

Structure matters: The decentralized Federal Reserve

An “End the Fed” demonstration took place recently outside my office on Main Street in Kansas City, Mo.

It was a reminder that democracy demands accountability from its most powerful institutions to its citizens. The Federal Reserve is no exception.

In my role as president of a regional Reserve Bank, I am well aware of the range of views on the topic of Federal Reserve accountability. For example, one commentator wrote that even if the central bank’s “power would remain in the hands of the wisest, the most honorable, and the most disinterested” leaders, “it would not be possible to satisfy the people throughout the country that the vast resources and powers of the bank were used only for the best interests of all the people and without partiality or favor to any section of the country, or to any class or set of people ...”¹ When it comes to the nation’s financial matters, someone else noted that authority should not be “concentrated in one city where a small clique could control the system.”²

Yet another comment stated that, “The business resources of the United States ... cannot be centralized. ... By reason of the great expanse of the country and the diversity of business conditions in the different sections of the country, the details of the business of a central bank could not be managed at a central office.”³ Finally, the desire for local control was highlighted in this comment: “No centralized power could dominate an organism

whose life is drawn from functions local to each community.”⁴

The sentiments behind these words—concerns about power and the concentration of financial resources—ring true, but they are not, in fact, comments on the recent financial crisis. This commentary offers a flavor of the robust and contentious public debate that preceded the signing of the Federal Reserve Act in 1913. It is striking to me how familiar those words are today. It was this public sentiment about the country’s economic future under a central bank that influenced Congress to shape the institution in a way that would garner the trust and confidence of the American public. The result was a decentralized structure that exists today with locations across the country operating under a rigorous system of checks and balances.

As a career Federal Reserve employee, bank supervisor and lifelong Missourian, I understand the importance of having a central bank that is accountable to the public. In fact, as an official with input to national policy who lives and works in the center of the United States, my role is not happenstance, but rather it is a deliberate choice on the part of the Federal Reserve’s congressional founders that reflects



¹ Victor Morawetz. *The Banking and Currency Problem in the United States*. 1909

² Robert Owen. *The Federal Reserve Act*. 1919.

³ “Doubts Money Plan.” *The New York Times*. Dec. 3, 1911.

⁴ Pamphlet produced by the National Citizens League, circa 1912.



their intentions for the structure of the nation's central bank. It is my view that the Federal Reserve's ability to achieve its broad objectives over the past century has been possible because of its decentralized structure.

Structure enhances public trust

The Federal Reserve Act established a framework for the nation's central bank that departed materially from that of the First and Second Banks of the United States. Congress rightly understood that the monolithic structure of these first two central banks was ill-suited to represent and serve the diverse interests, geographies and industries that make up the U.S. economy. The Federal Reserve's founders understood that the long-term success and credibility of the institution would rely on its ability to gain support outside the Washington-New York corridor of political and financial interests.

To ensure public accountability, the Federal Reserve Act called for a government agency—the Board of Governors in Washington, D.C.—composed of individuals who are nominated by the president and confirmed by the Senate to serve 14-year terms. The Board of Governors plays an important public oversight role for the entire system, without which a meaningful role for the quasi-governmental regional Reserve Banks would not likely be acceptable to the public. However, to ensure there was appropriate balance and representation, the Act also called for between eight and 12 Reserve Banks to be located across the country. A committee of cabinet members took several months to arrive at its decision to name the 12

Federal Reserve cities that would serve as the regional arms of the nation's central bank.

One hundred years ago, on May 18, 1914, a delegation signed paperwork to incorporate the Federal Reserve Bank of Kansas City. Similar meetings occurred that spring in 11 other cities, and the Federal Reserve System began operations on Nov. 16, 1914.

Each Reserve Bank is overseen by a local Board of Directors composed of community and business leaders from diverse sectors across each of the 12 regions. These directors share governance responsibility for Reserve Bank operations along with the Board of Governors.

In addition to Reserve Bank boards, individuals serve as directors on the boards at 24 Federal Reserve branch offices. All told, some 270 individuals across the country serve as Federal Reserve directors, providing real-time economic information for the Federal Reserve to consider in its policy formulation. In addition, through their experiences as leaders in business, and in the labor, consumer, banking and agriculture sectors, directors offer an independent perspective on Reserve Bank operations, budgetary issues and other strategic challenges.

Structure improves operational effectiveness

Over the past century, the Federal Reserve's local connections have proven to be valuable in carrying out its responsibilities. Whether responding to a crisis, delivering financial services or supervising banks, the deep understanding of regional interests has facilitated effective operational performance.



Importantly, the Reserve Banks are designed to understand credit availability issues at the local level. You need not go back to 1913 to find an example that underscores this. As financial markets seized up during the most recent crisis, the Board of Governors and the Federal Reserve Bank of New York focused their efforts and resources on designing liquidity facilities to ease financial conditions. Even as resources were dedicated to pulling Wall Street out of the depths of the financial panic, problems developed in other parts of the country that needed to be addressed, including in the Kansas City Fed's region.

crisis to a high of more than \$400 billion.⁵

As funding from Wall Street dried up in 2009, the effects rippled across the country. In my district, a sizable and healthy financial services firm lost access to its line of credit from a large Wall Street bank. While this regional institution would not be considered systemically important by today's regulatory definition, it certainly played an important role in the economy of its own Midwestern community.

