One Currency for Diverse Regions: A Balancing Act for Central Bankers

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One theme of this conference centers on the extent to which Europe will become more integrated, particularly in regard to its central banking arrangements. Let me make clear up front that I don't feel that it's my place to lecture Europeans about what they should or shouldn't do about such important issues. Nor do I think that there is one model or a magic formula that a group of countries can follow that will ensure the success of steps to create a currency union or an economic trading bloc. Europe's economies and its central banking institutions will undoubtedly evolve in their own way, based on their historical foundations and the challenges they will face in the future.

Europe consists of a large geographic area that contains a diverse set of economies that engage in a substantial amount of trade. The United States is also a large geographic area that includes a diverse set of regional economies that engage in substantial trade. Furthermore, the U.S. is an area that uses a common currency, and now a large part of Europe has adopted a common currency. Perhaps by telling you about the experience of the United States in establishing the structure of its central bank, I can offer you some insights about the challenges that Europe will face when it addresses changes in its own central banking arrangements. In addition, learning more about how the U.S. deals with having one monetary policy for a diverse set of regions within its borders may be helpful in understanding the conditions that Europe may face in the future.

History of Central Banking in the U.S.

Let me begin with some history of central banking in the U.S. Central banking in the United States evolved, it didn't just spring forth in its current form. Debates about the value of a central bank have waxed and waned over the more than 200 year history of my country. In fact, the concept of a national central bank has always been quite controversial in the United States.

When Congress in 1791 chartered my nation's first central bank, officially called the Bank of the United States but now simply called the First Bank, a major debate about its constitutionality continued for many years. The First Bank's charter, signed by our first President, George Washington, was limited to 20 years and the bank was located in Philadelphia.

Critics argued that Congress had overstepped the authority of the Constitution by establishing the First Bank, and some state representatives felt the First Bank, being a federal (or national) bank, was competing with and squeezing out the banks established by the separate states. The First Bank's charter was not renewed, and it ceased to exist in 1811. During the next few years came the War of 1812 and a boom followed by a bust. Despite a continuing debate about the constitutionality of a federal bank, this period of financial turmoil led Congress in 1816 to charter a second Bank of the United States, also located in Philadelphia.

The Second Bank got off to a rocky start, but eventually became rather influential. Historians maintain that the Second Bank became very effective in managing the country's financial system by finding ways to restrain or encourage the growth of money and credit, particularly by responding to foreign exchange and trade flows, which of course were very important when the U.S. was a young, developing country. But the Second Bank also had the misfortune of becoming involved in partisan politics and, as had been the case with the First Bank, its charter was not renewed.

After the demise of the Second Bank, some elements of central banking were then performed by the U.S. Treasury Department. But the United States was left without a central bank for the next 75 years.

After a series of financial panics in the late 1800s and early 1900s, Congress established a commission in 1908 to examine the need for another central bank. The head of that commission studied European central banks before proposing a new central bank for the U.S. Even with other central banks as a model, several years of debate ensued before Congress passed the Federal Reserve Act at the end of 1913. The debate at that time naturally occurred in the context of the history of central banking in the U.S. And the debate was just as heated in 1913 as it had been in 1791 and 1816.

The Federal Reserve began operating in 1914, and it was built on competing goals that had to be balanced. Let me discuss some of these competing goals.

Centralization vs. Decentralization

In the early 1900s, there were several views of what a central bank should look like. One view was that a central bank should be highly centralized. Another view was that it should be highly decentralized.

People debated whether the Federal Reserve should be located in Washington D.C. or in New York City. Washington was the center of the federal government, and New York was the center of the nation's financial industry. The rest of the country, of course, was not thrilled with either option. Congress ended up exhibiting Solomon-like wisdom by putting an oversight body in Washington, but decentralizing authority throughout the nation by providing for 12 separate Reserve Banks, including one in New York. In this sense, the Federal Reserve was truly created to be federal in nature -- just as the founders of the United States formed a union of 13 separate states that were part of a federal structure within a national government. Congress maintained a balance between centralization and decentralization even when it made major changes to the structure of the Federal Reserve in the 1930s and formalized the structure of the FOMC (the Federal Open Market Committee), which is now the Federal Reserve's main body for making monetary policy.

