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The Challenge of Central Banking
in a Democratic Society

Remarks by

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Good evening ladies and gentlemen. I am especially pleased to accept AEI's Francis Boyer Award for 1996 and be listed with so many of my friends and former associates. In my lecture this evening I want to give some personal perspectives on central banking and, consequently, I shall be speaking only for myself.

William Jennings Bryan reportedly mesmerized the Democratic Convention of 1896 with his memorable "...you shall not crucify mankind upon a cross of gold." His utterances underscored the profoundly divisive role of money in his time--a divisiveness that remains apparent today. Bryan was arguing for monetizing silver at an above-market price in order to expand the money supply. The presumed consequences would have been an increase in product prices and an accompanying shift in the value of net claims on future wealth from the "monied interests" of the East to the indebted farmers of the West who would arguably be able to pay off their obligations with cheaper money.

The debates, before and since, over the issue of our money standard have mirrored the deliberations on the manner in which we have chosen to govern ourselves, and, perhaps more fundamentally, debates on the basic values that should govern our society.

For, at root, money--serving as a store of value and medium of exchange--is the lubricant that enables a society to organize itself to achieve economic progress. The ability to store the fruits of one's labor for future consumption is necessary for the

accumulation of capital, the spread of technological advances and, as a consequence, rising standards of living.

Clearly in this context, the general price level, that is, the average exchange rate for money against all goods and services, and how it changes over time, plays a profoundly important role in any society, because it influences the nature and scope of our economic and social relationships over time.

It is, thus, no wonder that we at the Federal Reserve, the nation's central bank, and ultimate guardian of the purchasing power of our money, are subject to unending scrutiny. Indeed, it would be folly were it otherwise.

A central bank in a democratic society is a magnet for many of the tensions that such a society confronts. Any institution that can affect the purchasing power of the currency is perceived as potentially affecting the level and distribution of wealth among the participants of that society, hardly an inconsequential issue.

Not surprisingly, the evolution of central banking in this nation has been driven by such concerns. The experiences with paper money during the Revolutionary War were decidedly inauspicious. "Not worth a Continental" was scarcely the epithet one would wish on a medium of exchange. This moved Alexander Hamilton, with some controversy, to press for legislation that established the soundness of the credit of the United States by assuming, and ultimately repaying, the war debts not only of the fledgling federal government, but of the states as well. Equally

controversial was the chartering of the First Bank of the United States, which, although it had few functions of a modern central bank, was nonetheless believed to be a significant threat to states rights and the Constitution itself.

Although majority controlled by private interests, the Bank engaged in actions perceived to shift power to the federal government. Such a shift was thought of by many as a fundamental threat to the new democracy, and an essential element of what was feared to be a Hamilton plan to re-establish a powerful aristocracy. The First Bank--and especially its successor Second Bank of the United States--endeavored to restrict state bank credit expansion when it appeared inordinate, by gathering bank notes and tendering them for specie. This reduced the reserve base and the ability of the fledgling American banking system to expand credit. The issue of states' rights and concern about the power of the central government reflected the free wheeling individualism of that time. The Second Bank was a major issue of the election of 1832. Earlier in that year, President Andrew Jackson had vetoed the bill to extend its charter, and the election became a referendum on his veto. The outcome was a resounding victory for Jackson and the death knell for the Bank.

It has not been easy, however, to separate often seemingly conflicting threads in the debate between advocates of state powers over money and those seeking a national role. When Andrew Jackson vetoed the charter renewal of the Second Bank of the United States, for example, he argued for the severing of the

grip on the economy of easterners and especially foreigners, who owned a significant stock interest in the bank. Ironically, by helping to create what was perceived to be an unstable currency, he set the stage for the later development of a full-fledged gold standard, the institution that Bryan railed against in 1896 from much the same populist philosophical base as Jackson.

After the Civil War, redemption of the paper greenbacks issued during the war brought an era of a gold-standard induced deflation, which, while it may not have thwarted the impressive advance of industrialization, was seen by many as suppressing credit availability for the rural interests of the nation, which were still a majority. The general price level declined for more than two decades, which meant borrowers were paying off their loans in more expensive dollars than those they borrowed.

Not surprisingly, mounting pressures developed for reform, with Bryan bearing the standard for subsidized silver coinage, that is, free silver. Though Bryan lost to McKinley in 1896 (and again in 1900), the rural-based pressures for a more elastic currency did not diminish and ultimately were reflected, in part, in the creation of the Federal Reserve.

