

Federal Reserve Bank of Cleveland

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Annual Report

Contents

- 3 Foreword
- 4 Central Banking in the United States:
A Fragile Commitment to
Price Stability and Independence
- 18 Comparative Financial Statements
- 20 Directors
- 22 Officers



Foreword

Nineteen ninety-one was a year of changes—and often the changes took unexpected turns. The long-awaited bank reform bill was passed, but disappointed many in its lack of vision. The economy, which many observers expected to recover, seemed to stall and then founder at the close of the year.

At the Federal Reserve Bank of Cleveland, change also occurred with the departure of our president, W. Lee Hoskins, and the appointment of our new president, Jerry L. Jordan.

Lee, who left to become president and chief executive officer of The Huntington National Bank, made noteworthy contributions on several fronts. He developed influential public policy positions on the importance of price stability and financial regulatory reform. Under his leadership, the Fourth District made significant progress toward becoming the lowest-cost provider of high-quality services in the Federal Reserve System. Speaking for the directors, officers, and employees of the Federal Reserve Bank of Cleveland, I wish him well in his new responsibilities.

Jerry, who joined the Bank in March of this year, was most recently senior vice president and chief economist of First Interstate Bancorp in Los Angeles, California. He has extensive knowledge of monetary policy, banking, and economic issues. Jerry also has a national reputation in the public policy arena and experience in both the private and public sectors. We look forward to working with him on the challenges ahead.

One of those challenges is maintaining our progress toward a goal of price stability. Monetary policy was eased often and much throughout 1991, and in a manner that we believe does not compromise long-term price stability. As we argue in this year's annual report essay, future

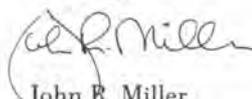
policy adjustments—and there will doubtless be many—should focus on this goal.

Twenty-three directors, representing banking, business, agriculture, consumer, and labor interests, guide the Federal Reserve Bank of Cleveland and its Branches. Their contributions are highly valued, as is the participation of our Small Bank and Small Business Advisory Councils.

Special thanks are extended to those directors who have completed their terms of service on our boards. We are especially grateful for the leadership of Kate Ireland (national chairman, Frontier Nursing Service of Wendover, Kentucky), who was chairman of our Cincinnati Branch board of directors. We also appreciate the contributions of Allen L. Davis (president and chief executive officer of The Provident Bank, Cincinnati, Ohio), who served on our Cincinnati Branch board; and E. James Trimarchi (president and chief executive officer of First Commonwealth Financial Corporation, Indiana, Pennsylvania), who served on our Pittsburgh Branch board. In addition, the Fourth District has been well represented on the Federal Advisory Council by John B. McCoy (chairman, president, and chief executive officer of Banc One Corporation), and we are grateful for his continuing dedication.

Finally, on behalf of the board of directors, I want to express my appreciation to the officers and employees of the Bank for making 1991 a successful year. I particularly want to commend them on their admirable performance during the transition period between presidents. To their credit, the Bank continued to function extremely well.

Sincerely,



John R. Miller
Chairman of the Board

Central Banking in the United States: A Fragile Commitment to Price Stability and Independence

During the past seven years, inflation in the United States averaged 3.9 percent, declining to a low of 2.9 percent in 1991. This represents a substantial improvement from the decade of the 1970s and marks our return to an elite group of low-inflation countries in the world. This achievement may be largely uncelebrated, because many Americans are currently focused on the stability of their jobs and incomes. However, both history and research suggest that very low inflation will improve economic performance, giving us reason to expect better times are ahead.

Conventional measures of inflation expectations indicate that most people believe that this favorable pattern will continue in 1992. But will the commitment to maintaining price stability be fleeting or enduring?

Given the mixed performance of our nation's central bank over the past few decades, this commitment to price stability seems fragile indeed. Over the years, the focus of policymakers has turned away from long-term economic growth and price stability, and has turned toward achieving short-term economic objectives for production, employment, long-term interest rates, and occasionally, foreign exchange rates.

When the Federal Reserve System was created in 1913 to improve the functioning of the commercial banking system, price stability was taken for granted. Yet, the Federal Reserve's creators recognized the dangers of political control of the money creation process and designed the System to withstand it. A review of history illustrates the wisdom of this approach: attempts to realize short-term objectives through the manipulation of money and credit inevitably lead to financial and economic distress.

This essay reviews the evolution of central banking in the United States and emphasizes the deliberate efforts to create a structure that would be insulated from partisan politics. We conclude that the Federal Reserve's accountability can be strengthened by having Congress resolve that price stability should be the Federal Reserve's first and foremost goal. With this mandate, and with continued insulation from political influence, the Federal Reserve can make a major contribution toward efforts to achieve maximum, sustainable economic growth.

Before the Federal Reserve

Our country's founders were aware of the dangers involved with granting the government or one of its agencies direct and unchecked control over the issuance of currency that has little or no intrinsic value. These leaders had witnessed firsthand the economic damage that ensued from debasing money to serve political needs during and in the aftermath of the American Revolution. Similar debasements and currency overissues had occurred during the prior century in Europe. Unbacked paper currencies, combined with legal tender laws, ruined the public credit of many of the prerevolutionary colonies and of the independent states that existed before the signing of the Constitution. The overissue of currency often resulted in inflation, financial chaos, and economic ruin, and our nation's leaders sought to guard against it.

