

## Central Banking and the Merits of a Federated Structure

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The recent recession has caused many to question the role of the Federal Reserve. The reforms under debate in Congress could significantly alter the regulatory responsibilities of the Federal Reserve or change the current decentralized nature of Fed policymaking. Many proposals, however, often do not consider why the Federal Reserve's policymaking process might be well-served by its organizational structure as a federated system.

The logic of a decentralized Fed is an important framework for analyzing competing reform proposals. Additionally, federated structures are not unique to central banks. The value added to other types of institutions and industries can highlight the advantages of a decentralized Federal Reserve System.

### What is a Federated Structure?

The federated structure is prevalent in many sectors of the economy: agriculture, wholesale purchasing, and nonprofit service organizations. In agriculture, federated cooperatives have a long history of strategic importance in the United States as well as other countries and often dominate a significant share of their markets. For example, CHS Inc. is one of the largest farm supply businesses in the United States and is a Fortune 100 company. Internationally, Colombia's National Federation of Coffee Growers (the owner of the famous Juan Valdez logo) dominates their coffee market. In the nonprofit sector, the YMCA and the Red Cross are

some of the largest community service organizations in the United States and the world.

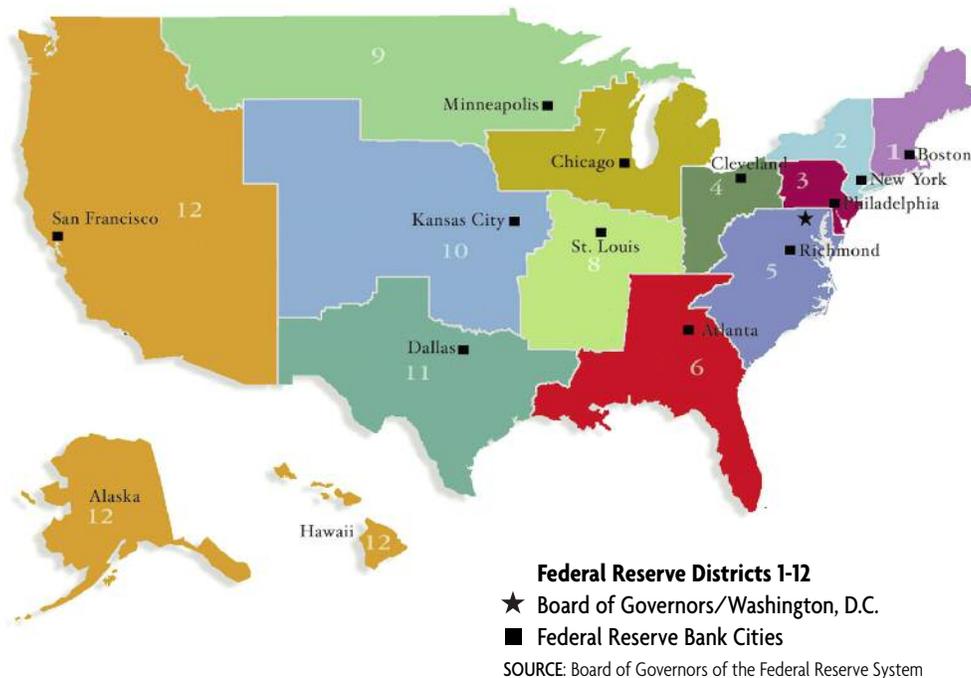
In a federated structure, a group of autonomous organizations with local or regional representation are part of an alliance under the umbrella of a national- or international-level organization. The local or regional organizations (often referred to as affiliates) retain independence over their internal affairs and are at least partially self-governing. Certain powers are, however, ceded to the national or centralized coordinating body, which is wholly or partially owned by all of the affiliates.

In the Federal Reserve System, there are 12 semiautonomous regional Reserve Banks, each operating in a distinct geographical territory, referred to as a district. The Board of Governors, which is a federal government agency, provides general supervision and regulatory oversight of the operations of the regional Banks. The Board comprises seven governors appointed by the President of the United States. The Board of Governors and five regional Bank presidents constitute the Federal Open Market Committee (FOMC), which sets the nation's monetary policy. The Board also approves the appointments of presidents and first vice presidents at each Bank. Each regional Bank has its own Board of Directors representing member banks and the general public. The regional Banks implement other functions of the Federal Reserve System, including payment processing, currency distribution, bank exams, discount window operations, and certain banking operations for the U.S. Treasury.