Nonetheless, many of the proponents of banking reform in the 1890s, and in the aftermath of the Panic of 1907, were suspicious of creating a central bank. In very large measure, those concerns underlay the various threads of reform that were joined together in the design and creation of the Federal Reserve System in 1913. Its founding followed a prolonged debate on the balance

of power between the interests of the New York money center banks and the rest of the nation, still largely rural. The compromise that resulted from that debate created twelve regional Reserve Banks with a Washington presence vested with a Federal Reserve Board. Its purpose was to "furnish an elastic currency,...to establish a more effective supervision of banking in the United States, and for other purposes." Monetary policy as we know it today, was not among the "other purposes." That evolved largely by accident in the 1920s.

Even with a central bank, the gold standard was still the dominant constraint on the issuance of paper currency and the expansion of bank deposits. Accordingly, the Federal Reserve was to play a minor role in affecting the purchasing power of the currency for many years to come.

The world changed markedly with the advent of the Great Depression of the 1930s, and the evisceration of the gold standard. The upheaval, and still festering fear of New York "monied interests," engendered the Banking Acts of 1933 and more importantly of 1935, which vested more of the Federal Reserve's authority with the Board of Governors in Washington. During World War II, and through 1951, however, monetary policy was effectively subservient to the interests of the Treasury, which sought access to low-cost credit. With the so-called Federal Reserve-Treasury Accord of 1951, the Federal Reserve began to develop its current degree of independence.

Although in the 1950s and early 1960s there were short-lived bouts of inflation that caused momentary concern about sustained increases in the price level, these events did little to shake the conviction of most that America's economic and financial structure would indefinitely and effectively contain any inflationary forces. This prescription certainly seems to have been reflected in the low inflation premium then embedded in long-term bonds.

That this view was profoundly wrong soon became apparent. The 1970s saw inflation and unemployment simultaneously at relatively elevated levels for some time. The notion that this could occur was nowhere to be found in the conventional wisdom of the economic policy philosophy that developed out of the Keynesian revolution of the 1930s and its subsequent empirical applications. Moreover, these models embodied the view that aggregate demand expansion, from almost any level, would permanently create new jobs. When that expansion carried the economy beyond "full employment" there would be a cost in terms of higher inflation--but only a one-time increase in inflation, so that there existed a permanent trade off between sustainable levels of inflation and employment.

The stagflation of the 1970s required a thorough conceptual overhaul of economic thinking and policy-making. Monetarism, and new insights into the effects of anticipatory expectations on economic activity and price setting, competed strongly against the traditional Keynesianism. Gradually the power of state

intervention to achieve particular economic outcomes came to be seen as much more limited. A consensus gradually emerged in the late 1970s that inflation destroyed jobs, or at least could not create them.

This view has become particularly evident in the communiques that have emanated from the high-level international gatherings of the past quarter century. That inflation could reduce employment was a highly controversial subject in the mid-1970s when introduced into communique language drafts. At the meetings I attended as Chairman of the Council of Economic Advisers, the notion invariably induced extended debates. Today in similar communiques such language is accepted boiler plate and rarely the focus of discussion. This shift in attitudes and understanding provided political support in 1980 and thereafter for the type of monetary policy required to rebalance the economy.

Despite waxing and waning over the decades, a deep-seated tension still exists over government's role as an economic policymaker. This tension is evident in Congressional debates, campaign rhetoric and our ubiquitous talk shows.

It should not be a surprise that the very same ambiguities and conflicts that characterize the rest of our political life have their reflection in the nation's current view of its central bank, the Federal Reserve. With regard to monetary policy, the view--or at least the suspicion--still persists in some quarters that an activist, expansionary policy could yield dividends in terms of permanently higher output and employment.

evident to the public at large, and that policy may have to reverse course from time to time as the underlying forces acting on the economy shift. This process is not easy to get right at all times, and it is often difficult to convey to the American people, whose support is essential to our mission.

Because the Fed is perceived as being capable of significantly affecting the lives of all Americans, that we should be subject to constant scrutiny should not come as any surprise. Indeed, speaking as a citizen, and not Fed Chairman, I would be concerned were it otherwise. Our monetary policy independence is conditional on pursuing policies that are broadly acceptable to the American people and their representatives in the Congress.

Augmenting concerns about the Federal Reserve is the perception that we are a secretive organization, operating behind closed doors, not always in the interests of the nation as a whole. This is regrettable, and we continuously strive to alter this misperception.

If we are to maintain the confidence of the American people, it is vitally important that, excepting the certain areas where the premature release of information could frustrate our legislated mission, the Fed must be as transparent as any agency of government. It cannot be acceptable in a democratic society that a group of unelected individuals are vested with important responsibilities, without being open to full public scrutiny and accountability.

