximum employment" encompasses a wide range of metrics, although the most attention is paid to the unemployment rate. That number, of course, will never be zero. Instead, we try to ensure that labor markets are functioning dynamically and efficiently. Associated with that goal is a fairly low unemployment level that economists term the "natural rate." Estimates vary, but most of us put it more or less at 5 percent. At 4.9 percent, that number is currently right on target, although I stress again that we do look at a variety of criteria to tell us the full shape and health of the labor market.

"Price stability" is, of course, low and stable inflation. That doesn't always mean working to keep inflation from taking off; for the past several years, in fact, inflation has been stubbornly low. For those of us who remember the '70s and '80s, the goal of increasing inflation seems completely at odds with what we were taught to want. But our goal at the moment is 2 percent, and we're still running low.

It's important to outline these goals because the decisions we make within the Fed — the way we look at the economy and respond to data — are built entirely on the foundation of our dual mandate.

Now that we've established that, I turn to the question so many people secretly want to ask: What, exactly, does the Fed do? I'm delighted to talk about it, but just as important, I'll also mention what we don't do.

I want to stop for a moment because I know that might sound a bit loaded. Perhaps I'm doubting whether most people can pass a Fed exam. But I find that a lot of what we do can be overlooked or misunderstood. I have literally had Ph.D. economists ask me why we didn't make loans to community organizations after the financial crisis, which, for the record, we are in no way authorized to do. And people often ask what we're doing about the deficit. Not to mention there is an avalanche of misinformation out there, and the Fed, as an organization, hasn't always been good at correcting it. In the absence of a rebuttal, the myth will take hold. Or, to borrow a famous maxim: A lie gets halfway around the world before the truth can get its pants on.

Not to mention, it occurs to me that the average American has much better things to do than memorize the intricacies of Fed mechanisms.

So, I hope you'll indulge me in an overview of the Fed and allow me to puncture a myth or two along the way.

**What Does the Fed Do?**

First off, the overview: The Fed sets monetary policy. We also regulate banks, along with an alphabet soup of government agencies. We're famously the lender of last resort in times of crisis. And the lede that always gets buried — and I wish it weren't so overshadowed by discussions of interest rates — is that we work within our Districts to help strengthen local communities' economies. We have a truly exceptional team in Philadelphia, and they work with partners all over the Third District, which I could tell you about all day, but first, the broccoli: monetary policy.

Monetary policy is a fairly limited field with a fairly limited set of tools. A lot of the questions I'm asked, as a Fed president, are about aspects of the American economy that affect our work but that we don't actually have any control over. Fiscal policy, for instance, which deals with debts, deficits, and taxes. Or investments to encourage growth. Or programs to spur job creation. Those all depend on elected officials, be they on the local, state, or national level.

Our job is to create the conditions in which a healthy economy can thrive, but we're essentially tilling the land. Sowing the seeds and tending the crops are the province of legislative action.

Monetary policy is about meeting our two goals — price stability and maximum employment — mostly by moving interest rates. There are other tools we use, and I'll get to those shortly, but in normal times, it's mostly about moving what is technically called the federal funds rate.

We set rates, as most of you know, when the Federal Open Market Committee — the FOMC — meets in Washington, which we do eight times a year. Regional Bank presidents don't always get to vote. Most of us rotate into a voting position every three years, but the governors always do, as does the president of the New York Fed. New York, owing to the presence of Wall Street, enjoys something of a "first among equals" status within the system. And while the rest of us don't always vote, we do always represent our Districts and play a part in the discussion.

**Is the Fed Politically Driven?**

That discussion, to address myth number one, is never political. Because we're appointed policymakers, we don't respond to swings in public opinion or election cycles. Unlike politicians, who suffer the slings and arrows of the 24-hour news machine, we operate in a rare, apolitical bubble, which, I should stress, is very much in the public interest because our policy actions aren't going to take effect for at least a couple of years.[3] The independence of the Fed is crucial to making the best decisions possible for the American economy, free from the pressures of politics.

The somewhat sad truth about the FOMC is that, unless you really love policy discussions, it's not exactly a party. It is literally just a room full of policy wonks talking through data and metrics and economic theory. There's no political discussion, no dramatic oratory; there's

[3] Tomas Havranek and Marek Rusnak, "Transmission Lags of Monetary Policy: A Meta-Analysis," *International Journal of Central Banking*, 9:4 (December 2013), pp. 39–75. http://www.ijcb.org/journal/ijcb13q4a2.htm.

definitely no *Hamilton*-inspired rap battles. We're plodding and methodical and circumspect. We're just looking to put the best policy in place.