Staff at the Federal Reserve Bank of Kansas City worked closely with the Board of Governors' staff to consider the firm's

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Among the roles served by the regional Reserve Banks is the statutory responsibility to act as a “lender of last resort” to depository institutions in the region. Specifically, the Federal Reserve is charged with lending against collateral to solvent institutions, making its role as a bank supervisor complementary to the ability to confirm eligibility to borrow on short notice. In the case of the Kansas City Fed, serving as a lender of last resort across its seven-state region means leveraging relationships and access to information on thousands of institutions. This information is a particularly critical resource during crisis situations. During the crisis of 2008, the monthly volume of discount window borrowing from the Federal Reserve spiked from less than \$1 billion pre-

qualifications to gain timely access to funding and avoid failure. The firm survived the crisis because the local Reserve Bank was familiar with the institution and was able to connect it with programs that allowed this otherwise viable firm to continue its vital operations.

Likewise, the regional Reserve Bank is able to gauge the local effects of financial market conditions and economic drivers through its role in supervising banks. Although considerable attention is focused today on systemic risk and systemically important financial institutions, the Federal Reserve's regional connections to more than 6,000 community banks and 50 state banking departments provide essential information about the economic health of small business, regional economies, credit

⁵ See <http://research.stlouisfed.org/fred2/series/DISCBORR>.



conditions and the impact of broader regulatory issues.

Through the Reserve Banks' presence in their respective communities, regional issues can be addressed with the expertise and knowledge that a regional Reserve Bank is equipped to provide. Having been so recently reminded that access to credit is critical to the economic success for communities large and small, I think it is quite feasible that if Congress were to design the Federal Reserve System today, it might well choose to have 50 Reserve Banks rather than just 12.

Structure fosters independent thinking

The system, by design, is intended to include a diverse range of perspectives, and the Reserve Banks contribute importantly to this diversity. Many have criticized this feature by suggesting that the cacophony of voices sends mixed signals. Yet, other public institutions reflect similar democratic processes where a mosaic of perspectives and input is sometimes messy. Essential to sound outcomes are leadership and governing processes to bring these voices together for the purpose of decision making. The same is true for the Federal Open Market Committee (FOMC).

The FOMC has a long-established process that provides for discussion and debate of policy options. But, the decision-making process is quite clear: 12 participants—seven from the Board of Governors and five from the Reserve Banks—cast votes at each meeting and the majority defines the policy action with a statement articulating its rationale. A \$17

trillion economy with complex dynamics is well-served by this process, which includes a range of viewpoints and inputs.

This structure also, by design, allows for dissenting views. This feature recognizes the value Americans place on independent thinking. Some have argued: Why not keep differing views internal and present a united or consensus view to the public? Wouldn't solidarity give more confidence and clarity to the public? I believe that masking differing policy views is inconsistent with central bank communication and transparency. Making differing views available to the public serves to clarify issues. It is the public duty of each participant of the FOMC to express their views. To suggest that FOMC members should appear to be unanimous in voting records is to suggest that diverse perspectives are not valued and underestimates the public's ability to discern intellectual honesty.

Finally, independent, stable and informed leadership is especially important to the Federal Reserve's policymaking process. Policy decisions have broad impact and benefit from the institution's research, thoughtful analysis and public input. Experience and informed judgment are as important to good policy as academic and theoretical frameworks.

The Federal Reserve Act calls for members of the Board of Governors to serve 14-year terms, yet according to one recent report, the average tenure of Federal Reserve governors since 1936 has been 7.3 years. Since 1986, the average tenure has fallen to five years, and the last 10 governors to serve have held their seats for an average of four years.⁶

⁶ *The New York Times*. "Tenures Becoming Shorter at a Short-Handed Fed." May 12, 2014.

Furthermore, whether monetary policy, banking regulation or payments, the public depends on those who serve to bring diversity of experience to the Federal Reserve's most challenging issues. This means honoring the Federal Reserve Act's requirement for diversity of background and geography among the governors. Consistent with this, I agree that the Federal Reserve Board would be strengthened by having someone with community banking or community bank supervision experience to fill one of its current openings.

Conclusion

The financial crisis is behind us, thankfully, but not far behind. The image in the rearview mirror is still large—and perhaps closer—than it appears. The Federal Reserve's history is important, but it is only helpful to the extent that it positions us to consider how we might address the considerable challenges that await the central bank in the years to come. Those challenges include normalizing monetary policy, effectively supervising the largest financial institutions, and ensuring a safe, efficient and accessible payments system.

Today's debate is not about second-guessing those who made difficult choices in the interest of the country during the depths of the financial crisis. However, it is not enough to defend the steps taken during the crisis by saying, "It could have been worse." Instead, the experience of the financial crisis should lead policymakers to the unequivocal conviction that they will not rest until the foundations of our financial system are shored up to avoid

similar outcomes next time. That is the pledge policymakers made to the American public. Through the broad-based input provided by the decentralized Federal Reserve, we can deliver on this pledge. Those demonstrating on Main Street in Kansas City and other parts of the country deserve this.

The Federal Reserve's centennial provides an opportunity to engage the public and to reflect on the values that have allowed the institution to serve the country. Its defining characteristics, if embraced, can continue to serve as a source of strength for the nation in the future. As former Senator Robert Owen noted in an October 1913 speech on the role of Reserve Banks within the Federal Reserve System, "Their function must be to protect the commerce of the nation, to stabilize the interest rate and to give permanency to the prosperity which this country ought to enjoy continuously."

That sentiment is as true today as it was 100 years ago.



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