

For Release on Delivery  
November 16, 1988  
5:30 P.M. Central European Time  
11:30 A.M. E.S.T.

NOV 16 1988  
11/16/88

THE AMERICAN EXPERIENCE WITH CENTRAL BANKING  
AND EUROPEAN MONETARY INTEGRATION

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Annual Meeting of the Swiss Association for Monetary Studies  
Zürich, Switzerland  
November 16, 1988

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It is a great pleasure for me to be with you today in the wonderful city of Zürich. When your esteemed Association invited me to reflect upon the American experience with central banking and to draw possible implications for European monetary integration, I gladly accepted the challenge.

Having spent half my life in Europe and half my life in the United States, it goes without saying that I remain keenly interested in European events. I also believe that American central banking history is well worth studying, because it represents a rich lode of experience gathered over two centuries.

Let me therefore follow your invitation to offer my personal views on this topic within the limited framework of a half-hour lecture. Needless to say, the topic is so vast that it could fill several scholarly volumes, and much will have to remain unsaid and unexplored.

Europe is now embarking on an historic endeavor toward greater economic, financial, and monetary integration. Living at the end of the twentieth century, and accustomed to viewing the United States as a mature,

integrated economy, we may forget that it, too, once confronted the problems of consolidating its economy and of developing appropriate institutions. These problems were compounded and complicated by the fact that the young nation was still expanding geographically - but so is the European Community.

The differences between America then and Europe now are vast. But America's experience was so rich and varied, and the issues that arose in America were so much like those now discussed in Europe, that a review of the American experience may yield some useful lessons for European integration as well.

Those who ignore history, we are told, are condemned to repeat it. And the American experience is replete with mistakes that do not bear repeating.

#### The First and Second Bank of the United States

The first Congress of the United States convened in 1789 in New York. After electing George Washington as President, naming Philadelphia as the temporary capital of the new country, and establishing Washington as the permanent capital, attention quickly turned toward financial matters: the need to raise revenue and the founding of the First Bank of the United States.

Alexander Hamilton, the first Secretary of the Treasury, urged the creation of a national bank. The Bank was to be chartered for 20 years with headquarters in Philadelphia.

The bill establishing the First Bank of the United States won by a comfortable margin in the House of Representatives -- 39 to 20. But 19 of the "No" votes came from the representatives of the largely rural southern states. They feared that the bank would serve mainly the interests of the merchants and investors of the North by restricting the supply of money and thus depriving the farmers and the yeomen of the South of the easier money they wanted. Thus, at its very inception, the Bank was already seen as the servant of particular regional interests.

In spite of these problems, the First Bank served the new nation well, and proved essential in the early development of the nation by providing the country with a sound and elastic currency. To prevent overissue, the bank redeemed excess bank notes in specie. Also, much like a modern central bank, it offered fiscal services for the government such as transferring government funds and providing a safe depository for bank notes. In addition, it helped to collect revenues and provided the bullion needed by the mint

for coinage.

The First Bank of the United States dissolved when its charter ran out in 1811 during James Madison's presidency. Although a strong opponent of the original bill in 1791, Madison rethought his initial constitutional objections and favored rechartering the bank for economic expediency. Even so, the bill to recharter failed in both houses by a one-vote margin.

After the overextended structure of credit granted by state banks collapsed under the pressure of the British invasion of Washington in 1814, President Madison pushed for the establishment of the Second Bank of the United States. By 1816, the Second Bank of the United States was in operation, again with a 20-year charter. After fueling an inflationary boom, the Bank was blamed for the bust of 1819 -- which was actually part of a world-wide collapse.

Animosity toward the "Federal Banking Monster" became so strong that individual states attempted to tax the operations of the national bank in an effort to close its doors. However, in 1819, the Supreme Court upheld the constitutionality of the Bank in the celebrated case of *McCulloch v. Maryland*. "The power to tax is

the power to destroy," wrote Chief Justice John Marshall in a decision that had historic ramifications far beyond the issue of the legitimacy of the central bank. He argued that individual states did not have the power to nullify acts of the Congress by attacking its agencies. The Bank had withstood the threat to its existence.

In 1823, Nicholas Biddle became president of the Second Bank, and for nearly a decade the Bank maintained a sound and stable currency. At the same time, however, state-chartered private banks often overextended credit, and financial instability was widespread. Many bankers viewed the Second Bank of the United States as an unnecessary constraint on their activities, and the traditional opponents from the southern and western states continued to voice their displeasure at the bank's monopoly. When President Andrew Jackson, along with conservative groups, questioned the Bank's constitutionality, the institution was doomed. The Bank had lost its popular support, and President Jackson vetoed its rechartering. Thus ended the Second Bank of the United States.

The lesson to be drawn is that no central bank -- no matter how well managed -- can survive without the support of the people it serves.

