

# SOME THOUGHTS ON THE ROLE OF THE RESERVE BANKS

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The last speaker at a daylong conference is never in an enviable position. This is particularly true when the earlier talks are on challenging economic topics and the speakers are knowledgeable, as has been the case today. My topic, the role of the Reserve Banks, is an important one, but it has the potential to be interesting to a smaller group of people, at best. To address the downside of my slot and topic, I am going to be intentionally provocative. That does not mean untrue or extreme, but rather that I plan on emphasizing ideas I hope will stimulate response and further discussion.

## A SUMMARY OF MY POSITION

The Federal Reserve needs to balance independence and political accountability in order to conduct monetary policy effectively. I believe that involvement in the monetary policy process by Reserve Banks, with their considerable operational responsibilities and largely autonomous governance structures, has helped to achieve a successful balance. In particular, the operational responsibilities and autonomy of the Reserve Banks has contributed to the stature of their presidents, thereby supporting, albeit indirectly, the presidents' participation in Federal Open Market Committee (FOMC) deliberations and making credible their commitments to a low-inflation policy. But political accountability requires that the Federal Reserve carry out its responsibilities in a cost-efficient manner. Inefficiency in Federal Reserve operations is indefensible and potentially invites political intervention.

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Strategies for achieving cost effectiveness in the current environment have involved and must continue to involve centralization and specialization, given the new technologies of financial services and ongoing changes in the structure of the industry. Maintaining a system where decentralized, autonomous Reserve Banks carry out significant operations risks overemphasizing independence at the expense of accountability. Indeed, I believe that going forward the case may well be made that Federal Reserve operational responsibilities focus increasingly narrowly on interbank payments services.

The Federal Reserve System does have options for maintaining and possibly bolstering the stature of the Reserve Banks in a time of diminishing operational responsibilities. The analytical and research capabilities of the Banks have increased and can be strengthened further. I believe that the resulting intellectual contributions can provide Reserve Bank presidents with some of the stature needed for internal and external credibility.

## **DO RESERVE BANK OPERATIONS MATTER TO MONETARY POLICY?**

The Federal Reserve needs to be sufficiently independent to maintain a credible, low-inflation policy. A credible commitment to low inflation may require the Federal Reserve to take politically and economically controversial decisions, decisions that elected officials in the executive or legislative branches of the government might seek to influence or to forestall. If successful, such influence would reduce the credibility of the Federal Reserve and ultimately lead to inflation.

At the same time, the Federal Reserve needs to be accountable in order to effectively carry out monetary policy. Given our democracy, the Fed cannot stand beyond the review of the public, elected officials, and the political process. The justification for accountability goes beyond the ethos of representative democracy. In fact, accountability should make it easier for the Federal Reserve to establish a credible low-inflation policy. The public will better understand an accountable, open organization and put more trust in its decisions. What is perhaps more important, an emphasis on accountability should reduce the chance that the Federal Reserve will engage in misuse of public resources or appear incompetent or inefficient in carrying out its tasks. As a result, elected officials will have less reason to intervene and threaten Federal Reserve independence.

Although independence and accountability both contribute to effective monetary policy, there are trade-offs between the two. The Board of Governors, for example, has several features that contribute to independence, including off-budget status and long-term appointments for the governors. However, the appointment process, frequent testimony before

the Congress, legislation governing Fed operations, and even a location in Washington assure the Board's public accountability.

If the Board of Governors is a primary source of accountability, I believe the Reserve Banks are a critical source of independence and, in particular, that the Bank presidents add credibility to monetary policy commitments. To play this role effectively, the presidents must have stature, and, in turn, the stature of the president emanates both from those who fill the position and from the position itself. The position of president historically comes with significant responsibilities and a high community profile.

I believe the operational responsibilities of the Reserve Banks have been valuable both in attracting talent to the presidency and in giving the position stature. In particular, the weight of the operational responsibilities, and the fact that the president leads a large complex organization, help attract strong candidates. The responsibilities are particularly important given that accountability leads to relatively low salaries (by private sector standards). Being the head of a large organization with private-firm-like responsibilities also gives the position stature in the community. The fact that the Reserve Banks have some powers similar to those of commercial banks and a private-firm-like corporate governance structure helps distinguish them from typical government agencies subject to political control.