The Constitution gave Congress the power "to coin money" and "to regulate the value thereof." Historians maintain that this language reflected specific intent that the new nation adopt a specie standard—that is, coin actually made of a precious commodity. Soon after the Constitution was ratified, Congress established its monetary standard: a dollar had to contain 371.25 grains of fine silver or 24.75 grains of fine gold!

In effect, the United States had adopted a silver standard and an official exchange rate between silver and gold. The founders had not only stabilized the value of the nation's currency, but had also guarded against political influence by failing to grant the Executive Branch the power to issue a paper currency.

Paper Currency

Until the Civil War, the use of paper money in the United States largely developed outside the direct control of the federal government. As banks were chartered by states and established

around the country, they began to issue their own circulating liability notes to their customers. These notes, which circulated as "currency," were implicitly backed by gold and silver held at the issuing bank and could be redeemed for such by the bearer. Also, the First and Second Banks of the United States issued circulating notes that were receivable for taxes as long as they were redeemable at par in gold or silver.

State-chartered banks were constrained by market forces in their ability to issue notes. The probability that the notes would be redeemed at the bank for specie—gold and silver coin—served as a constraint on a bank's ability to issue notes. Under normal circumstances and market pressures, then, each bank had to be careful to reserve an appropriate amount of specie in relation to its issue of bank notes.

Between the charters of the First and Second Banks of the United States (1812-1816) and after the expiration of the Second Bank's charter (1836), the natural constraint on bank note issue was tested. Banks wishing to take advantage of the rules of the circulating bank note regime placed themselves at long distances from financial and commercial centers and issued much larger volumes of notes than their reserve of specie warranted. However, when bank notes circulated to places far away from their point of issue, recipients often demanded discounts commensurate with the difficulty of sending the notes back for redemption. Market forces, in effect, "priced" the value of the notes.

The U.S. banking system showed great promise in its ability to formulate private market solutions for the problems associated with a maturing financial system and economy. By the 1850s, the banking system was far from perfect, but it displayed enough stability and efficiency so that there was no real political impetus to change the system until the Civil War.

Greenbacks

The outbreak of the Civil War cleared the way for the very development that the nation's founders had sought to prevent: discretionary control of money by the Executive Branch, within loose limits imposed by Congress.

During the early 1860s, the U.S. Treasury found it increasingly difficult to issue more debt to finance the war. The Treasury had already drained available specie from the nation's largest banks, and there was widespread concern about the possibility of default on government bonds.

The Legal Tender Acts were passed to provide the Treasury with an alternate method of financing its debt. Through the Acts, the Treasury acquired the authority to issue legal tender paper, known as "greenbacks." This action was strongly opposed by creditors, because the Treasury could now use the notes' legal tender status to force the public, including banks, to accept them as payment for the government's bills. The Treasury expected greenbacks, as legal tender for all public and private debts, to circulate as currency. In effect, the banking system was allowed to monetize federal debt.

In retrospect, Congress clearly was searching for an expedient way to finance the Civil War and the Reconstruction, despite constitutional obstacles. In fact, the legality of the Legal Tender Acts was challenged after the war and, although eventually upheld by the Supreme Court, the constitutionality of the Acts is debated by legal scholars to this day.

The new issue of greenbacks was finally terminated in 1878, but the Treasury's control of money and credit had already been firmly established by the National Banking Act of 1863 and its subsequent amendments in 1864 and 1865. These statutes created nationally chartered banks and allowed them to issue notes only if they were secured with deposits of U.S. Treasury bonds.

By expanding and contracting federal debt, the Treasury could indirectly control the amount of national bank notes in the economy. Time and again, however, this system displayed its inadequacies. From 1863 until the creation of the Federal Reserve System in 1913, the U.S. economy was marked by periodic episodes of volatile prices and interest rates, financial panics, and severe economic booms and busts.

Many observers attributed the intermittent economic chaos to the "inelasticity" of note circulation under the Treasury's bond-deposit system. The quantity of authorized federal debt was strictly limited because the Treasury generally operated with a surplus. In addition, until the Treasury adopted modern debt auction procedures in 1896, the process of purchasing new bonds by banks was unduly expensive and occasionally slow. Banks were therefore often prevented from purchasing new bonds and depositing them with the Comptroller, even when additional note issues could have been justified from a strict monetary policy perspective.

At the same time, banks had difficulty retiring notes, since the same formalities and expense had to be endured for cancellation. Consequently, the banking system was unable to provide easily for an expanding and contracting volume of currency in response to the public's seasonal and cyclical demand for money.

Financial Panic

Because national banks placed such a high demand on U.S. Treasury bonds to support currency note issues, these securities became unprofitable for banks to hold. In what might be the first modern financial market innovation in response to government regulation, demand deposits became the most important source of bank funds. Banks were not required to hold bonds against demand deposits and, furthermore, could count demand deposits held by other banks as reserves.

From time to time, depositors put substantial pressure on banks for cash withdrawals. However, with a low supply of bank notes in their reserves and because of the difficulty in quickly obtaining an additional supply, banks were sometimes forced to suspend payments and sharply restrict credit, contributing to financial panics and economic collapse.

The complex system of banks that developed under the National Banking Act was believed to exacerbate panics. Country banks were required to keep part of their reserves in deposits at designated "reserve city banks," and reserve city banks were required to keep part of their reserves in larger city banks, known as "central reserve city banks," located in New York, Chicago, and St. Louis. These relationships served to transmit payment suspensions and panics from one region or particular bank to another and, ultimately, throughout the system.