The regional Banks earn their primary revenue from interest on securities and fees for services provided to depository institutions. Service fees are set at the System-level so as to cover the costs of providing these services. The net revenue is first allocated as fixed dividend payments to member banks and then to maintaining an adequate surplus. The remainder, which has historically been approximately 95 percent of the total, is paid to the U.S. Treasury.

### Historical Background: The Populist Influence

When it was created in 1913, the structure of the Federal Reserve System was a political compromise. The original idea of some legislators was to con-



struct a national banking system led by a strong central (and centralized) bank. However, the country's relatively recent experiences with the First and Second Banks of the United States (1791-1811 and 1816-1836) tainted the public's opinion of a central banking system. As a result, policymakers explored decentralized banking systems and central bank models in other countries.

One difficulty in imposing a truly centralized structure on the banking industry in the early 20th century was related to the industry's size. A survey taken on April 28, 1909, reported 22,491 banks in existence in the United States and its island possessions. At the time, the banking industry was composed of national banks, state banks, mutual savings banks, stock savings banks, private banks, and loan and trust companies. National banks are distinct from state banks because their charter comes from the federal government rather than a particular state. The federal government thus had regulatory control over the national banks, but not state banks.

In the banking industry of 1909, state banks vastly outnumbered national banks (11,319 and 6,893, respectively). However, in terms of assets, national banks dominated state banks. The national banks that participated in the survey reported a total of more than \$9.3 billion in assets compared to roughly \$3.3 billion for the state banks. This difference in assets partly reflects the role of national banks as depository institutions for bonds from the U.S. Treasury.

The banking industry's characteristics also varied by geography. In the New England and Eastern states, the number of national banks dwarfed the number of state banks. The opposite trend prevailed in the Southern, Middle Western, Western, and Pacific regions.

Decentralization was the predominant characteristic of the U.S. banking industry. Yet the banking system reforms designed by Senator Nelson W. Aldrich, which arose out of the work of the National Monetary Commission of 1908 to 1912, advocated a more centralized system than what was finally passed in the Federal Reserve Act of 1913. The purpose of the commission was to study the existing U.S. financial system and its history as well as look to other nations for ideas on appropriate currency and banking reforms that would prevent or lessen the damage from events like the Bank Panic of 1907. Senator Aldrich, chairman of the commission and a Republican from Rhode Island, politicized the reform effort by identifying the Republican Party as the supporters of a central bank plan. The Democratic Party platform of 1912 opposed a central bank. The Aldrich Plan introduced in the Senate on Jan. 9, 1912, would have established a "National Reserve Association" which was "strictly a bankers' bank with branches under the control of separate directorates having supervision over the rediscount operations with member banks."

The element of centralization in the Aldrich Plan came from the establishment of one central body that controlled the system and a membership board that would be chosen by

both the banking sector and the federal government. The system was to be comprised of 15 districts with a branch of the National Reserve Association in each district. The Executive Committee of the National Reserve Association would be in charge of operations. However, the banking industry would be given more of a voice on the board than government officials. In recognition that his plan leaned more heavily to banking interests, Aldrich sought to minimize this dominance by limiting the powers of the National Reserve Association and spreading membership on the directorate board across the geographic banking regions. Aldrich's approach was described as "fifteen chapels united by a solid dome."

Because of the political climate of an election year, Aldrich's bill never received full congressional consideration. The congressional and presidential elections of 1912 placed the Democrats as the party in power both in the Congress and the White House and they began to fashion their own banking and currency reform legislation. The Democratic effort was spearheaded by Congressman Carter Glass of Virginia and Senator Robert Owen of Oklahoma. Both men represented a departure from Senator Aldrich whose work on banking reform was viewed as tainted by moneyed interests because John D. Rockefeller, Jr., the son of the founder of Standard Oil, was his son-in-law. Glass' background was in journalism as a newspaper reporter, editor, and owner while Owen had worked as a teacher and lawyer before organizing the First National Bank of Muskogee, a small bank in Oklahoma.

To ensure its passage, any piece of banking reform legislation put forth by the Democrats needed William Jennings Bryan's stamp of approval. Bryan, the Secretary of State appointed by President Wilson in 1913, was born and raised in rural Illinois and Nebraska and represented the latter as a U.S. Representative between 1891 and 1895. His Democratic Party base was comprised of newly arrived immigrants, agrarian reformers, and supporters of women's suffrage. William Jennings Bryan became an overnight sensation in Democratic circles while still in his 30s and was that party's nominee for president in 1896, 1900, and 1908. His platform included breaking up perceived monopolies, fighting big banks and railroads, and generally promoting populist ideas.

