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Some Thoughts on the Role of the Reserve Banks: Discussion

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This topic, and Gary Stern's well-done comments, take us to the heart of an ongoing debate within the Federal Reserve System that really involves some inside baseball. Given that, let me proceed with a few thoughts. I tend to agree with Gary, particularly about the nature of the changes facing Reserve Banks in the payments system. But I disagree with the thought that the Banks will be done out of a job any time soon by virtue of operating more efficiently; in fact, increased consolidation may help us play our payments and financial stability roles more effectively.

Where are the Reserve Banks going? Clearly, the current structure seems odd. The locations of the twelve Banks and twenty-four branches are out of keeping with twenty-first century population and financial service trends and with the waves of technological change that make centralization more and more efficient and effective.

But Reserve Banks are more than just operations centers. They are important eyes on the real economy in their respective regions. They also perform important supervisory responsibilities. Over the years, they have become integral parts of their communities. Most important, Reserve Bank presidents and Research Departments contribute significantly to monetary policy formation. Stern points out, and I agree, that the balance between Reserve Bank independence and accountability is vital to the effective conduct of monetary policy. There is no doubt that Reserve Banks have a role to play in maintaining central bank independence through this accountability.

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Stern, perhaps to be provocative, states that measures to further enhance the efficient management of Reserve Bank resources, undertaken so as to be accountable, could jeopardize the independence of Reserve Bank input to policy, by affecting the stature of the current Reserve Bank presidents or the qualities of those individuals the Banks could attract in the future. I am less convinced of this than Stern's paper suggests he is; however, some of his comments here today are more in line with my thinking.

No one would be more in agreement about the importance of the regional Reserve Bank than Frank Morris. From his position here as president, not only did he convey the sense of things in New England to the Open Market Committee—the excesses of real estate lending in the late 1980s is the most recent example—but he also played a key leadership role in Boston itself. As a member of the Vault, the group of Boston business leaders so vital to the changes that occurred in the city in the 1970s and 1980s, and also as chairman of the Private Industry Council, Morris was instrumental in focusing business attention on the Boston public schools in a time of crisis. Morris also lent the support of the Research Department to the study of issues important to the region generally and to the Commonwealth specifically. He increased the quality of the Bank's regional research staff, and he weighed in on topics as hard to handle as the demise of the shoe industry.

One particular analysis became a potential hot potato: the bottle bill. Work done at the Bank suggested that legislation requiring a deposit on beer and soft drink cans and bottles would not cause the loss of thousands of jobs, as feared by bottle and can manufacturers. In fact, the study suggested, jobs might actually increase, as the law would create a need for handlers and processors of returned containers. The bottle bill referendum passed by an overwhelming margin in the fall of 1976, and some observers credited the Boston Fed's research as being critical to this effort.

In arguably bigger matters as well, Frank Morris was not hesitant to get involved. In the Massachusetts fiscal crisis of 1976, the state ran into difficulty raising much-needed capital. Massachusetts had been hit hard by the national recession, and bond dealers were looking for evidence that the state had the capacity to put its fiscal house in order. At the state's request, two Boston Fed researchers, with experience in state government, examined the budget and the state's plans to balance it. Satisfied that the state's plan was sound, Frank and other staff members traveled to New York City to report their findings to a group of Wall Street dealers. They assured the wary dealers that the state recognized the severity of the problem and had implemented the appropriate cost-saving and revenue-generating measures. The dealers were satisfied and, gradually, the fiscal crisis eased.

Frank Morris knew the impact an effective regional Reserve Bank could have on its District. And I am convinced he also believed that the hands-on involvement in these issues made his contributions to monetary policy more grounded in the real world than they ever could have been had he resided in an agency in Washington.

Whatever the future of the bricks and mortar of a Reserve Bank—and I am a bit more optimistic about that than Gary Stern—what we cannot lose is this regional contribution to policymaking. Without it, I fear that this incarnation of the United States central bank, not even 100 years old as yet, would face the same concerns that brought about the demise of the first two Banks of the United States. The establishment of regional banks was one of the compromises that enabled the Federal Reserve System to be created. Their existence is just as vital to policymaking and policy acceptance today as it was in 1914.

In that context, Stern makes some important points. Reserve Banks first grew by virtue of the role they played in clearing a vast number of paper checks. They provided an ever-increasing amount of cash to depository institutions. And they made fiscal services, like savings bonds sales, available to the public. But times change. Many depository institutions operate nationwide, and consolidation has reduced their number. Technology can and will make big inroads into paper payments. The U.S. Treasury has led the way in operations consolidation and conversion to electronics. We cannot and should not shy away from making our own operations as efficient as possible, by consolidating as much of our back office as possible and standardizing as much as we can. A lot of this has happened already, and it will continue.

Does this spell the demise of the Reserve Bank from the perspective of clout? Of stature? Does it make the Banks solely ivory towers? Does it rob the Reserve Bank president of the stature needed for internal and external credibility? Maybe. But I am not totally sold on this idea, either in the short term or in the long run, for some of the reasons that Stern mentioned in his comments.

First of all, his comments on the importance of monetary policy and on the visibility of monetary policy are right on the mark. I have been with the System for thirty-two years. I remember taxi cab drivers and other people you would talk to, as a young person. They would say, "Where are you working?" I would say, "The Federal Reserve Bank." And they would ask, "Which branch?" It was no different in New York than it was wherever you started, Gary. In contrast, today everybody knows all about monetary policy and interest rates, about Alan Greenspan and the Open Market Committee.