Another common but somewhat more controversial belief was that financial panics stemmed fundamentally from the lack of an institutional mechanism that would allow the nation's money supply to expand and contract with currency demand, which in turn expanded and contracted with real economic activity.

Exquisite Balance

The political and social heritage of the United States resulted in a confluence of pressures that were, and to a large degree still are, uniquely American. From the very inception of central banking in the United States with the chartering of the First Bank of the United States in 1791, the political debate about central banking has been focused on the values and dangers of centralized authority. The structure of the Federal Reserve System reflects the nature of these tensions.

After a deep and acute panic in 1907, Congress set up the National Monetary Commission to study these monetary problems. The Commission's recommendations resulted in two courses of action. First, the Aldrich-Vreeland Emergency Currency Act of 1908 authorized private bank clearinghouses to temporarily issue bank note currency against trade-related paper, not just government bonds. Later, the Federal Reserve Act of 1913 established a quasi-governmental organization to issue currency notes based on either gold or commercial paper.

Thus, the new Federal Reserve Banks were designed to displace the clearinghouses. In addition, the perceived need for a mechanism to allow the expansion and contraction of the nation's money supply was made explicit in the very legislation that created the Federal Reserve System. The preamble to the Federal Reserve Act describes it as "An Act to provide for the establishment of Federal reserve banks, to furnish an elastic currency..."

An early attempt to create a central bank that would serve to "furnish an elastic currency" was presented by Senator Nelson Aldrich of Rhode Island in 1911. The Aldrich plan proposed a single central authority, with branches throughout the country, that would be run and directed by private bankers.²

This plan was fiercely opposed by so-called progressive Democrats, most notably the three-time Democratic presidential candidate and future Secretary of State, William Jennings Bryan. Bryan and his allies favored a central

bank controlled by public interests, with centralized authority outside the control of private banking interests.

But the seeming irreconcilability of these opposing views did not eliminate the impulse for the creation of a central bank. Consistent with the American political experience, the ultimate outcome was a compromise that was sufficient to satisfy the majority needed to pass the Federal Reserve Act.

Congress has employed its undoubted power to regulate the banking industry and the nation's money supply by a system that is in part private although it includes significant avenues for decisive governmental influence. Few issues in the history of this nation have been as thoroughly considered and debated as central banking and the regulation of the money supply, and private participation, or even control, have been (its) hallmarks...The current system...represents an exquisitely balanced approach to an extremely difficult problem.³

Harold H. Greene, United States District Judge,
John Melcher v. Federal Open Market Committee, 1986

Fashioned largely by Virginia Representative Carter Glass, President Woodrow Wilson, and economic advisor H. Parker Willis, the Federal Reserve System emerged as a hybrid institution, a balance between public and private decision making. The genius of the compromise was to create an entity with no dominant central authority, thereby assuring each faction that it would not be overwhelmed by the other.

The Federal Reserve Act called for not less than 8 nor more than 12 Federal Reserve Banks, each with a substantial degree of autonomy within the System, and a Board of Governors to provide coordination and oversight. The Board of Governors is a government agency, and the Board members are government officials. The Reserve Banks are government instrumentalities — corporations chartered by the federal government to act in the public interest.

Essentially, the Federal Reserve replaced or competed directly with the private clearinghouse arrangements, which were operated by the largest banks. Such clearinghouse arrangements had been created in 1853 in New York and earlier in

New Orleans and other regional banking centers. The Federal Reserve System allowed equal access to its clearinghouse by all banks. Financial shocks could be more easily absorbed under this new framework, because the resources of the entire Federal Reserve, not just the resources of a single clearinghouse, could be directed at banking panics.

The Federal Reserve System could also accommodate fluctuations in the demand for currency. The goal of supplying an elastic currency was

to avoid banking panics, in which the public sought to shift their funds from deposits to currency. To prevent such panics from either destroying banks or causing the restriction of cash payments by banks, the new central bank aimed to convert deposits to currency without reducing the total of the two. The issuance of the new currency, Federal Reserve notes, could be rapidly expanded in panics, but was fully convertible, on demand, into gold.

The Federal Reserve's discount window provided an easier way for banks to convert their commercial and agricultural assets into that currency. A measure of local control and expertise was provided by the fact that each Federal Reserve Bank was made responsible for administering the discount window. The regional Reserve Bank presidents had an important voice in the operation of the Federal Reserve System, provided practical experience in banking and commerce, and kept the Federal Reserve Board abreast of regional economic conditions.

A Modern Central Bank

Central banks, of course, were not unknown at the turn of the century; virtually all industrialized countries had formed central banks by 1900. Furthermore, some central bankers regarded their responsibilities as having grown to encompass the same general concern for the safety of financial markets and the payment system that motivated the debate surrounding the enactment of the Federal Reserve Act.

In important respects, however, the context into which the Federal Reserve System was organized was decidedly unique. The European and Japanese central banks were created primarily to organize note issue and to facilitate clearinghouse operations among private banks. In this regard, existing

central banks — that is, “bankers’ banks” — were much closer in character to the First and Second Banks of the United States. The Federal Reserve System truly was the first central banking institution specifically designed to address issues relating to the interaction of financial instability and macroeconomic risk.

At its inception, the Federal Reserve may have been more dedicated to controlling short-term fluctuations in the price level than to planning for long-run price stability. But the long-run stability of prices was presumed because the creation of the Federal Reserve System occurred in the context of the gold standard. Not until much later, after the gold standard gave way to our present monetary system, did the long-run stability of prices emerge as a serious concern in the conduct of monetary policy.