## The Era of Free Banking

An era of free banking ensued, in which individual state-chartered banks issued bank notes that circulated as currency, and credit was freely granted to all comers. Land speculation was rampant, and prices skyrocketed. Needless to say, the same conservatives who had opposed the Second Bank for the constraints it imposed viewed these developments with deep misgiving. They demanded that the government sell its land only for gold or silver. When this policy was implemented in the summer of 1836, the speculative land boom burst. It did not take long for commodity prices and the stock market to collapse, and the Panic of 1837 was on.

Matters were further complicated by the failure of three large British banks in 1836. When their credit lines to American banks were cut off, American financial woes worsened. Banks failed everywhere and bankruptcies multiplied, pulling the economy into a severe recession.

But these were also the years when the American Midwest was settled and when the push to the Pacific Ocean began. The days of the "Wild West" and free banking were on.

During the following decades, two powerful undercurrents dominated the American economic and financial scene. On the one hand, western and southern farmers, ranchers, and miners saw easy money and credit in their interest because it enhanced the monetary value of the commodities they produced. On the other hand, those in commerce, trade, and manufacturing in the East felt that their interests would be served best by "sound" money and a "strong" dollar, both at home and abroad.

During this period, the U.S. Treasury exercised various central banking powers, along with some of the stronger private banks. But no institution was formally charged with the responsibility of controlling money and credit in the public interest. At times, the nation was effectively on a gold standard; at other times, it was on a bi-metallic standard. Private banks freely issued bank notes that were supposed to be convertible into specie or "lawful money", but it was not always easy to track down the bank and actually to get paid in gold or silver. News circulars published the current value of bank notes issued by various banks, just as today's newspapers publish exchange rates and stock market prices. Speculative booms and busts alternated with frustrating rapidity. And apart from the tragic consequences it had for the nation's political and



social history, the Civil War had a devastating economic and financial impact. What kept the nation going was the tremendous westward expansion and the riches that could be amassed by enterprising men.

To the late nineteenth-century observers in Europe, the American monetary and economic boom-and-bust cycles were distressing -- a distress that was more than purely intellectual. Many European investors participated in the speculative excesses in the United States; and many paper fortunes were lost, along with hard-earned investment funds that had been gambled away in alluring but risky investments.

Eventually, the Panic of 1907 forced politicians and the public to face up to the need for monetary and currency stability. Bitter experience had taught the nation that a central bank fulfilled essential functions; and the search for an appropriate framework began.

### The Federal Reserve System

This was the environment in which the Federal Reserve System was formed. When it came into being in 1913, the new institution was seen as a bulwark against periodic collapses of the financial system like those

that had plagued the United States since the Second Bank of the United States went out of existence.

The commission charged with planning the new organization drew extensively from the experience of European countries with central banks. The European central banks served the public and national interests by providing for a sound currency and through controlling the amount of money and credit in existence. They also intervened in financial markets during liquidity crises to forestall cumulative monetary contractions.

The U.S. Congress and the administration saw clearly that these powers, as exercised successfully in Europe, were also desirable for a central banking system in the United States.

However, the United States consisted of a collection of individual states, each with its own banking laws and with its own interests dictated by its special economic circumstances. Various factions proposed alternative plans -- some calling for a strong central institution, some favoring a system of regional reserve banks. Nelson Aldrich, a conservative Senator from Rhode Island, urged the establishment of a strong central bank, while Carter Glass, a Representative from

Virginia, sponsored a plan calling for the establishment of 20 privately controlled reserve banks. The division of North versus South, merchant versus farmer, federal power versus state power, persisted.

In the end, President Woodrow Wilson and the Congress crafted a unique institution that balanced regional and private interests with the interests of the nation as a whole. Within the Federal Reserve System were twelve regional Federal Reserve Banks, each under the direction of a Board of Directors that represented the banking, commercial, and public interests of that region. The System as a whole was placed under the direction of a federal agency, the Federal Reserve Board, which consisted of the Secretary of the Treasury, the Comptroller of the Currency, and five persons appointed by the President.

The Congress explicitly refrained from creating one all-powerful central bank for the United States that might ignore the needs and interests of a far-flung and diverse nation. Instead, the system devised was intended to be responsive to the special circumstances of each District. The District Banks were to provide reserves and liquidity to the banks that were members of the System as the needs of the local economy required. The discount rate of each Reserve Bank was

to be established by its Board of Directors with the approval of the Federal Reserve Board. It was fully anticipated that discount rates would differ among the Districts. Similarly, when the Reserve Banks more or less discovered open market operations as they invested the reserves the member banks deposited with them, each began to buy and sell Treasury securities as it deemed desirable for the needs of its local economy.