To be sure, if we are to carry out effectively the monetary policy mission the Congress has delegated to us, there are certain Federal Reserve deliberations that have to remain confidential for a period of time. To open up our debates on monetary policy fully to immediate disclosure would unsettle financial markets and constrain our discussions in a manner that would undercut our ability to function. Nonetheless, we continue to look for ways to expand the flow of information to the public without compromising our deliberations and purposes. We have recently commenced to announce all policy actions immediately, federal funds rate changes as well as discount rate changes, and have expanded the minutes of the Federal Open Market Committee.

For many years, the Federal Reserve has maintained what we trust is a highly sophisticated day-by-day, near real-time, evaluation of the American economy and, where relevant, of foreign economies as well. We are able, partly through our twelve Reserve Banks, to monitor continuously developments in the real world. The information supplied about local conditions by the directors of the Reserve Banks has been frequently useful in identifying emerging national trends and in evaluating their underlying regional implications.

The issues with which we are confronted differ in urgency over time. Inflation concerns were not a dominant factor in economic forecasting in the 1950s and early 1960s, for example. Since the late 1970s, however, such concerns have become an important element in policy-making. More recently inflation has

been low, but its future course remains uncertain. The development of comfortable product, but tight labor, markets has been a crucial factor in short-term economic forecasts of recent months--a phenomenon for which there is scant historic precedent.

There is, regrettably, no simple model of the American economy that can effectively explain the levels of output, employment, and inflation. In principle, there may be some unbelievably complex set of equations that does that. But we have not been able to find them, and do not believe anyone else has either.

Consequently, we are led, of necessity, to employ ad hoc partial models and intensive informative analysis to aid in evaluating economic developments and implementing policy. There is no alternative to this, though we continuously seek to enhance our knowledge to match the ever growing complexity of the world economy.

At different times in our history a varying set of simple indicators seemed successfully to summarize the state of monetary policy and its relationship to the economy. Thus, during the decades of the 1970s and 1980s, trends in money supply, first M1, then M2, were useful guides. We could convey the thrust of our policy with money supply targets, though we felt free to deviate from those targets for good reason. This presumably helped the Congress, after the fact, to monitor our contribution to the performance of the economy. I should add that during this period we maintained a fully detailed analysis of the economy, in part,

to make sure that money supply was still emitting reliable signals about the state of the economy.

Unfortunately, money supply trends veered off path several years ago as a useful summary of the overall economy. Thus, to keep the Congress informed on what we are doing, we have been required to explain the full complexity of the substance of our deliberations, and how we see economic relationships and evolving trends.

There are some indications that the money demand relationships to interest rates and income may be coming back on track. It is too soon to tell, and in any event we can not in the future expect to rely a great deal on money supply in making monetary policy. Still, if money growth is better behaved, it would be helpful in the conduct of policy and in our communications with the Congress and the public. In the absence of simple, summary indicators, we will continue our detailed evaluation of economic developments. As we seek price stability and maximum sustainable growth, the changing economic structures constantly present more analytic challenges.

I doubt the tasks will become any easier for the Federal Reserve as we move into the twenty-first century. The Congress willing, we will remain as the guardian of the purchasing power of the dollar. But one factor that will continue to complicate that task is the increasing difficulty of pinning down the notion of what constitutes a stable general price level.

When industrial product was the centerpiece of the economy during the first two-thirds of this century, our overall price indexes served us well. Pricing a pound of electrolytic copper presented few definitional problems. The price of a ton of cold rolled steel sheet, or a linear yard of cotton broad woven fabrics, could be reasonably compared over a period of years.

But as the century draws to a close, the simple notion of price has turned decidedly ambiguous. What is the price of a unit of software or a legal opinion? How does one evaluate the price change of a cataract operation over a ten-year period when the nature of the procedure and its impact on the patient changes so radically. Indeed, how will we measure inflation, and the associated financial and real implications, in the twenty-first century when our data--using current techniques--could become increasingly less adequate to trace price trends over time?

So long as individuals make contractual arrangements for future payments valued in dollars, there must be a presumption on the part of those involved in the transaction about the future purchasing power of money. No matter how complex individual products become, there will always be some general sense of the purchasing power of money both across time and across goods and services. Hence, we must assume that embodied in all products is some unit of output and hence of price that is recognizable to producers and consumers and upon which they will base their decisions. Doubtless, we will develop new techniques of price measurement to unearth them as the years go on. It is crucial

that we do, for inflation can destabilize an economy even if faulty price indexes fail to reveal it.