Evolution of Monetary Policy

In its early days, the Federal Reserve Banks’ primary policy tool was making loans secured by sound collateral through their discount lending facilities. The interest received from these loans was the primary source of revenue for the Federal Reserve Banks. Today, open market operations — the purchase and sale of government securities in the money market — is the major tool of monetary policy. The transition from discount lending to open market operations created conflicts within the Federal Reserve over the System’s governance.

In the early 1920s, after the war finance program for World War I was completed, the volume of Federal Reserve Bank loans to commercial banks dropped severely, thus impairing System revenues. In order to shore up weak profits, the Reserve Banks took advantage of their authority “...to purchase Government bonds within the limits of prudence, as they might see fit.”⁴ Open market operations grew and noticeably influenced credit markets and banking reserves.

Establishing the FOMC

The Federal Reserve Act contained no explicit provision for the current form of open market operations, since its use as a policy tool developed quite unexpectedly. In fear that the U.S. Treasury might step in and assert its authority in open market operations, the Reserve Banks formed a committee of four Reserve Bank presidents in 1922, under the leadership of New York Fed President Benjamin Strong, to coordinate the 12 Districts’ open market operations. Later that year the committee was expanded to five presidents, who at that time were called “governors.”

Throughout the 1920s, the Board in Washington, D.C. — which included five members, plus the Secretary of the Treasury and the Comptroller of the Currency as ex officio members — displayed increasing displeasure about its lack of input in open market operations. In fact, Board member

Adolph Miller complained that the Board should have a more active voice in decisions concerning open market operations.⁵

In March 1923, the Board decided to claim its own jurisdiction by dissolving the Reserve Banks' committee. The Board then reestablished a similar group, the Open Market Investment Committee, to carry on its work under principles and regulations determined by the Board. Because the Treasury was represented on the Board by both its Secretary and the Comptroller of the Currency, this structure provided the Treasury with a means for direct influence over monetary policy.

The Board's influence over open market operations was strengthened as a result of policy disagreements among the Reserve Banks in the late 1920s. However, monetary policy was used ineffectively at the onset of the Depression. In 1930, the Open Market Investment Committee was replaced by the Open Market Policy Conference, which included a representative of each Federal Reserve Bank. The new Committee submitted all decisions to the Board for approval and, without the Board's approval, the Committee could not act. This reallocation of power was ratified and somewhat amplified in the Banking Act of 1933.

The consolidation of control over open market operations at the Board was consistent with sentiment in favor of a greatly enlarged federal presence in the national economy during the troubled Depression years. While the Banking Act of 1933 shifted some of the administrative power over open market operations to the Board, the Act, at the same time, strengthened the independence of the Federal Reserve System by lengthening Board members' terms from 10 to 12 years.

The Banking Act of 1935 brought more sweeping changes. The Committee (renamed the Federal Open Market Committee, or FOMC) would now include five voting representatives of the Reserve Banks along with the full Board, giving the Board a 7-to-5 majority on the FOMC. In addition, the

Board's political independence was strengthened by eliminating the Secretary of the Treasury and the Comptroller of Currency from the Board of Governors, and by again extending the governors' terms — this time from 12 years to 14 years.

Thus, having confronted several opportunities to eliminate the public — private mix that had characterized the Federal Reserve System, legislators instead strengthened that feature by writing into law the role of the Federal Reserve Bank presidents in open market operations and removing the Secretary of the Treasury and the Comptroller of the Currency. Since the Banking Act of 1935 and the subsequent amendment in 1942, which gave the New York Federal Reserve Bank permanent representation on the FOMC, no major legislative changes have been made to the monetary policymaking structure of the Federal Reserve System. In short, the Banking Act of 1935 established the monetary policy structure of the Federal Reserve System largely as it exists today.

Financing U.S. Debt

When the United States entered World War II in December 1941, the Federal Reserve's primary objective was to facilitate — as it did during World War I — the Treasury's financing of the country's huge deficits. The Federal Reserve's assistance during World War II differed, however, in two important aspects from its activities during World War I.

In the earlier war, the Federal Reserve encouraged banks to buy government securities by maintaining low discount rates. Banks bought government securities at yields higher than the discount rate, and the discount window guaranteed short-term liquidity for those bank assets. Of course, this steered bank credits away from commerce, industry, and agriculture and toward government bonds. The Federal Reserve Banks bought few Treasury securities themselves, largely confining their monetary operations to discount window activities and purchases of bankers acceptances.

During World War II, at the Treasury's behest, interest rates were not allowed to rise at all. As wartime financing grew, however, the Fed became more concerned about the inflationary consequences of maintaining constant interest rates. When the Fed threatened to break away from Treasury policy, the Treasury emphasized the problems that a change in the structure of rates

As the postwar period progressed, the Federal Reserve and the Treasury increasingly disagreed about the appropriate monetary policy for the nation. In essence, the Treasury argued that the Federal Reserve could best support the expansion of the economy by maintaining a relatively fixed price structure for federal debt instead of allowing prices to fluctuate with market demand.