The stature of the presidents and the Reserve Banks, resulting in part from the Banks' operational responsibilities, helps attract capable individuals to Board of Directors' positions. This is significant in that it gives the Banks and their presidents more stature and influence in setting monetary policy and communicating that policy to the public. The directors can also directly assist in giving the Reserve Banks a public face.

In summary, I view the Reserve Bank presidents as being particularly important in establishing a credible monetary policy because of their relative independence and stature, and I believe that the operational responsibilities of the Banks contribute to those characteristics. Assigning Reserve Bank operations a prominent, albeit indirect, role in effective monetary policy suggests that changes to such operations should be rare and made with caution. But the need to balance independence and accountability means that we cannot defend and maintain those features of the Federal Reserve System that contribute to independence without regard to cost.

## **THE COSTS OF MAINTAINING DECENTRALIZED RESERVE BANK OPERATIONS**

Successful conduct of monetary policy requires a long-run balance between independence and accountability. Achieving the latter requires cost-effective operations. Maintaining significant operational autonomy

at each Reserve Bank has become increasingly inconsistent with cost-effective operations, because of advances in the technology of financial services provision and, more generally, because the market for payments services has changed appreciably. Sticking with the old regime could ultimately threaten Federal Reserve independence by generating unsatisfactory financial results or by inviting political scrutiny and external reform.

Advances in communication and information-processing technology have raised the minimum efficient scale for the types of processing operations the Fed carries out. Centralization of activity is thus necessary to exploit scale economies and drive costs down. The Federal Reserve would be manifestly and transparently cost-inefficient without such centralization.

Other factors also push Federal Reserve operations toward centralization and a corresponding diminution in Reserve Bank autonomy. Changes in technology have led commercial banks that are both customers and competitors of the Federal Reserve to increase the scale of their activities. The largest commercial banks control an ever-increasing share of banking activities and now operate nationally. As a result, the Federal Reserve must serve these large banks on a consistent, national basis. A single Reserve Bank could not meet the full range of needs of such customers without coordinating products and policies across all Reserve Banks or sharing facilities outright. Such steps naturally lead to a reduction in independence of Reserve Bank actions and budgets. In addition, as these large commercial banks or associations of banks take advantage of scale economies, they become more cost-effective competitors. The contrast between these institutions and the Federal Reserve's more decentralized approach may become hard to justify, if it is not already.

Changes in the legal environment have reinforced the need to respond to advances in technology. The Monetary Control Act (MCA) formalized congressional expectations of accountability for Federal Reserve operations, and the MCA compels us to move to cost-effective technologies or to price ourselves out of business.

This commentary is hardly news to those within the Federal Reserve System or to astute external observers. Indeed, the establishment of Federal Reserve Automated Services (FRAS), the product offices, the Financial Services Policy Committee (FSPC), and, most recently, the check standardization effort reflect a shift to operations on a larger scale, greater coordination of products and policies, and a general recognition that individual Reserve Banks cannot maintain previous levels of autonomy and responsibility.

Although significant, the changes already made by the Federal Reserve will likely be only the first of many that reduce the operational autonomy and responsibility of the Reserve Banks. I believe that the

stunning rate of advance in technology will make it ever more difficult to justify a decentralized operational structure going forward, even with the benefits it provides. For example, I believe that the check processing business of the Federal Reserve at some point will face a serious threat from the growth of electronic payments. More generally, the current period of innovation raises doubt about the ability of the Federal Reserve to remain an effective, long-run participant in this business. Much of this skepticism comes from an assessment of the ability of our organization, with its government-like incentives, financing arrangements, and processes, to respond quickly and effectively to innovation. Our legal cost-recovery mandate, for example, could hinder our ability to make the necessary capital investments. Such investments are costly and the Federal Reserve budget is only so "elastic." In the aggregate, payments services providers in the private sector are far larger entities, which are likely to undertake riskier, potentially higher-return investments and then simply cut their losses on those that fail.