The visibility of monetary policy is critical to the intellectual content of what we are doing, and also to our ability to attract the right people to the System and have the right stature within the community. It gave Frank a platform. It gave Dick Syron a platform. It gives me a platform. It gives all Reserve Bank presidents, Research Departments, and other staff a platform from which to talk about and make an impact on important issues within the region and for the nation as a whole.

Second, we talked a lot about checks in the last presentation. Of course, everybody is familiar with them—they represent a whole avalanche of paper. But checks are not the most important payments system in this country, by a long shot. The most important payments system is the large-dollar funds and securities transfer system that operates through the books of the Reserve Banks. Ben Friedman, I know you are thinking a lot about this, and that you believe the advent of electronic money would take this important role away from the central bank. Maybe financial institutions will be willing to accept credits on something other than a Reserve Bank for the very large-value transactions, but I rather doubt it. This is more than a critical operational role; Reserve Banks act as the final source of liquidity and net settlement in the U.S. financial system. This adds to and contributes to both the complexity of the job of president of a Reserve Bank and the stature of the person who has it.

Third, let us talk a little bit about paper payments. Sixty or seventy billion checks are written each year, and the Reserve Banks collect or touch about seventeen billion of them in some way. Twenty-five percent of our presentments are now made electronically, and we are doing everything we can to make that paper go away. But I am not convinced that it will happen any time soon. I participated in studies in the 1970s about the checkless society. I would bet we could do one right now and be every bit as wrong as we were then. That paper, that vast avalanche of check paper, is not going away. Our volumes are going up, not down. Reserve Banks, from the point of view of both stature and size, are in the paper business. Moreover, most financial institutions want it that way; even if they compete with us, they also use our services and turn to us for backup in times of instability.

The other avalanche of paper is the cash avalanche. Year in and year out, cash in circulation grows by about 6 or 7 percent. That is a tremendous job. We are going to have a new Federal Reserve Bank office in Phoenix within the next year just to handle cash.

Despite consolidation in the industry and Reserve Bank consolidation and standardization, and despite the keen focus that we all have on improving productivity, the number of operational staff across the System is only about 10 percent lower today than it was twenty years ago. I am not looking at bank examiners or researchers or anybody like that. I am looking just at hard-core operations people. Thus, if size is a determinant of policy clout, I am not convinced we have much to worry about, at least in the near term.

Another argument involves whether or not Reserve Banks lose stature—and good people—as a result of technological consolidation. The Banks may still be there, and sizable, given their paper businesses, but unattractive as places to work. I disagree. For too long, some Reserve

Bank people have defined their importance by the operational systems they run. Now, as a result of consolidation, none of us has a mainframe any more. We do not process our own accounting statements, we do not sell savings bonds. Soon we will not run our own check computers and, increasingly, the services we do offer need to be standardized. But that should not take us out of the markets we serve. Regional Reserve Banks can do a much better job than we ever have of understanding the financial services and payments systems and exchanges within our Districts and devising innovative solutions to market and processing problems. We have to do that because our ability to react in times of financial crisis is critical. If we do not know what is going on, who the players are and how the process works, we cannot step in to solve systemic issues. To me, that has always been the most important reason why regional Reserve Banks play the roles that they do in the payments system. I would argue that we can do that whether or not the individual Reserve Bank has its hands on the specific operational controls associated with the payments system. In a sense, consolidation can free us from day-to-day operational hassles. It can give us more room to develop the local insights so important to monetary policy, bank supervision and regulation, and the maintenance of financial stability in times of crisis.

I am also not as pessimistic as some about the Reserve Banks' individual or collective ability to contribute to innovation. Bob Eisenmenger and Paul Connolly were eloquent on the subject of innovation in the payments services, particularly in the check arena. We, at this Bank, acting for the Federal Reserve System as a whole, invested $20 million over a decade in some very real, high-tech R&D. Collectively, the Reserve Banks now have a couple of million dollars in their budgets over the next two years to engage in primary R&D efforts in the payments system. And it is probably not enough, as Elliott McEntee pointed out. In one year, we are going to be looking at new paper characteristics to reduce check fraud. In another, we will conduct in-depth market research on possible electronic alternatives to checks. Thus, we have a role to play in innovation. We have a role to play in the payments system. That role can be hands-on, whether or not we are actually processing that piece of paper.

Finally, one of the critical roles we can and do play in the payments system is the role of honest broker. We have the bigger, the longer view of the payments and settlement systems. Increasingly, we act as a convener on such important issues as payments system risk, impediments to electronic check collection, and the necessary standards so vital to realizing the network effects that could be possible with increased electronic payments. We have a real role to play in understanding the evolution of technology and in reaching out and engaging the private sector in developing better U. S. and international payments and settlement systems.

Gary Stern suggests, and I believe he is accurate in this, that maintaining the strength of a Reserve Bank is related to the quality of its policy-related intellectual contributions to monetary policy, to supervision, and to payments. Reserve Bank operations are not going away any time soon, and even if they were, the capacity to understand payments markets is critical to maintaining financial stability. That role, combined with the visibility of monetary policy and the complex issues involved in supervision, should, I think, attract and retain the high-quality Reserve Bank personnel so necessary to central bank independence.