The present somewhat complicated arrangements for the election and appointment of directors of Federal Reserve Banks, and for the appointment of presidents of Federal Reserve Banks by these directors... (have the advantage of keeping) presidents of Federal Reserve Banks directly in touch with men who are aware of banking and credit conditions and economic developments in their Districts, and who can help to interpret credit policy to the banking, business, and agricultural community, without making the presidents subservient to whatever may be the selfish interests of any group in the community.⁶

Allan Sproul, "Reflections of a Central Banker," 1956

was likely to cause, because federal government securities and government-guaranteed loans made up an important share of the assets structure of banks and other public and private institutions?

To limit inflation and to prevent rising private demands from diverting resources away from the war effort, direct wage and price controls were established. The Federal Reserve regulated the expansion of private-sector credit directly. While the controls kept consumer and business spending in check, the inflationary potential was large indeed, once the controls were lifted.

Setting Goals

After World War II, concern about inflation and economic growth resulted in the enactment of the Employment Act of 1946, which called for "maximum employment, production, and purchasing power."⁸ Responsibility for achieving the goals of the Employment Act of 1946 was not assigned specifically to the Federal Reserve System or to any other agency of government. Rather, the Act was an expression of goals to be pursued by all government agencies to the extent that their usual operations and powers enabled them to do so.

The Federal Reserve maintained that it could not achieve the goals of the Employment Act by pegging the price of government securities, because that would subordinate monetary policy to the fiscal needs of the U.S. Treasury. In addition, the outbreak of the Korean War in 1950 set off a wave of inflation and intensified policy disputes between the Federal Reserve and the Treasury.

After much debate, the Federal Reserve and the Treasury reached an agreement, commonly referred to as the 1951 Accord. The Accord reestablished the Federal Reserve's independence within government and gave the central bank the flexibility to decide how, and for what purpose, to conduct open market operations.

Bretton Woods

The two World Wars affected more than the interaction between monetary and fiscal policy. For all practical purposes, the international gold exchange standard had effectively vanished during World War I. After that war, many countries attempted to return to their former gold standards,

but were unsuccessful. In 1933, in the depths of the Great Depression, the United States ceased gold convertibility.

At the conclusion of World War II, at Bretton Woods, New Hampshire, a system was established that required each country to set a “par” value of its currency relative to the dollar. The U.S. Treasury was committed to redeem surplus dollar claims of foreign central banks, in gold, at the rate of one ounce for every \$35.

Under the Bretton Woods agreements, deficit countries had to use their international gold reserves to redeem their own currencies from the surplus countries at the fixed exchange rate. Alternately, countries with trade deficits would have to use restrictive monetary or fiscal policies to curb their imports, thereby restoring a balance of payments with their trading partners at the declared fixed exchange rates.

As long as the United States ran trade surpluses, running out of gold reserves was not a concern. However, pressures on the U.S. gold reserve began as early as 1958, and despite efforts to adjust the U.S. economy and curtail the gold outflows, these pressures continued and intensified as Vietnam War expenditures increased. Because the domestic economy was straining against its productive capacity, the U.S. balance of payments position deteriorated rapidly, and inflation escalated.

A speculative run on the dollar commenced when world markets became convinced that the United States would not restrict the growth of its domestic economy to support the purchasing power of its dollar. After more than 25 years, the Bretton Woods system of fixed exchange rates collapsed in August 1971, when the United States suspended foreign gold sales.

Although severing the dollar from gold in the international arena initially disrupted trade and somewhat reduced U.S. foreign policy stature, it really did not cause immense domestic economic problems. The volume of foreign trade was small

relative to the size of our economy at the time. Nevertheless, the event was highly significant, in hindsight, as a reminder of the lengths to which our government was willing to go to prevent domestic economic slowdowns. This realization did little to restore foreigners’ confidence in the dollar during the 1970s.

Multiple Objectives

In their 1962 Report, the Council of Economic Advisers argued that discretionary policy was essential for achieving the employment, production, and price stability goals of the Employment Act of 1946.⁹ Some economists called for closer coordination of fiscal and monetary policies.

Throughout the 1960s and 1970s, as policymakers learned that monetary and fiscal policies could have powerful effects on the economy, they began advocating frequent policy changes (that is, using fiscal and monetary policies to “fine-tune” the economy) in an attempt to keep the economy constantly at full capacity. Legislation was enacted that encouraged fine-tuning.

The Full Employment and Balanced Growth Act of 1978, also known as the Humphrey-Hawkins Act, expanded the list of national goals to include “...full employment and production, increased real income, balanced growth, a balanced federal budget, adequate productivity growth...an improved trade balance...and reasonable price stability.”¹⁰

Like the original Employment Act of 1946, the Humphrey-Hawkins Act established general goals for all agencies of government rather than specific assignments for each one. The 1978 Act also established procedures to help coordinate the policies of the various agencies of government to achieve those goals. For example, the Federal Reserve is required to report its monetary policy plans to Congress semiannually, and to comment on the relationship of those plans to the President’s goals.

Balancing Goals

In contrast to those laws, the Federal Reserve Reform Act of 1977 assigned some specific goals to the nation's central bank. Congress amended the Federal Reserve Act of 1913 to require the Federal Reserve "...to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."¹¹ However, the Federal Reserve has the responsibility to decide how best to pursue those goals.