**Is the Fed Audited?**

Although we're independent, that doesn't mean we're unchecked. The Fed is what's considered "independent within government." We're overseen by Congress, but neither they nor the presidential administration have a say in the decisions we make.

This is where one of the most prevalent recent myths about the Fed originates, that being the idea that the Fed is not audited. Most people, when they hear the word "audit," think of a financial audit. And, in that respect, we are altogether transparent. We are financially examined by both governmental agencies and independent auditors from the private sector. Our balance sheet is published weekly, and we produce an annual report of each Bank's financial statements as well as one for the Board of Governors.

Recent calls to "audit the Fed" are actually about assessing our policy decisions, not our financial ones. But this goes back to the critical independence that Congress mandated. If the Fed were open to interference by elected officials, that pressure could result in short-termism and encourage hasty decisions to please political ends, rather than economic ones. And, in fact, the Chair testifies to Congress at least twice a year, often more, as do many Fed officials. The Fed minutes are published, the Chair holds a press conference every other meeting, and we all speak publicly about our own views on policy decisions.

**Does the Fed Print Money?**

Those decisions, as I said, are mostly about moving the federal funds rate, our primary monetary policy tool. As I also said, the FOMC is generally a pretty milquetoast affair. In extreme times, however, like the financial crisis and the Great Recession, the Fed turns to what's called "unconventional" policy. The most well known of them is quantitative easing, or QE, and it plays a role in the last myth I want to address, which is that the Fed prints money.

The Fed does issue money under its authority, but the Treasury's Bureau of Printing and Engraving does the actual printing. If you look at a bill — in newer ones, it's on the upper left —

you'll see a letter and a number: B2, L12, F6. Those tell you which regional Fed Bank issued that bill. We're C3: the Third District, with the corresponding third letter of the alphabet.

That feeds into part of the misconception, which is a fairly pedantic distinction to make. But the bigger issue is the perception that the Fed prints money with abandon and could flood the market with cash at any point, destabilizing the economy.

That's the part I want to address because it can sound incredibly concerning stripped of detail.

First things first: The Federal Reserve is essentially the banks' bank. We want to ensure that institutions can cover their debts, so banks are required to hold a certain level of funds with us. The federal funds rate is the interest rate on loans that banks make to each other overnight. That rate tends to influence interest rates more broadly so the effect ripples through the economy. Low rates encourage economic activity, which spurs job growth, which is why we keep rates low during times of economic crisis. When economic activity ramps up, we increase rates to keep inflation under control.

The reason rates have been so low for so long — they were essentially at zero for close to eight years — was to help the economy make it through the recovery.

Of course, that's not always sufficient, as we found after the financial crisis. In those instances when standard policy can't move us around the bases, we have to play with a bigger bat. That's why the Fed turned to QE, which is what was casually called "printing money," a term that's not quite accurate.

QE was a round of programs of large-scale asset purchases. The Fed bought assets from the banks that hold accounts with us, which came in the form of long-term Treasury- and mortgage-backed securities. The so-called printing of money was the way we paid for them: The Fed credited money to the banks' accounts, money that had not been printed and technically didn't exist before we pressed the metaphorical "Enter" key.

So, in that sense, the money was created. But it wasn't printed, and that's part of the issue. The system wasn't flooded with physical dollars; it was an electronic credit on a transaction sheet so banks could lend more money. And the total amount of assets in the economy did not change because each transaction was an exchange of one asset for another — a bond for a reserve, for instance.

The “why” of this is that the fed funds rate focuses primarily on short-term interest rates. QE helped keep longer-term rates low as well, which encourages individuals to take out loans and spend on bigger items, like homes or cars, and businesses to invest in expanding. That stimulates economic activity and encourages job growth. Lower rates also drive more money into the stock market, which doesn’t sound great to a lot of people. It sounds like Wall Street getting a bonus, right? But a lot of pension funds and other investments made by Americans at all points on the wealth scale are tied to the markets, so this benefits Main Street as well.

QE is in the past at this point, so why do I bring it up?

I do it for the same reason I think it’s important to continue to explain, as well as we can, what the Fed is doing. It wasn’t clear to a lot of people what was happening when it was underway, and misunderstanding can breed mistrust. We operate on the good faith of the American people, and it’s important that we be as clear as we can be about the steps we’re taking to protect our economy. And it’s an economy we all live and work in; it’s an economy we’re steering for our families as well as yours, so we all have skin in the game.

**Conclusion**

It’s been 225 years since the First Bank of the United States was established, and some of the function of its eventual incarnation remains as mysterious today as the founders’ penchant for wigs. What we can learn from history, both recent and far gone, is how to better communicate and ensure our constituents understand what we’re doing and why.