When the Federal Reserve Banks were originally formed, it was with the idea of operating 12 different monetary policies. Each Reserve Bank established its own discount rate (the interest rate at which it provided collateralized loans to commercial banks), and initially the discount rates in the agricultural areas of the nation were not the same as those in the industrialized northeastern region. But it soon became clear that the nation could not have 12 different monetary policies, because money and credit flowed readily between regions. The credit markets were national, not regional, markets. What's more, the buying and selling of government securities by the individual Reserve Banks came to be coordinated by a committee in order to avoid conflicting effects on credit markets. The formalization of the FOMC in the 1930s as a committee of the seven Fed Governors and five (of the 12) Reserve Bank presidents was also a way to balance the regional and central elements of the central bank.

Public Interest vs. Private Expertise

The Federal Reserve as an institution also is a balance between the public interest and private expertise, much as the First and Second Banks had been. Congress established the Federal Reserve as a partnership between the private sector and the public sector. This structure allows the System to benefit from private expertise while ensuring that the public interest is served. This is done in several ways. One is by having representatives from the private sector serve on boards of directors that oversee each regional Reserve Bank. Another is by having advisory councils representing the private sector meet regularly with Washington policymakers. Yet another is to have regional Reserve Bank presidents appointed by the regional boards of directors, subject to the approval of the Board of Governors in Washington.

Having a board of directors whose members come from the private sector has been extremely valuable in running an efficient and effective Reserve Bank. My Reserve Bank has to deal with many of the same problems that corporations do.

The benefits of having private-sector expertise also show up in monetary policy. Official statistics come out with a lag, so the Fed can get an early reading on the economy from business, labor, and community people who serve on its boards. This information is conveyed to Washington when regional boards recommend changes in the discount rate. But the discount rate cannot be changed without the approval of Washington's Board of Governors, so there remains a central authority over monetary policy even with this decentralized

input. Meanwhile, the Federal Reserve benefits by receiving a timely flow of information from the regional boards of directors.

But let me make clear that there are checks and balances to ensure that individuals cannot make private gains. The central bank has strict ethics rules for Reserve Bank directors and for its officers and employees. Reserve Bank presidents work under the same ethics rules as do senior federal government appointees. And we go through security clearance procedures and background checks, just as they do. And, of course, Reserve Banks are overseen by the Board of Governors -- a purely governmental body.

Wall Street vs. Main Street

The congressional founders of the Federal Reserve provided the central bank not only with a balance between centralization and decentralization but also with a balance between Main Street and Wall Street. By Wall Street I mean financial firms, such as banks and securities firms. By Main Street I mean the average person and nonfinancial businesses. The U.S. Congress did not put the main body of the Federal Reserve in the nation's financial center, New York; it spread authority for monetary policy around the nation in 12 Reserve Banks and in the Board of Governors in Washington. A key benefit of this decentralized approach is that Main Street and Wall Street are both heard.

Let me give you an example. The long economic expansion in the United States during the past nine years has brought down the unemployment rate. In the early years of the expansion, which began in 1991, many economists in the United States believed that the unemployment rate could not fall much below 6 percent without leading to a pickup in inflation. As the unemployment rate fell below 6 percent, and later below 5.5 percent, many financial analysts on Wall Street warned that inflation would soon accelerate.

However, many businesses -- the people on Main Street -- were reporting that they were achieving significant gains in productivity from the introduction of new technologies. At the same time, they were reporting that international competition constrained their ability to raise prices. According to Main Street, then, the risk that inflation would rise was quite low. Indeed, actual inflation was declining as the expansion matured.

Clearly Main Street businesses and Wall Street financial analysts had a different view about the inflation risk posed by further reductions in the unemployment rate.

One of the things I and my colleagues at other Reserve Banks do regularly is go out and listen to business people and community leaders in our regions. During the 1990s, as the unemployment rate fell even lower and eventually fell below 5 percent, I did a lot of that. I invited people into the Reserve Bank and I traveled around Philadelphia's Third District to speak directly with business people. Most businesses I talked with expressed the view that fierce competition limited their ability to raise prices and that improvements in productivity were helping them to reduce costs and improve profits. Consequently, I was less concerned about the risk that inflation would rise simply because the unemployment rate was below 5 percent, and that affected my views about the appropriate actions that monetary policy needed to take. My conclusion from talking to Main Street was different from what it would have been had I listened only to financial economists on Wall Street.

The regional Reserve Bank system allows Main Street's views to enter policy discussions. Before each FOMC meeting, I make a point of visiting with groups of business people and community leaders to get their impressions of the strength or weakness of business activity. Each Reserve Bank also contacts a wide range of businesses and prepares a report on regional economic conditions before each meeting of the FOMC.