In politically or economically difficult times, incumbent U.S. politicians indulge in a bipartisan practice of blaming the economic ills of the country on the 'misguided' monetary policies of an 'independent' Federal Reserve System.... Holding other things equal, the more dissatisfied that the polls show contributors and swing voters to be with any aspect of the national economy, the closer the date of the next election, and the tighter a Fed-basher's election campaign, the more abuse he or she tends to heap upon the Fed.¹²

Edward J. Kane, "Bureaucratic Self-Interest as an Obstacle to Monetary Policy Reform," 1990

The major drawback to the statutory encouragement of fine-tuning is its infeasibility. To strike a balance among the multiple goals requires that they be reliably linked to one another. Furthermore, the existing legislative framework assumes that monetary policy is capable of influencing simultaneously all three economic dimensions (maximum employment, stable prices, and moderate long-term interest rates) in the desired directions and quantities. This approach to economic policymaking is no longer supported by most new academic thinking nor by practical experience.

By attempting to maintain a balancing act among complex economic goals, the Federal Reserve causes substantial confusion about its capabilities and intentions. Rather than being held accountable for accomplishing anything in particular, the Federal Reserve is expected to manage the entire economy without possessing the tools to do so.

Having multiple goals permits the Federal Reserve to choose which goal is emphasized at any moment, rather than committing to a particular

goal over time. The absence of any prioritization of the legally mandated goals emboldens political and special-interest groups to campaign for the policy stance of greatest current importance to each group.

Ironically, elevating the importance of price stability could enhance the Federal Reserve's ability to craft short-run policy actions in response to problems and crises without affecting inflation expectations. Although the long-term relationship between money and prices appears

to be strong and stable, temporary and unforeseen factors may cause the price level to deviate from its desired course. Fortunately, achieving long-run price stability does not require close, short-run control of the price level. Taking full advantage of the short-term flexibility that these relationships afford, however, requires a profound respect for the price stability objective.

The United States has experienced long periods of both price stability and inflation. A sober assessment of our modern history brings the conclusion that inflation neither buys economic growth nor eliminates business cycles. How much more beneficial for the country it would be to aim for something that monetary policy can actually deliver — price stability — than to unreasonably demand satisfaction on all fronts.

From our early history, we know that political leaders aspired to achieve one simple goal for the country's monetary standard—to protect it from debasement. In particular, they wanted to prevent the government from issuing debt and repaying it later with inflated dollars. They did not countenance unbacked, government-issued paper money.

The transformation of the pre-1933 economy into today's economy required the abandonment of commodity-backed money for two main reasons: gold and silver are expensive to move around safely in large quantities, and a banking system chained to convertibility of bank liabilities proved to be inflexible in accommodating changes in money demand. These shortcomings gave rise to our Federal Reserve System and to other central banks around the world.

But eventually, along with the development of central banks came the belief that monetary and fiscal policies could be used to precisely control the growth of the economy. This view was imposed on the Federal Reserve System by Congress, and the result was that our central bank became accountable for all of the nation's economic goals—an impossible mission.

How can nations design their monetary authorities to be both independent within government, and yet accountable to government? Accountability, improperly framed, can become a serious impediment to the necessary functioning of central banks. But if expectations are limited to achieving one goal, and if expectations for achieving that goal are correspondingly strengthened by Congressional mandate, accountability can provide useful support for central banks.

A Strong Commitment

This commitment to a single goal of price stability seems to be gathering adherents around the world. By law, the German central bank is “not subject to instructions from the Federal Government or, of course, to instructions from any other authority.” Legislation passed in 1957 also specifies that the Bundesbank “support the general economic policy of the Federal Government, but only in so far as this is consistent with its duty of safeguarding the currency.”¹³

In this respect, the Bundesbank's situation is different from the Federal Reserve's. More than one goal is specified by law for the German bank, but the law states that the goal of price stability is to be given highest priority whenever another goal might conflict with maintaining price stability. That is a major reason why Germany's price performance has surpassed that of the United States. The U.S. inflation rate was twice the German rate between 1960 and 1990!¹⁴

Austria and New Zealand have amended their central bank laws to make price stability the central bank's primary mandate. In addition, the Maastricht agreement, which spells out the framework for establishing a European central bank in 1999, makes price stability the primary objective for the new central bank.

Even some countries with poor inflation performance, such as Chile, have sought to restore their central bank's credibility. By enacting legislation that gives them more formal independence from their governments in conducting monetary policy, such nations have taken the first step toward achieving price stability. Similar steps are being considered in Argentina, Czechoslovakia, and Poland.

If the United States were to legislate a clear price stability objective for the Federal Reserve, the nation would benefit. The next best solution (the one actually followed, in fact, in this country from the time of Alexander Hamilton) calls for a central bank whose structure provides the most independence that the political system can bear.

"Exquisite Balance" Revisited

The framers of the Federal Reserve Act intentionally built in provisions to keep the Federal Reserve independent from political pressures. Subsequent revisions to the Federal Reserve's structure, especially in 1935, added more layers of insulation to protect the System from the countervailing economic and political realities that evolved.

Long terms for members of the Board of Governors are a keystone of the System's structure. The seven governors are appointed by the President of the United States and approved by the Senate. Governors are appointed for 14-year terms, which are staggered, every two years, to keep turnover on the Board at a measured pace. No two governors can be from the same Federal Reserve District. Removing the Secretary of the Treasury from the Board in 1935 further emphasized the congressional desire to shield the Federal Reserve from the partisan political arena.

Reserve Bank presidents and directors also contribute to the Federal Reserve's independence. Directors oversee Bank operations, which are conducted like for-profit businesses. These individuals have vast experience in banking and commerce, and continue to provide the practical and regional input to the Federal Reserve that was a hallmark of the System at its inception. Because directors are not political appointees (in fact, they are prohibited from participating in partisan political activities during their tenure as directors), they provide an added degree of insulation to the System.