An alternative view suggests that the long history of Federal Reserve innovation, combined with a commitment to efficiency, can leave Reserve Banks with some considerable operational role. I am skeptical of this conclusion, believing that the Federal Reserve may have a relatively narrow comparative advantage with regard to payments, at least as technology and the marketplace are now evolving. Because specialization promotes efficiency, I would argue that the Federal Reserve should focus on those activities closely related to its core functions. The central bank appears to have a comparative advantage in interbank payments, but it is far from obvious that it has an advantage in other payments areas, particularly in the prospective retail payments arena. Taking steps to maintain a presence in areas where the Federal Reserve does not currently have a comparative advantage or where that advantage is eroding rapidly would be inconsistent with public accountability. I am not suggesting that the Fed exit current lines of business, but rather I suggest that aggressive steps to stay in those lines when innovation and private competition diminish our role are not appropriate.

## **INTELLECTUAL CONTRIBUTIONS AND STATURE OF THE SYSTEM**

Much of this discussion might be viewed as simply a story about adjustments the Federal Reserve System has made and will continue to make to its role in payments, were it not for the concern that a reduction in operational responsibility and autonomy ultimately could adversely affect the conduct of monetary policy. The issue is this: As payments operations decline in importance, do other, appropriate activities exist that, if emphasized, would maintain the viability of the Reserve Banks and support their role of leadership in monetary policy?

The answer to this question is a qualified “Yes,” in that other things beyond payments have changed in the Federal Reserve over, say, the past twenty years since the passage of the MCA. Specifically, monetary policy has taken on far greater visibility and importance. It is now generally recognized that inflation is an important and difficult problem and that monetary policy is the tool with which to address it. The importance accorded monetary policy provides Reserve Bank leadership and staff with a platform from which to publicize their research and analysis. Making intellectual and policy contributions becomes easier when the audience is predisposed to view your organization and your work as significant. And the importance of monetary policy raises the stature of those involved in it.

The intellectual contributions of the Reserve Banks go beyond monetary policy. They have supervisory responsibilities that they likely will retain. The presidents will remain party to deliberations on the management of systemic crises. Such involvement in the financial sector has given Reserve Bank staff a clear reason to analyze a wide range of topics, including those involving banking, capital markets, and payments systems. The link between the setting of monetary policy and almost any topic related to domestic and international economic performance, including distributional concerns, makes it even more natural for Reserve Bank staff to take on a broad array of topics. As a result, the Fed has become credible on a large number of issues, assuming almost a “national resource” role. Thus, our emphasis on intellectual contribution fits solidly with expectations about the type of activity the Federal Reserve will carry out. That is, a role in intellectual leadership is not at odds with political accountability. (Obviously, carried to extremes in staffing and expense, research and analysis would not be consistent with accountability, however.)

In summary, I believe the increased intellectual and public presence of the Reserve Banks could effectively substitute as a source of stature as their operational activities diminish. The research and analytical capabilities of the Reserve Banks provide the presidents and their institutions with an independent voice with regard to monetary policy and other issues, thus adding to their credibility with the public and at the FOMC. The intellectual contributions of the Reserve Banks also help to attract top-flight directors and presidents. Finally, their publications and research give the Reserve Banks a public face and are vehicles for effective communication.

However, it is not clear that intellectual contributions will prove entirely adequate in replacing the role of operations. One concern is that the Reserve Banks will come to look like think tanks. Such a label could suggest that their presidents do not have significant responsibilities. The think-tank badge also implies a lack of real world grounding. This would leave the Federal Reserve open to charges that it is divorced from reality.

Finally, think tanks have come to be viewed as partisan, and a strategy emphasizing intellectual contributions could even put the Reserve Banks in the middle of highly charged political debates.

## **CONCLUSIONS AND IMPLICATIONS FOR FEDERAL RESERVE POLICY**

The role of the Reserve Banks in the Federal Reserve System is in transition. Their operational autonomy and responsibilities have helped to achieve a balance between independence and accountability, but it is no longer tenable to maintain former degrees of autonomy and responsibility in operations. One option to maintain and, indeed, to strengthen the Reserve Banks is to emphasize their policy-related intellectual contributions.