In 1896, Bryan was also the Populist Party's presidential nominee. That party, established in 1892, grew out of the Panic of 1873, which began in September of that year with the failure of Jay Cooke & Company, an investment bank heavily involved in the financing of railroad expansion. Its failure triggered the collapse of other banks which led to the temporary closure of the New York Stock Exchange. The effects of the panic were felt across the nation and led to the Depression of 1873-1879. During this period, a constrained money supply led to deflation resulting in plummeting values for agricultural prices. Many farmers believed the government's monetary policy was being controlled by the large banks and industrial monopolists on the East Coast. They strongly advocated the abolition of national banks

and the control of the currency by the “people” instead of bankers.

The Federal Reserve Act that was ultimately passed in 1913 allowed between eight and 12 regional Banks. This approach gained support for two reasons. First, the system needed to be able to adapt to the economic conditions occurring in the different regions of the country, particularly with regard to setting discount rates. Each regional central bank could set the appropriate rate for its region rather than trying to have one central bank maintain several different discount rates. Second, there was a desire to break up or weaken the control that New York banks had on the money market. The ability for another “money trust” to develop and dominate the financial sector would be curtailed if economic power was more decentralized across the country.

The Federal Reserve Act also departed from its predecessors in terms of the distribution of power in the system. The Aldrich Plan was severely criticized for the perceived dominance that business interests could have over the National Reserve Association, so the Federal Reserve Act went in the opposite direction by including a stronger voice for the federal government in the system. The government’s influence is embodied in the fact that the members of the Federal Reserve Board are nominated by the President and subject to congressional approval.

The interjection of politics into the Board’s membership was one of the necessary changes made in order to gain Bryan’s support for the Federal Reserve Act. As Bryan wrote to Glass in August 1913, “the bill provides for Government control of the issue of this money ... This is another distinctive triumph for the people, one without which the Government issue of the money would be largely a barren victory.” The Republicans and the banking industry were opposed to such governmental interference in banking. As Glass wrote at the time, “I also told the President his proposition would put the whole scheme into politics and that he could not expect a powerful Republican minority in the Senate to sit quietly by and permit the creation of a banking system, the absolute control of which, to begin with, would be in the hands of men all appointed by a Democratic President.”

The banking industry was presumed to have a voice in the boards of directors of the regional Federal Reserve Banks, which represent their member banks. Each regional board consists of nine members. The Federal Reserve Board of Governors controls the appointment of three directors. The remaining six directors are elected by their member banks with three directors representing the interests of stockholding banks and the other three as representatives of nonbanking activity like agriculture, commerce, or industrial sectors. E.W. Kemmerer, a Princeton University economist, argued in 1922 that the term “federated” was applied to the structure of these boards because they were organized in a way that would, “1) recognize the public’s dominant interest in matters of broad policy; would 2) recognize the dominant interest of the bank and the banker’s

business customer in the narrower banking questions, such as the goodness of paper against which advances were to be made, the amounts to be loaned individual member banks, the quality of open-market investments, and the like; and would 3) permit of a democratic control among the member banks of this banking business.”

Bryan and other populist Democrats at the time also would have been familiar with the federated agricultural cooperative structure, which was particularly prevalent in the Midwest. In 1915, there were more than 5,400 agricultural cooperatives in the United States with more than 650,000 members. This type of organizational structure was promoted by Edwin Nourse, an economist trained at the University of Chicago. Nourse, who grew up on a small farm in Illinois and eventually served as chairman of the first Council of Economic Advisers under President Truman, was staunchly opposed to monopolies and believed that local cooperatives could force agribusiness firms to behave more competitively by achieving scale through a federated system.

The division of power in the Federal Reserve Act between the Federal Reserve Board and the regional Federal Reserve Banks is a distinctive feature of the U.S. central banking system. Since 1913, the System’s inherent regional structure has been able to remain in place with only a few revisions. Some restructuring occurred during the Great Depression. The Banking Act of 1933 redefined the Federal Reserve’s powers and the Banking Act of 1935 established the FOMC. The “accord” of March 3, 1951 between the U.S. Treasury and the Federal Reserve solidified the notion of the independence of the Federal Reserve System within the government.