I want to emphasize that information from Wall Street is also important. The financial system and the real sector both have to work well. We at the Federal Reserve watch for signs from both.

Accountability vs. Independence

The Federal Reserve's structure also provides a balance between public accountability and its need for independence from partisan politics.

In a democracy like that of the United States, the central bank has to be accountable for its activities. In the U.S., the Federal Reserve is accountable to Congress and is required to report to Congress about its actions in a variety of ways. The Federal Reserve chairman is required by law to testify twice each year about monetary policy, but Federal Reserve officials often testify before Congress on a wide variety of other issues. The Federal Reserve Banks are also audited by an outside accounting firm, as well as having their operations overseen by the Board of Governors and, in many cases, by the General Accounting Office of the Congress. The Federal Reserve has its own independent Inspector General, whose findings are regularly reported to Congress. The Federal Reserve also publishes a large number of documents designed to keep the public informed of its actions and its deliberations.

On the other hand, the Federal Reserve's congressional founders did not want the central bank to become embroiled in partisan politics the way the Second Bank did in the 1800s. Congress attempted to insulate the central bank from politics, for example, by appointing Reserve Board Governors for 14-year terms and by making the Federal Reserve self-supporting and not subject to the political pressures inherent in the annual federal budget process. To avoid making debate about renewing the central bank's charter a political issue every 20 years, Congress also eliminated the 20-year limit on the charter of the central bank. To ensure that the Federal Reserve remains nonpartisan, the central bank has rules that prevent its officials from being involved in party politics or holding political office. And the Federal Reserve's legislative mandate allows it to make independent monetary policy decisions.

Regional vs. National Considerations in Monetary Policy Decisions

Finally, let me comment on the conduct of monetary policy in a country that contains diverse regional economies. The job of monetary policy in the United States is to foster an environment friendly to sustainable economic and job growth -- to let the economy reach its potential without contributing to excesses. To accomplish this, the central bank seeks to keep inflation very low. I believe the historical evidence shows that long-run economic growth is maximized by maintaining an environment in which there is so little inflation that expectations of future inflation have little or no influence on the decisions made by households and businesses.

Although both the discount rate and the conduct of open market operations have become more centralized than they were in the early years of the Federal Reserve, there is still a regional role in both policy decisions. In discount rate decisions, the regional Reserve Banks' boards of directors recommend changes in the discount rate before the Federal Reserve Board in Washington acts to approve or disapprove them. As part of this process, the regional directors provide comments about the performance of the economy, both in their region and in the nation as a whole, which the Federal Reserve Board takes into account in making its decisions.

There is also a regional role in the monetary policy decisions that alter the central bank's open market operations. All 12 of the regional Reserve Bank presidents participate in monetary policy discussions at the FOMC meetings, and five of the 12 presidents vote at these meetings. At the FOMC meetings, the Reserve Bank presidents always comment about their regions' economic conditions and outlook as well as commenting about the nation's economic conditions and outlook.

Policy decisions by the regional Reserve Banks are, of course, influenced by regional considerations, but they also reflect national economic conditions. It is understood that the U.S. can have only a single monetary policy for the country. So if, for example, some region is experiencing very weak economic conditions but the national economy is experiencing inflationary pressures, all of the regions ultimately will support tighter monetary policy. Of course, in the U.S., low barriers to labor mobility among its regions and a common language make this easier.

Nevertheless, having mechanisms by which the diversity of the regional economies is recognized in monetary policy discussions has served the United States very well. Certainly I can tell you that a system of one central bank with a single monetary policy for a large geographic area with diverse regions does work in practice, not just in theory. Indeed, recently the U.S. has been enjoying a remarkable period of economic growth. Our current economic expansion is now the longest in U.S. history, inflation has been quite low, and

the U.S. unemployment rate, now close to 4 percent, is the lowest it has been in 30 years. Of course, more than monetary policy has been at work in fostering U.S. prosperity. But a well-functioning central bank that balances the diverse interests of the country's many regions has been a positive influence.

Conclusion

To conclude, the Federal Reserve was built on the need to balance competing goals. Some of the issues that were debated when the Federal Reserve was first established still come up in various forms today, 86 years later. Similar debates about balancing competing goals occurred when our nation first established a central bank in 1791. Such debates are likely to continue, because balancing competing forces is part of the ongoing institutional nature of a central bank. And as U.S. history has shown, maintaining balance is critically important for a central bank to function effectively and serve the broad public interest in a large, diverse nation. I suspect that these are some of the same issues that Europe will also face from time to time as it evaluates its own central banking arrangements.