The Board of Governors appoints three of the nine directors and, from those three, designates a chairman and deputy chairman of each Bank's board. Each Reserve Bank's board of directors, in turn, is responsible for appointing the president of its Reserve Bank — subject to approval by the Board of Governors. The presidents participate in the monetary policy process through the FOMC. The president of the New York Fed is a permanent voting member, along with the 7 governors. The remaining 11 presidents vote on the FOMC on a rotating basis (only 4 of the 11 vote at each meeting).

The entire process yields an FOMC consisting of a majority set of public officials and a minority set of Reserve Bank presidents acting for the public good. The majority set of officials ensures that the legitimate interests of government are represented. The President of the United States also designates and appoints the chairman of the Board of Governors to a four-year term. The Board of Governors has exclusive power to determine the discount rate upon receiving recommendations for changes from the boards of directors of the Federal Reserve Banks.

The minority set of FOMC members is selected by a process designed to minimize the effects of short-term political pressures. Their presence serves as an institutional, flesh-and-blood buttress to the commitment of central bank independence within government.

To some, the Federal Reserve System's design might appear needlessly complex, but an appreciation of history and politics reveals why economic statesmen crafted an institution with such a broadly dispersed power structure. If they had thought of monetary policy as a cookie jar, eternally tempting to politicians, the Federal Reserve's sponsors would have regarded their structure as a means of placing that jar on the top shelf of a tall, locked cupboard. A determined and persistent government could eventually get that jar down from the shelf, but it would have to be very serious about its mission to do so.

Conclusion

Our performance on price stability since 1935 could have been better. Once the nation formally broke away from the gold exchange standard, the U.S. dollar lost its anchor to price stability, and inflation rapidly spun out of control in the 1970s. The political will to rein in inflation took nearly a decade to muster. More recently, the Federal Reserve has made great progress in reducing inflation from the high levels of the late 1970s and early 1980s. However, inflation has not been eliminated, and the important progress of recent years rests on a fragile commitment that may be abandoned.

The nation should not be wholly satisfied with the performance of the Federal Reserve System. By assigning the Federal Reserve multiple monetary policy objectives, Congress has provided insufficient guidance. Consequently, some people are correctly suspicious of the Federal Reserve's ultimate commitment to price stability.

A price stability mandate would shift the focus of monetary policy away from short-term fine-tuning to the long term, where it belongs. Such a mandate would enforce accountability for the one vital objective that the Federal Reserve can achieve, and it would officially sanction those sometimes unpopular short-run policy actions that most certainly are in our nation's long-term interest.

Fortunately, the Federal Reserve has a structure that permits it to operate with some degree of independence from partisan political pressures. The present structure originated in a different era, when the responsibilities and powers of the Federal Reserve were thought of quite differently. As the role of the central bank evolved, Congress contemplated changing the structure many times, but essentially has not done so for more than 50 years. Changes that are made should be consistent with strengthening, not weakening, the Federal Reserve's commitment to price stability and its independence.

Contemplated changes to the Federal Reserve System should be debated widely, openly, and at length. In this essay, we argue that the focus of the debate should be on how to improve the Federal Reserve's performance. Setting clear, achievable objectives and holding the Federal Reserve publicly accountable for achieving those objectives will result in monetary policy that contributes to maximum sustainable economic growth.

Footnotes

1. Edwin Vieira, *Pieces of Eight: The Monetary Powers and Disabilities of the United States Constitution* (Darby, 1983), pp. 98-9.
2. Suggested Plan for Monetary Legislation, Senate Document No. 784, 61 Cong. 3 Sess. (Government Printing Office, 1911).
3. *John Melcher v. Federal Open Market Committee*, United States District Court for the District of Columbia, Civil Action No. 84-1335 (1986).
4. Board of Governors of the Federal Reserve System, *First Annual Report of the Federal Reserve Board*, 1914 (GPO, 1915), p. 16.
5. Lester V. Chandler, *Benjamin Strong, Central Banker* (The Brookings Institution, 1958), p. 222.
6. Allan Sproul, "Reflections of a Central Banker," *Journal of Finance*, vol. XI (March 1956), pp. 4-5.
7. A. Jerome Clifford, *The Independence of the Federal Reserve System* (University of Pennsylvania Press, 1965), pp. 163-96.
8. Employment Act of 1946, Section 2, as recorded in the *United States Code: Congressional Service, Laws of 79th Congress, Second Session* (West Publishing Company), p. 20.
9. *Economic Report of the President*, January 1962 (GPO, 1962).
10. Full Employment and Balanced Growth Act of 1978, as recorded in the *United States Code: Congressional Service and Administrative News, Laws of 95th Congress, Second Session* (West Publishing Company).
11. Federal Reserve Reform Act of 1977, as recorded in the *United States Code: Congressional Service and Administrative News, Laws of 95th Congress, First Session* (West Publishing Company).
12. Edward J. Kane, "Bureaucratic Self-Interest as an Obstacle to Monetary Reform," in Thomas Mayer, ed., *The Political Economy of American Policy* (Cambridge University Press, 1990), pp. 287-8.
13. Bank for International Settlements, *Eight European Central Banks* (George Allen and Unwin Ltd., 1963), pp. 56-7.
14. *Economic Report of the President*, January 1991 (GPO, 1991), p. 408.

