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The Structure of Our Nation's Central Bank

As our nation's central bank, the Federal Reserve System is responsible for determining and carrying out monetary policy. In addition, the System has major responsibilities for supervising and examining state chartered banks that are members of the Federal Reserve System, regulating all bank holding companies, writing regulations to implement numerous consumer protection laws (such as Truth-in-Lending), and contributing to a smoothly functioning national payments system by providing wholesale banking services, including currency and coin, and check collection.

The Federal Reserve is unique among the world's central banks in that it is not a single entity but a "System" involving a blend of public and private, as well as national and regional, elements. The Board of Governors—called the "capstone" of the System by Woodrow Wilson, who signed into law the act creating the Federal Reserve in 1913—is an agency of the United States government consisting of seven members appointed by the President with the advice and consent of the Senate. These members, called Governors, serve staggered 14-year terms but can be removed by the President for cause. Board members (including the Chairman and Vice Chairman, who are appointed to these particular posts for four-year terms) are representative of "the financial, agricultural, industrial and commercial interests and geographical divisions of the country" and cannot be officers, directors or stockholders in any banking institution. No more than one Governor can be selected from each of twelve Reserve Districts. Each District is served by a Reserve Bank with its own president and board of directors and Reserve Bank branches with their own boards of directors.

Role of the Board of Governors

The Board of Governors exercises the major responsibility for formulating monetary policy as its seven members constitute a majority of the twelve-member policy-making body, the Federal Open Market Committee (FOMC). Reserve Bank presidents fill the remaining five voting spots on a rotating basis. The exception is the president of the Federal Reserve Bank of New York, who is a permanent voting member because the New York Fed acts as agent for the FOMC and all twelve Reserve Banks in carrying out the FOMC's directives. Presidents not serving in a voting capacity nevertheless contribute their views on issues of monetary policy.

To protect the Fed from the sometimes fierce short-term partisan political pressures to which both the Congress and the Executive branch naturally are subject, the Congress over the years has endeavored to provide the System with a substantial degree of "independence," or insulation, in its day-to-day conduct of monetary policy. In addition to the provision for long and staggered terms for the members of the Board of Governors, this insulation includes exemption from the Congressional appropriations process. (However, in addition to internally conducted audits, the System is subject to financial audit by a nationally recognized, independent audit firm, as well as to financial and operational, but not policy audit, by the GAO.)

Because the Congress believed that the Federal Reserve was at times subject to excessive pressure from the Executive branch of government, it removed the Treasury Secretary and the Comptroller of the Currency from membership on the Board of Governors in 1935, positions which they had held since the Fed's inception in 1914. Senator Glass, an architect of the original Federal Reserve Act and Secretary of the Treasury, had cited his own actions as well as those of other Treasury secretaries in exerting enormous influence on the Board, oftentimes treating it as "a bureau of the Treasury" and the System as "a doormat of the Treasury."

The rationale behind the Fed's substantial degree of independence reflects a tacit recognition—one underscored by historical experience—that it is not desirable to place direct control over the power to create money in the hands of those (the Congress and the Treasury) who develop spending programs and who pay the government's bills. Congress expected this insulation to place those charged with managing the nation's money and credit (in this case, the Fed) in a better position to frame their policies in relation to what they perceive as the nation's best *long*-term interest, even though such policies could be painful in the short-run.

The decision to grant the Fed a substantial degree of independence also reflects a recognition by the Congress that a large deliberative body such as itself simply is not well-equipped to deal with the complexities of monetary management on a day-to-day basis. This consideration is especially true in today's rapidly changing financial environment.

Nevertheless, by law and practice, the System remains fully accountable to the Congress, which exercises a thorough (and frequently critical) oversight and broad "policy audit" of the System, and which can change the ground rules and constraints under which the System operates whenever it chooses. Congress has, in fact, done so on numerous occasions although, on balance, it has strengthened System "independence" materially over the years and has made the System both more effective *and* more accountable.

The vastly expanded reporting requirements and hearings on monetary policy pursuant to the Humphrey-Hawkins "Balanced Growth and Full Employment Act of 1978" is one example. These requirements include the formalized targeting procedures for the monetary and credit aggregates and their relation to projections of national income, employment and changes in the price level. Another is the substantially broadened director representation on the boards of the Reserve Banks mandated by the Federal Reserve Reform Act in 1977. Most recently, the Monetary Control Act of 1980 demonstrated the Congress' ability to alter the Federal Reserve's operations in a fundamental way. It called for sweeping changes that included provisions for mandatory reserves and open access to System services to *all* depository institutions (member or non-member, bank or thrift). The Act also required that these services be priced to users on a basis which, over the long-run, would cover all direct and indirect costs, including the imputed cost of taxes and a return on capital comparable to that of private competitors.

In addition to its monetary policy responsibilities, the Board of Governors exercises supervisory authority over the operations of the Reserve Banks. It must formally approve the selection of Reserve Bank presidents (who first are appointed by the Reserve Bank boards of directors) and it selects three of the nine directors of a Reserve Bank, including the chairman and deputy chairman. The Board of Governors also has the power to remove any Reserve Bank director, officer, or president. The Board also must approve any change in the discount rate proposed by a Reserve Bank's directors, and set the rules under which a Reserve Bank may lend to depository institutions. It also approves Reserve Bank budgets and levies assessments on the Banks to cover its own expenditures.

