Roger W Ferguson, Jr: The evolution of central banking in the United States

Remarks by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, at a European Central Bank Colloquium in Honor of Tommaso Padoa-Schioppa, The European Central Bank, Frankfurt, Germany, 27 April 2005.

The references for the speech can be found on the website for the Board of Governors of the Federal Reserve System.

*   *   *

This conference honors the many contributions of Tommaso Padoa-Schioppa. As a staff member at the Banca d'Italia starting nearly four decades ago and as a member of the Executive Board of the European Central Bank (ECB) since 1998, Tommaso has been deeply involved in what central banks do and how they are organized.

Tommaso has stated: "In shaping monetary policy operations, the role of the financial environment is not less important than the charter."[1] That observation was made in the context of the way open market operations ought to be conducted, but I would like to interpret it more broadly in my remarks today. In particular, I will address the question of whether a central bank's operations depend in an important way on the architecture of the financial system and the economy it serves. The charter imposes a certain framework, but events may require changes to procedures and, on rare occasion, changes to the charter.

To explore this topic, I would like to discuss the evolution of central banking in the United States, with particular reference to currency, relations between the regions and the center, mandates, and communication. Along the way, I will compare our experience with that of the ECB. I will, of course, be speaking for myself and not my colleagues at the Federal Reserve. To start, let me address the title of this session: "A Single Currency and a Team of Thirteen Central Banks." How did the United States develop a single currency, and what are the parallels that we can draw with the euro?

A single currency

Although the notes of the First and Second Banks of the United States achieved relatively wide circulation, not until the 1860s, during our Civil War, did a national paper currency become established. The first step was an issuance of Treasury currency, commonly known as "greenbacks" because of the color of the ink used to print the notes. Shortly thereafter, the Congress authorized the establishment of national banks, which issued notes that were backed by holdings of government bonds. National bank notes of different banks were similar in design and widely accepted in transactions, but the system had some flaws - the main one being that there was no means of quickly adjusting the supply of national bank notes to changing circumstances. In other words, we had established a national currency system but not a central bank to manage it.

This beginning contrasts with the way the euro was established as a single currency out of many European currencies. Rather than having no central bank, what was to become the euro area had, in fact, twelve national central banks, each managing its own currency. Those currencies were brought into line with one another, first through the exchange rate mechanism and later by the permanent fixing of exchange rates. The ECB then was created as a central bank to manage the euro even before a euro paper currency came into existence.

Federal Reserve notes began to circulate in 1914. The System's treatment of these notes serves as an example of Tommaso's observation that central bank operations respond to financial events. Initially, notes issued by one Reserve Bank could not be reissued into circulation by another Reserve Bank. A person could travel from Boston to New York with notes from the Federal Reserve Bank of Boston in his pocket, spend the notes in New York, and have them accepted. But when the notes made their way to the Federal Reserve Bank of New York, that Bank returned the notes to Boston for re-issue. With regard to currency, then, the Federal Reserve System's charter established twelve banks issuing similar, but not identical, currency. Over time, however, financial practice made this distinction unimportant, and the treatment was later discontinued. Today, currency is treated fungibly

---

1 Padoa-Schioppa (2004), pg. 86.

by the Reserve Banks, regardless of which Bank issued the note. The notes still carry identifiers that let us track the Reserve Bank to which the notes were originally assigned, and they are still allocated as liabilities to individual Reserve Banks. But there is no practical distinction between the notes of the Reserve Banks.

My understanding is that euro banknotes circulate in a similar fashion within the euro area and that any national central bank can re-issue fit euro banknotes regardless of the original issuer. Although the country that originated the production order is indicated by the letter prefix to the euro banknotes' serial number, even that designation is becoming less important as the Eurosystem moves to a pooled system of printing banknotes. Even though the Eurosystem contains the central banks of sovereign nations, the unified treatment of euro banknotes recognizes the unifying force of a single currency.

Clearly, then, as one considers currency, the history of the Federal Reserve supports and reflects the truth of Tommaso's statement. As our economy evolved from regional to national, our currency moved more completely in that direction. I would argue that the euro reflects a different perspective, with the currency playing a catalytic role in the development of a continental economy as well as reflecting developments in that regard.

Regions and the center

In 1913, the very idea of a central bank was contentious in the United States. The result of the Federal Reserve Act was a compromise, with regional Reserve Banks owned by their member commercial banks and a Board in Washington to provide oversight. Although the integration of U.S. financial markets was considerable by the time the Federal Reserve Act was passed, remaining segmentation made it possible to have different prices for Reserve Bank credit in different regions during the System's early years. To be sure, these differences were not huge - basic discount rates differed by as much as 1-1/2 percentage points, with differences of 50 to 100 basis points persisting for long periods. In Tommaso's terms, monetary policy operations - that is, discount policy - reflected both the regional nature of the System's charter and the partial segmentation of the financial environment.