Comparative Financial Statement

For years ended December 31

Statement of Condition

Assets

	1 9 9 1	1 9 9 0
Gold certificate account	\$ 692,000,000	\$ 688,000,000
Special drawing rights certificate account	645,000,000	645,000,000
Coin	30,183,268	39,289,608
Loans and securities:		
Loans to depository institutions	-0-	-0-
Federal agency obligations bought outright	378,205,795	379,907,713
U.S. government securities		
Bills	8,299,003,637	6,740,802,414
Notes	6,352,112,831	5,475,949,688
Bonds	2,022,987,976	1,866,912,501
Total U.S. government securities	16,674,104,444	14,083,664,603
Total loans and securities	17,052,310,239	14,463,572,316
Cash items in process of collection	353,848,298	256,888,868
Bank premises	34,300,807	36,121,850
Other assets	1,777,907,651	2,126,715,647
Interdistrict settlement account	1,765,980,255	1,076,627,132
TOTAL ASSETS	\$22,351,530,518	\$19,332,215,421

Liabilities

Federal Reserve notes	\$19,949,460,886	\$17,005,076,555
Deposits:		
Depository institutions	1,571,163,262	1,816,463,408
Foreign	7,755,000	8,250,000
Other deposits	87,808,726	2,061,427
Total deposits	1,666,726,988	1,826,774,835
Deferred availability cash items	269,814,840	82,867,142
Other liabilities	143,216,304	166,785,489
TOTAL LIABILITIES	\$22,029,219,018	\$19,081,504,021

Capital accounts

Capital paid in	\$ 161,155,750	\$ 125,355,700
Surplus	161,155,750	125,355,700
TOTAL CAPITAL ACCOUNTS	\$ 322,311,500	\$ 250,711,400
TOTAL LIABILITIES AND CAPITAL ACCOUNTS	\$22,351,530,518	\$19,332,215,421

Income and expenses

Current income

	1 9 9 1	1 9 9 0
Interest on loans	\$ 477,189	\$ 773,106
Interest on government securities	1,181,833,460	1,176,904,432
Earnings on foreign currency	129,935,784	143,052,007
Income from services	43,638,765	43,460,030
All other income	635,040	623,087
Total current income	\$ 1,356,520,238	\$ 1,364,812,662
Current operating expenses	77,244,050	69,518,138
Cost of earnings credits	8,545,603	10,432,184
CURRENT NET INCOME	\$ 1,270,730,585	\$ 1,284,862,340

Profit and loss

Additions to current net income		
Profit on foreign exchange transactions	\$ 21,833,126	\$ 3,772,191
Profit on sales of government securities	8,018,932	117,666,511
All other additions	935	11,432
Total additions	\$ 29,852,993	\$ 121,450,134
Deductions from current net income		
Loss on foreign exchange transactions	\$ -0-	\$ -0-
All other deductions	6,240	1,712
Total deductions	\$ 6,240	\$ 1,712
Net additions or deductions	\$ 29,846,753	\$ 121,448,422

Assessments by Board of Governors

Cost of Unreimbursable Treasury Services	\$ 9,694,406	\$ 11,878,601
Board of Governors expenditures	6,028,900	5,676,400
Federal Reserve currency costs	16,602,497	12,427,914
Total assessments by Board of Governors	32,325,803	29,982,915
NET INCOME AVAILABLE FOR DISTRIBUTION	\$ 1,268,251,535	\$ 1,376,327,847

Distribution of net income

Dividends paid	\$ 9,032,226	\$ 7,488,534
Payments to U.S. Treasury (interest on Federal Reserve notes)	1,223,419,259	1,366,983,763
Transferred to surplus	35,800,050	1,855,550
Total distributed	\$ 1,268,251,535	\$ 1,376,327,847

Directors

As of December 31, 1991



Cleveland Directors
(standing) Alfred C. Leist; William T. McConnell; Frank Wobst;
Laban P. Jackson, Jr.; (seated) Deputy Chairman
A. William Reynolds; Chairman John R. Miller.

Cleveland

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As of December 31, 1991

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Senior Vice President
& Director of Research

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Vice President

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Robert B. Schaub
Assistant Vice President

Columbus

Charles F. Williams
Vice President

The Federal Reserve System is responsible for formulating and implementing U.S. monetary policy. It also supervises banks and bank holding companies, and provides financial services to depository institutions and the federal government.

The Federal Reserve Bank of Cleveland is one of 12 regional Reserve Banks in the United States that, together with the Board of Governors in Washington, D.C., comprise the Federal Reserve System.

The Federal Reserve Bank of Cleveland, its two branches in Cincinnati and Pittsburgh, and its Columbus Office serve the Fourth Federal Reserve District. The Fourth District includes Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky.

**Federal Reserve
Bank of Cleveland**

Main Office

East 6th Street and
Superior Avenue
Cleveland, OH 44114
216.579.2000

Cincinnati Branch

150 East 4th Street
Cincinnati, OH 45202
513.721.4787

Pittsburgh Branch

717 Grant Street
Pittsburgh, PA 15219
412.261.7800

Columbus Office

965 Kingsmill Parkway
Columbus, OH 43229
614.846.7494

Design: Michael Galka
Photography: Bill Pappas

This annual report was prepared by the the Public Affairs and Bank Relations Department and the Research Department, Federal Reserve Bank of Cleveland.

For additional copies of this report, contact the Public Affairs and Bank Relations Department, Federal Reserve Bank of Cleveland, P.O. Box 6387, Cleveland, OH 44101, or call 1-800-543-3489.