Role of the Reserve Banks

Technically, the Reserve Banks are organized in the form of private corporations whose stock is subscribed to by the member banks in their respective districts. The provision for member bank subscription to Reserve Bank stock was designed in part to let the Treasury avoid paying the costs of setting up the new system in 1913.

Stock ownership in Reserve Banks does not convey the usual proprietary interest and control associated with holding stock in private firms. Member banks are limited by law to an annual dividend of 6 percent and must surrender their stock when they withdraw from the System. The *public nature* of the Reserve Banks (and of the entire System) is evident in the fact that after deducting operating expenses and payment of the small statutory dividend, all of the System's net earnings are paid to the Treasury. In 1984, these payments (mostly earnings from its portfolio of government and other securities and from its lending to depository institutions) amounted to $16.1 billion and represented 87 percent of the System's gross income.

Members have the right to elect six of a Reserve Bank's nine directors. However, only three of these directors can be bankers, one each representing large, medium and small sized banks. The other three directors elected by member banks must represent the public "without discrimination as to race, creed, color, sex, or national origin, and with due but not exclusive consideration to the interests of agriculture, commerce, industry, service, labor and consumers." They cannot be officers, directors or employees of any banking institution. The same is true of the final set of three directors that serve on a Reserve Bank's board, although they must meet the additional stipulation that they cannot hold bank stock. The final three directors are appointed by the Board of Governors rather than elected by member banks. The Board of Governors also designates the chairman and deputy

chairman of a Reserve Bank's board of directors from among this set of public directors.

The same constraints apply to directors of Reserve Bank branches, four of whom are appointed by the directors of a Bank's headquarters office and three (including the branch board's chairman) by the Board of Governors in Washington, D.C.. Currently, there are 25 branch boards in the System.

Reserve Bank directors are responsible by law to the Board of Governors for the general administration and management of the Reserve Banks. In addition, they appoint Reserve Bank presidents and first vice presidents (subject to the approval of the Board of Governors) as well as other officers and the District's representative to the Federal Advisory Council. The last meets periodically with the Board of Governors to discuss the business situation and to make recommendations on various issues affecting the System.

With their very wide array of backgrounds and expertise, the directors bring to the Reserve Banks a broad range of managerial experience. In addition, they offer valuable input to the formulation of monetary policy by providing a "grass roots" information network about economic conditions in their business communities.

They do this in connection with two related functions, the first being the requirement (by law) that they set the discount rate — the rate at which the Reserve Banks lend to borrowing depository institutions. In carrying out their discount-rate responsibilities, they must meet at least every 14 days. In so doing, they normally exchange views with the Reserve Bank president and the Bank's research staff before they set the rate, which is subject to "review and determination" by the Board of Governors.

The second monetary policy function performed by directors involves the perspectives they provide the Reserve Bank president in his capacity as a member of the FOMC. With their grass roots connections and differing backgrounds, the directors act as a channel through which the particular problems and concerns of the various regions and sectors of the economy find consideration in the policymaking process. Even in an era of substantial "homogenization," major differences still exist in the structure and operations of the various regions of the country, differences that cannot always be detected in data that are national or "aggregate" in character. Under these circumstances, there is no substitute for having ready access to timely, firsthand knowledge of potentially significant developments. Directors are in a unique position to provide this knowledge as a complement to the internal economic data-gathering and research activities of the staff at the Reserve Banks and the Board of Governors.

Summary

As Chairman Volcker has noted, "from the beginning, the Federal Reserve System has been based on a combination of central and regional elements...in order to assure a proper consideration of viewpoints and needs from all sections of the country. The premise was that all wisdom does not reside in Washington and that some further insulation from short-term and partisan political pressure would come from giving an important role to the Reserve Banks."

Verle B. Johnston

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.
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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 01/23/85	Change from 01/16/85	Change from 01/25/84 Dollar	Change from 01/25/84 Percent[7]
Loans, Leases and Investments[1] [2]	187,199	– 807	13,233	7.6
Loans and Leases[1] [6]	169,089	– 808	15,261	9.0
Commercial and Industrial	51,981	– 244	6,131	13.4
Real estate	61,997	102	2,654	4.5
Loans to Individuals	32,368	6	5,611	20.9
Leases	5,269	3	229	4.5
U.S. Treasury and Agency Securities[2]	11,014	– 13	– 1,157	– 9.5
Other Securities[2]	7,095	13	– 869	– 10.9
Total Deposits	191,743	–3,592	9,732	5.3
Demand Deposits	43,311	–2,762	2,439	5.9
Demand Deposits Adjusted[3]	28,575	–1,193	437	1.5
Other Transaction Balances[4]	12,542	– 521	837	7.1
Total Non-Transaction Balances[6]	135,890	– 309	6,456	4.9
Money Market Deposit Accounts—Total	42,965	62	3,276	8.2
Time Deposits in Amounts of $100,000 or more	39,623	– 188	1,067	2.7
Other Liabilities for Borrowed Money[5]	20,707	– 693	1,536	8.0

Two Week Averages of Daily Figures	Period ended 01/14/85	Period ended 12/31/84
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	21	74
Borrowings	22	30
Net free reserves (+)/Net borrowed(–)	0	44

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately
[7] Annualized percent change