Further integration of the money market over time shifted the focus of policy from twelve regional discount policies to a single national policy. In addition, concern about operational efficiencies and about the level of borrowing led to a move from discount rates to open market operations as the policy instrument of choice. This shift may also have been aided by the expansion of the government bond market during and after World War I. The use of open market operations accelerated the desire for coordination of policy at the national level, so that one Reserve Bank was not draining liquidity at the same time that another was adding liquidity. Again, the financial environment contributed to developments in policy implementation.

The balance of policy power shifted from the regions to the center, when the Banking Act of 1935 established the Federal Open Market Committee in its modern form, with the Board having the majority of votes. From the perspective of monetary policy, it was at that point that the Federal Reserve System became a single central bank rather than a confederation of regional central banks. Thus, as Tommaso might suggest, charter changes also played an important role in the structure of policy.

In the Eurosystem, the balance between the center and the regions is still evolving. The composition of the Governing Council, the Eurosystem's equivalent to the FOMC, and the administrative roles of the Governing Council and the Executive Board reflect the relative strength of the national central banks. This difference in the relative power of the center, however, should not have great significance for the conduct of monetary policy. As in the Federal Reserve System, each Eurosystem policymaker is expected to act in the interest of the entire currency area.

In the United States, once policy implementation boiled down to managing the consolidated balance sheet of the Federal Reserve Banks, it made sense to concentrate open market operations in New York, where most major banks and dealers had offices. New York bought and sold on the FOMC's orders, but the resulting portfolio was allocated to each Reserve Bank based on its capital. In the Eurosystem, open market operations are conducted in a unified but decentralized manner. Each national central bank collects bids from financial entities in its country and relays those to the ECB where they are ranked and allocated accordingly.

I would argue that these slight variations in the implementation of monetary policy reflect the financial circumstances under which each institution operates, with a unified money market in the United States and more-fragmented (but consolidating) money markets in the eurozone.

Internal dynamics

Although the 1935 legislation that created the Federal Open Market Committee of today shifted monetary policy power from the regions to the center, important questions remained about the internal workings of the FOMC itself. With only five of the twelve Reserve Bank Presidents on the Committee at any one time, how were these seats to be allocated?[2]

The FOMC finally settled on a rotation system that was a compromise between strict equality and relative importance of each District in the financial system. New York was given a permanent seat. Cleveland and Chicago were grouped together, and the remaining Reserve Banks were put into groups of three. Thus, Presidents of Reserve Banks other than New York would be FOMC members every other year or every third year. That rotation structure has remained unchanged since 1942.

The FOMC operates through formal votes on policy questions, yet in recent years dissents in the recorded votes have been remarkably rare. Through discussion and with the leadership of the Chairman, the Committee often crafts a policy action that all members can agree on. Yet, if one looked only at the final vote, one would miss the lively and wide-ranging debate that goes on within the meetings themselves. We try to give the flavor of this debate in the minutes released three weeks after each meeting, and we do release detailed transcripts with a lag of five years.

My understanding is that the ECB's Governing Council operates by consensus, although a procedure is in place for a majority vote to determine the course of monetary policy. So far, the ECB has maintained the principle of one member, one vote, with the six Executive Board members and the twelve national central bank presidents voting equally regardless of the economic size of the country that they represent. The ECB has had to wrestle with how to adjust voting as the euro area expands over the next decade or so. The European Council has accepted a proposal from the ECB to cap the number of voting national central bank presidents at fifteen and to begin rotational voting once the number of countries in the euro area exceeds fifteen. The voting rotation would look a bit like that initially established by the Federal Reserve, with the frequency of voting by individual members depending in part on the economic and financial size of their regions. The big difference, however, is that the national central bank presidents would have fifteen votes versus the six votes of the Executive Board members, whereas Federal Reserve Board members have a seven-to-five voting advantage over regional Fed Presidents.

Clearly the system that we follow, with strong regional representation but a majority in the center, reflects the judgment made in 1935 regarding the primacy of political appointees with a national mandate. I would argue, although those closer to the scene might correct me, that the ECB's approach to its regional representation reflects an evolving compromise that attempts to balance the ongoing legitimacy of national monetary authorities with the need for a practical solution to the challenges posed by the increasing number of nations within the eurozone.

Mandates and approaches to monetary policy

The original Federal Reserve Act contained almost no explicit macroeconomic goals for the System to follow. The gold standard was thought to be sufficient to produce price stability, and the central bank's lending to meet the needs of trade ("real bills") was seen as fostering financial stability and the smooth functioning of the economy. Nonetheless, fairly early in its history, the Federal Reserve interpreted its mandate to be the promotion of monetary and credit conditions that would foster sustainable growth

[2] At any given time, the FOMC consists of only twelve members - the seven members of the Board of Governors and five of the twelve Reserve Bank Presidents on a somewhat complicated rotating basis. By custom, however, all twelve Reserve Bank Presidents attend the meetings of the Committee. The extra seven presidents are not considered nonvoting members of the FOMC; they are just not on the Committee at that time. Since there are no nonvoting members of the FOMC, the term "voting member of the FOMC" is redundant. A more accurate term is "non-voting participant." To complicate matters further, some of the extra seven Reserve Bank Presidents are designated as alternate members of the FOMC, depending on the rotation group arrangement.

and a stable value of the dollar. After the Great Depression and World War II, the federal government took a more-active role in managing the macroeconomy. The Employment Act of 1946 committed the federal government to use its resources to foster maximum employment. This act provided some broad guidance for the Federal Reserve but not explicit goals for monetary policy.