### **Federated Tensions and Resilience**

The relationship between the local and national organizations in any federated structure is complex and contains inherent tensions. The sustainability of federated systems requires that all local organizations remain “loyal” to the system. For example, if local cooperatives conducted most of their business outside of their federated system, it would threaten the viability of their regional organization and ultimately the entire federated structure.

In the case of the Federal Reserve, this loyalty manifests itself as speaking with one voice on policy decisions after they have been made. Although FOMC votes are recorded and dissents are noted, the final decision is formally supported by all Reserve Bank presidents. Paul M. Warburg, a member of the first Federal Reserve Board, wrote in 1930, “A regional system that is to operate successfully must remain a balanced system. That is to say, the Reserve System must be under the leadership and direction of the Reserve Board; but with a generalship on the part of the Board that does not rest on the assertion and bureaucratic or dictatorial exertion of its legal powers but on the reserve banks’ full confidence in the competence, fairness, and impartiality of the Board, and on the clear recognition by the reserve banks of a coordinating leadership by a Board

seeking their harmonious cooperation as indispensable to the successful and undisturbed functioning of the System.”

The fundamental tension in any federation stems from the potential incompatibility between maximizing benefits derived from the national organization and maximizing local benefits. If local benefits can be increased by doing business outside the federation, the local organization has to weigh those potential gains against possibly smaller benefits derived from a weaker federated system. In the extreme case, if a local organization fails to derive substantial benefits from the federated system, they are better off operating “disloyally,” which is to say as a truly independent organization. This extreme case is hard to imagine in the case of the Federal Reserve System, because the regional Banks are legally bound to the System — they cannot set their own monetary policy, for example. However, it is also important to distinguish between loyalty to the policy decisions made by the System and allowing a difference of opinion about monetary policy and theory to be expressed by each regional Bank.

As Warburg recognized in 1930, the relationship between the Board and the Reserve Banks is complicated by all of the factors that made the European central bank model inappropriate to the United States, such as the “vast expanse of our country; the immensity and diversity of its resources and interests; the complexities of our political life and of a decentralized system of thousands of individual banks; and the existence of stock exchanges and industries of towering strength, standing outside of the System’s immediate control” to avoid interference.

The federated structure, however, has some significant comparative advantages in the face of diverse local conditions. The primary advantage in comparison to alternative centralized structures is that it allows the local affiliates or organizations to retain their flexibility when serving their unique local markets. For example in the nonprofit sector, a federated model of governance has allowed YMCAs in different countries and communities to offer diverse programs that meet local needs. In the case of the Federal Reserve System, it allows each Reserve Bank to respond to local conditions when regulating their member banks and providing technical assistance to local communities.

The federated structure also supports the flow of local,

independent information and opinions upward within the organization. In the case of the Federal Reserve, each Reserve Bank collects its own economic data and information that is used to define an independent monetary policy perspective. Each Reserve Bank president provides policy opinions at FOMC meetings. A centralized structure would not provide the same incentives for independent information and opinions from each region. Instead, policies would be made centrally and funneled down through the organization. Although this type of decisionmaking may be less costly in some sense, such centralized policymaking might not generate or accommodate diverse opinions as effectively as the current structure and thus might result in uninformed policies.

Federated structures are also often criticized for operational inefficiencies. For example, local affiliates may operate their own IT and payment systems or maintain different accounting standards. These types of inefficiencies are avoided in centralized structures where uniform systems are typically adopted by headquarters and all branches. In the case of the Federal Reserve, some system-wide operations have been adopted. For example, all 12 banks share the same payment, contracting and IT platforms.

### Why a Federated Structure Still Matters

During a time of crisis, it is common to want to undertake major policy changes in order to prevent another from occurring. However, in a rush to reform the national banking system, there may be a tendency to dismiss the broader rationale behind the central bank’s organizational structure. Arguments for keeping a federated structure for the United States’ central banking system still have the same credibility in 2010 as they did in 1913 when the structure was created.

Each regional Reserve Bank in the Federal Reserve System has a unique culture and perspective that reflects its district. The federated structure has allowed each regional Bank to maintain its unique policy voice while also realizing the efficiencies of consolidated operations. The diversity of opinion within the Fed continues to generate solid, consensus-driven policy decisions and can be seen as one of the strongest arguments in favor of the current structure. **RF**

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