But where do we draw the line on what prices matter? Certainly prices of goods and services now being produced--our basic measure of inflation--matter. But what about futures prices or more importantly prices of claims on future goods and services, like equities, real estate or other earning assets? Are stability of these prices essential to the stability of the economy?

Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? And how do we factor that assessment into monetary policy? We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability. Indeed, the sharp stock market break of 1987 had few negative consequences for the economy. But we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy. Thus, evaluating shifts in balance sheets generally, and in asset prices

particularly, must be an integral part of the development of monetary policy.

The public examination of Federal Reserve actions extends well beyond our stewardship of monetary policy. Our overall management of the Federal Reserve System should, and does, come under considerable scrutiny by the Congress. Since we expend unappropriated taxpayer funds, we have an especial obligation to be prudent and efficient with the use of those funds. I am not particularly concerned about the one-third of our annual \$2 billion budget that is expended to provide financial services to the private sector in competition with other providers. Such services include the clearing of checks, the operation of the Fedwire system, and the processing of automated clearing house payments. We are reimbursed for those services, and at competitive prices still make a reasonable profit for the Treasury. If we became inefficient and uncompetitive, we would be priced out of the market, and eventually out of that line of business.

An additional one-sixth of our expenses are for providing services to the Treasury and other agencies of government for which we are subject to reimbursement with appropriated funds. For the remainder, which mainly covers monetary policy, supervision and regulation of banks, and currency operations, we have to be especially diligent, for there is no external arbiter.

The rapidly changing technologies of recent years are pressing us to review thoroughly our structure and operations.

We have already engaged in major consolidations of operations when such consolidations have been made cost effective by the newer technologies. Although in my experience the Federal Reserve System has been responsible, efficient, and has performed well, the rapidly changing external environment frequently requires us to rethink our role and mission. Even where we can be competitive, it is not the role of a government agency, especially one vested with an unsurpassable credit rating, to seek out all available market opportunities. Accordingly, where specific priced services have become effectively and competitively provided by private sector suppliers, the Federal Reserve needs to reassess whether the extent of our participation in those services fulfills a reasonable public purpose. There are, of course, certain services that the Congress has, and will in the future, deem appropriate for us to subsidize. But these areas presumably will remain circumscribed.

As a step in our periodic reassessment, a special committee of Federal Reserve Board governors and Reserve Bank presidents has been set up to review our priced services operations and other Systemwide activities.

Another step has been to engage outside accounting firms to audit the Federal Reserve Board and the twelve Reserve Banks. We had been quite satisfied with the Board as general auditor of the Reserve Banks since 1914. But the range of activities and the reach of the Federal Reserve in recent years requires us to address the perception that we are auditing ourselves without the

full arm's length relationship deemed appropriate in today's environment.

Finally, the substantial changes under way in bank risk management are pressing us to continuously alter our modes of supervision and regulation to keep them as effective and efficient as possible.

Most importantly, all of our recent initiatives, especially the strengthening of the payments system and supervision, are critical to a central mission of the Federal Reserve, to maintain financial stability and reduce and contain systemic risks. This mission is an extension of our monetary policy. Our country can not enjoy the long-run "maximum employment and stable prices" objectives we are given for monetary policy if the financial system is unstable. In this regard the successes that most please us are not so much the visible problems that we solve, but rather all the potential crises that could have happened, but didn't.

Doubtless, the most important defense against such crises is prevention. Recent mini-crises have identified the rapidly mushrooming payments system as the most vulnerable area of potential danger. We have no tolerance for error in our electronic payment systems. Like a breakdown in an electric power grid, small mishaps create large problems. Consequently, we have endeavored in recent years, as the demands on our system have escalated (we clear \$1-1/2 trillion a day on Fedwire), to

build in significant safety redundancies. This has been costly in terms of equipment and buildings.

Along with our other central bank colleagues, we are always looking for ways to reduce the risks that the failure of a single institution will ricochet around the world, shutting down much of the world payments system, and significantly undermining the world's economies. Accordingly, we are endeavoring to get as close to a real time transaction, clearing, and settlement system as possible. This would sharply reduce financial float and the risk of breakdown. Meaningful progress has already been made in this direction.

This evening, I have tried to put current central banking issues in historical context. Monetary arrangements, including central banks, naturally are under constant scrutiny and criticism. This is no less true of the Federal Reserve in 1996 than of the gold standard in 1896. Central banks need to respond patiently and responsibly to the commentary, and we need to adapt to changing circumstances in markets and the economy.

A democratic society requires a stable and effectively functioning economy. I trust that we and our successors at the Federal Reserve will be important contributors to that end.