

*Fed Focus for Community and Business Leaders
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The Role of the Federal Reserve in the Economy

- I. Good morning. It's a pleasure to be with you today.
 - A. I'd like to try to answer some of the questions that I often hear people ask:
 - 1. What's the Fed's role in the economy?
 - 2. How does it function?
 - 3. What can it do for the economy?
- II. I'll begin by describing the Fed's role in a nutshell:
 - A. As the nation's central bank, the Fed basically does three things:
 - 1. It works to keep the banking, financial, and payments systems safe, sound, and stable.
 - 2. It also provides financial services to the government and the public.
 - 3. Finally--and very importantly--the Fed's conduct of monetary policy contributes to the long-run health of the economy by promoting maximum sustainable employment and stable prices.
 - B. Since its founding in 1913, it has evolved with some special characteristics:
 - 1. public and private
 - 2. national and regional
 - 3. subject to congressional oversight, but "independent" and insulated from day to day political pressures.
 - 4. These characteristics create important checks and balances for conduct of

policy and operations.

- C. Structure embodies public/private, national/regional, independent characteristics
 - 1. BOG in Washington: 7 members with staggered 14-year terms; appointed by President with consent of Senate; Chairman preeminent.
 - 2. 12 Reserve Banks cover all 50 states
 - a. Reserve Banks are each incorporated
 - b. and have own boards of directors,
 - (1) made up of bankers, businesspeople, and the general public.
 - 3. SF Fed--Twelfth District
 - a. Headquarters plus four branches cover largest geographic territory—nine westernmost states
 - b. nearly one-fifth total US population and employment
 - c. and almost one-sixth of total U.S. banking assets.
- D. Reserve banks provide banking services, bank supervision and regulation, and discount window.
 - 1. Banking services
 - a. check processing and collection
 - (1) SF handles about eight million checks per day
 - b. electronic wire payments system (Fedwire)
 - (1) SF handles \$122 billion per day;
 - (2) other electronic payments services (ACH)
 - c. banker for U.S. Treasury
 - (1) handles payments for Treasury through account at Fed

- (2) sells Treasury securities and keeps track of ownership through book entry system
 - (3) provides fit coin and currency
 - 2. Supervision and Regulation
 - a. state-chartered member banks
 - b. bank holding companies
 - c. consumer protection and securities lending regulations
 - 3. Discount Window
 - a. provides temporary funds against collateral to depository institutions
- III. Monetary policymaking also reflects national/regional, public/private, independent characteristics.
 - A. Conducted by FOMC
 - 1. 12 members: 7 Governors plus 5 Reserve Bank presidents on a rotating basis.
 - 2. All Reserve Bank presidents attend FOMC meetings and participate fully in discussions,
 - a. providing independent perspective on national policy and regional information.
 - B. The tools the Fed uses to conduct policy are
 - 1. open market operations--federal funds rate
 - 2. discount rate.
 - 3. With these tools, the Fed can affect credit conditions in the economy, which affect people's demand for goods and services, and ultimately economic performance.
 - C. The Fed uses these tools to achieve both short-run and long-run goals.

1. For example, a short-run goal would be to deal with a recession;
 - a. in that case, the Fed may ease up on interest rates,
 - b. and that would help stimulate the economy and promote a recovery.
2. But in the long-run, the goal is low inflation, because monetary policy is the main determinant of inflation in the long run.
 - a. This is true not only for the Fed, but also for central banks around the world.
 - b. Keeping inflation low is the best way a central bank can promote maximum sustainable growth and employment, which are keys to the nation's economic health.

IV. Now some people might wonder—if monetary policy can boost the nation out of a recession, why doesn't the Fed also use it to give a boost to specific regions that are in recession?

- A. In other words, some people ask—"Doesn't the Fed *care* about regional performance?"
- B. Well, the Fed certainly *does* care. And that's one of the reasons for the national and regional structure of the Fed that I mentioned before.
 1. That structure is critical in the conduct of policy, because it helps the Fed get a good picture of what's going on in *all* the regions of the country.
 - a. For example, one of the most important things we ask of our directors is a good *grassroots* perspective on economic conditions.
 2. And at each meeting, we spend a good deal of time going around the table talking about each District's economy.
 3. That's how we put together a picture of how the whole economy is doing.
- C. But the *object* of policy has to be the economic health of the nation as a whole.
 1. Often enough, *some* state or region is going through a recession of its own while the national economy is humming along.

2. If the Fed stimulated whenever *any* state had economic hard times, we'd be stimulating almost *all* the time.
 3. The upshot of that strategy would be a very inflationary environment,
 - a. and ultimately a deteriorating economy as well.
- D. There's another reason why the Fed *can't* use monetary policy to help a weak region:
1. The tools of monetary policy work through *national* credit markets, so they affect the whole economy.
- E. Let me explain how this works very briefly.
1. Suppose the Fed tried to pump bank reserves into Hawaii to make interest rates lower here than in, say, New York.
 2. Well, with the tremendous speed of financial transactions today, that differential in rates wouldn't last very long at all.
 - a. Financial institutions would borrow cheaper funds from Hawaiian banks and sell them at a profit in New York.
 - b. That would push interest rates *up* in Hawaii and push them *down* in New York.
 3. So, because of the fluidity of national credit markets, pretty soon interest rates would be the same in both Hawaii and New York.
 4. In other words, monetary policy is a "blunt" instrument--
 - a. --by necessity, it affects the whole U.S. economy,
 - b. and it's just the wrong tool to use to pinpoint economic trouble spots.
- V. So far, I've tried to give you a broad overview of how the Fed tries to strike a balance in conducting monetary policy--
- A. --a balance between concern over the short-term measures of economic performance, and attention to the long-term goals of sustainable growth and

employment and low inflation.

- B. Looking at where we are now, I think it's fair to say that our efforts to strike the right balance have worked well for the country's economy.
1. For the past several years, we've been in a pretty good position.
 - a. Long recovery
 - b. Robust growth
 - c. Low unemployment
 - d. Well-behaved inflation
- C. But there are challenges ahead.
1. For example, the Asian situation has had a negative effect on our economy, and the situation in that part of the world has deteriorated further in recent months.
 2. In addition, problems in other parts of the world are of concern, and it's too soon to tell how much we might be affected by them.
 3. Finally, declines in equity values in the U.S., and to some extent in foreign markets, are likely to slow domestic consumer and business spending to some extent.
- D. Although the strength in our economy in recent years should give us some resilience in the face of foreign shocks like these, we at the Fed will be paying close attention as developments unfold.
1. Our ultimate aim, of course, is to keep the U.S. economy on the expansion track while maintaining low inflation.