Against the backdrop of poorer economic performance in the 1970s, the Congress gave the Federal Reserve explicit goals in a 1977 amendment to the Federal Reserve Act. These goals were stated in terms of maintaining long-run growth of monetary and credit aggregates that would promote "maximum employment, stable prices, and moderate long-term interest rates." Thus, the mandate really contained three goals, but the last one has been widely interpreted as those long-term interest rates consistent with the first two goals, giving the Federal Reserve a "dual mandate" of maximum employment and stable prices.

Many times in recent decades, the Federal Reserve has stressed its long-run goal of stable prices, linking it with the other half of our mandate by noting that in the long run the two do not conflict. However, at times the Federal Reserve has used the flexibility that our dual mandate provides to consider the variability of real output in policymaking.

For the ECB, the Maastricht treaty mandated that price stability would be the primary objective. The treaty also established that the ECB should support the general economic policies of the European Community, aiming at growth and employment but only insofar as price stability is not endangered. This focus on price stability helped establish credibility for the new central bank and has helped anchor inflation expectations among the public. A case can be made that the primacy of the inflation goal also reflected the Bundesbank's distaste for inflation in light of the German hyperinflation of the 1920s and that this legacy was bequeathed to the new European Central Bank. Still, policymakers need to be free to act when severe supply shocks occur. The ECB has wisely interpreted its mandate as maintaining price stability "over the medium term," giving it flexibility to deal with temporary shocks.

Obviously, in both the United States and Europe, external conditions and experiences have guided the development of the mandate, as Tommaso would have suggested and common sense dictated.

Communication and transparency

As the conduct of monetary policy has changed over time, it has become increasingly important that the central bank communicate in an effective and transparent manner. The Federal Reserve's communications efforts are a work in progress, with several significant advances being implemented over the past few years. In March 2002, the FOMC began to release the vote of its members immediately after its meetings. In December 2004, the FOMC accelerated the release of its minutes from an average of six weeks after the meetings to just three weeks after the meetings. As part of its communication efforts, the Federal Reserve, since the late 1970s, has been providing forecasts of inflation and real economic activity twice a year, as several other central banks have elected to do more recently. Until recently, these forecasts had a horizon that could be as short as one year. This past January, the semiannual FOMC forecasts reported in the Monetary Policy Report were extended to include the following calendar year.

ECB communication practices differ in some notable aspects from those of the Federal Reserve, with the differences partly reflecting the ECB's unusual situation as a multinational central bank. The ECB does not release minutes or transcripts and does not provide information on Governing Council votes. Rather than detailing the differing views of individual members, who might feel pressure to represent their national interests if their votes were made public, the ECB focuses on explaining the analysis behind the Governing Council's consensus. In particular, the ECB follows its monetary policy meetings with a news conference in which the president reads a statement reflecting the Council's deliberations and then answers questions.

Changes to ECB communication policy in recent years also have reflected the ECB's multinational status. In December 2000, when the ECB started releasing twice-yearly forecasts of gross domestic product and inflation, it chose to release its staff forecasts, in contrast to the practice of the Federal Reserve, which releases the range and central tendencies of projections of the individual FOMC members.

I would argue that the Federal Reserve's ongoing process of transparency may also reflect the highly developed state of our financial markets and a growing recognition that, against that financial backdrop, shaping the expectations of market participants can on occasion be an important adjunct to monetary policy. I would be curious to learn the degree to which the ECB's approaches to communications reflect the financial circumstances as well as the multinational nature of the institution.

Conclusion

In conclusion, I would like to stress the importance of Tommaso's observation about policy that I quoted at the outset. Monetary policy arrangements do, and should, adjust over time to changes in the economic and financial environment. This brief review of the history of the Federal Reserve shows this adjustment process at work over our ninety-year history. The charter lays out a structure for policy implementation that is appropriate for the financial system of the day. The financial system then changes and policy implementation must adapt. Eventually, changes in the financial system can trigger changes in the charter that give policy implementation a new context. While there is no single best way to arrange monetary policy and central bank functions within a multiregional system, I am struck by the broad similarities between the Federal Reserve and the Eurosystem as each grapples with a large, complex, and ever-changing macroeconomy. In some ways, your experience has collapsed into several years changes that evolved over decades for the Federal Reserve. But both experiences, and the ongoing changes in the economic environment in which we operate, suggest that the art of central banking is certainly likely to undergo further changes.