As you might expect, in an economy with no geographic constraints on trade or credit flows, differentials in regional interest rates could not persist; and different open market operations by Reserve Banks meant simply that one District's actions offset another's in the national total. In an attempt to avoid the pursuit of conflicting policies, the Federal Reserve set up a committee to oversee the System's open market operations. But it was not until 1935 that Congress created the official Federal Open Market Committee to determine and to implement open market operations. Even here, the regional principle had a strong influence: the FOMC comprised five of the twelve Reserve Bank presidents and the seven Members of the Board of Governors of the Federal Reserve System.

The composition of the Federal Reserve Board itself was also changed. To underscore the independence of the Federal Reserve from the administration, the Secretary of the Treasury and the Comptroller of the Currency were dropped, and the Board henceforth consisted of seven governors serving 14 year terms, with a chairman and vice chairman appointed for four year terms. Once again, regional interests were acknowledged: no Governor was to be from the same district as another Governor.

Thus, the Federal Reserve System became one central bank that conducts and implements a unified monetary policy for the United States. Yet it still reflects its regional and decentralized foundations and draws strength from them. In particular, the regional Boards of Directors and the Presidents of the Reserve Banks bring important regional and sectoral information to bear on the decisionmaking process.

This experience offers two important lessons: One, there is strength in diversity and an institution that reflects a broad spectrum of information and policy perspectives is appropriate for a large and diversified economy. Second, in a dynamic world, economic institutions must change to reflect the changing needs of the economy they serve.

## Possible Lessons for Europe

How might the American experience help you in Europe as you move toward economic, financial, and monetary integration? Certainly, our institutions differ; and certainly, the times are different. But the long and sometimes painful history of the American central bank may well provide important lessons as you debate the future financial system for Europe.

First of all, as the economic integration of Europe proceeds, it will bring with it an increasing need for financial and monetary integration as well. Important first steps have already been taken through the creation of the European Monetary System, and one should build upon that experience to bring about a further and more complete financial and monetary integration.

Second, the early experience of the United States exposes the perils awaiting an institution that does not recognize the legitimate interests of its diverse constituencies, and that does not have the full support of the political establishment and of the people it is designed to serve. While the majority may impose such an institution, it will be vulnerable to dissension and to attacks that ultimately may doom it.

Most of the European currencies are already tied together in the European Monetary System, which sets narrow bands for the permissible fluctuations in the various currency values. One may well build upon that successful framework for monetary cooperation and in effect create a set of conditions that might result in the general acceptability throughout Europe of any of the member currencies, and therefore, the de-facto creation of a commonly acceptable means of payment.

To implement this plan one would simply multiply the value of each currency by the reciprocal of its central rate versus the European Currency Unit, the ECU, and new bank notes, all similar in design, would be issued by the European central banks.

What would result from this simple step? By multiplying the value of each currency with the reciprocal of its current value of the ECU, the value of all the European currencies would be equal to each other. One mark would now be equal to one franc, one guilder, or one lira. No further conversion calculations would be necessary.

Furthermore, because all the currencies would be similar in design, perhaps distinguishable only by pictures of the various national heroes, the European

public would soon come to accept the various national currencies throughout the continent. In effect, a common European means of payment would be created. Life would be simpler for tourists and businessmen as shops, restaurants, hotels, ticket vendors, and toll collectors could all accept at par the bank notes issued by the central banks. The still permissible margins of fluctuations in currency values should be compensated by the lack of transaction costs at the exchange bureau. The situation would be similar to the one prevailing centuries ago, when gold coins issued by the various princes and kings of Europe circulated throughout the continent. The proposal simply revives an ancient and workable practice.

This proposal sidesteps the thorny political and administrative problems that the immediate creation of a central bank for Europe would pose; it preserves the current administrative structures; it does not require a formal cession of national sovereignty. On the other hand, it gives the advocates of a common European currency much of what they want: a generally acceptable means of payment and a symbol of European togetherness.

Under this proposal, the existing European monetary councils could evolve from institutions that facilitate monetary cooperation to institutions of monetary



coordination. Eventually, they might design and implement a common monetary policy. But the process of achieving monetary unification would be a gradual one, not marked by the instant delegation of national sovereignty to a central organization.

### Conclusion

In conclusion, I believe that just as the United States gained greatly from a study of the European experience with central banks when it designed the Federal Reserve System 75 years ago, Europeans may find it profitable to consider the American experience with a decentralized system. It should also be possible to take the important symbolic step toward a commonly acceptable European means of payment without creating immediately a central European monetary authority.

I hope that my observations and suggestions regarding some of the possible avenues for further progress toward European monetary integration will be taken in the friendly spirit in which they are offered. In any case, I wish Europe well in this historic endeavor to bring the economies and the people of the Continent closer together.

Thank you very much.