

# An Independent Central Bank in a Democratic Country: The Federal Reserve Experience

*by William J. McDonough*

I am honored this evening to address this distinguished group of central bankers, economists, representatives of international institutions, and others interested in the process of reform in Eastern Europe and the Newly Independent States. In sponsoring this conference on the role of central banks in the region, the University of Chicago Law School, and especially Professors Kenneth Dam and Geoffrey Miller, deserve our deepest thanks.

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One very timely issue confronting policymakers in Eastern Europe and the Newly Independent States is the proper scope for central bank independence. As the organizers of this conference have rightly noted, central banks that are both powerful and autonomous, yet at the same time responsive to the needs and wishes of their people, are fundamental to the economic development and political stability of all countries.

Integral to economic development and political stability is a commitment to the liberty, dignity, and independence of

people. These are ideals all our countries share today. But liberty and independence, while precious, assume different form as they take root in countries throughout the world. How much liberty and independence do we give to our people? How much is responsibility for governing our people to be centralized? How much is sovereignty to be divided? In the United States, these are questions that our ancestors sought to answer and that we continue to air and debate in public.

This evening, I would like to share with you some of my views as to how these issues took hold in the United States in the development of the Federal Reserve System and why I believe central bank independence is so very important in a democracy. Independence has, perhaps, a special meaning in the context of the United States' experience with central banking. We as a nation were born primarily of individuals who set an independent course for themselves by leaving their own countries to seek a better life in the New World. Our country owes its growth, its prosperity, and its prominence to these individuals. How to preserve the individual liberty they sought and won has become an enduring theme in the history of the United States.

This history reflects the dynamic tension set forth in our Constitution of checks and balances to ensure that the powers of government do not alienate the rights of people. The responsibilities of government versus the rights of individuals, the centralization of power in the federal government versus its dispersal to the states, the mistrust of government versus faith in individuals are notions that are as alive in the Federal Reserve System today as they were when our republic was being shaped more than two centuries ago.

Compared with a number of other countries' experience

Remarks by William J. McDonough, President, Federal Reserve Bank of New York, before the University of Chicago Law School Conference on Central Banks in Eastern Europe, Chicago, Illinois, April 22, 1994

with central banking, which goes back centuries, the Federal Reserve, at some eighty-years-old, is a relative youth. Not widely known is that there were two earlier central banks in the United States prior to the creation of the Federal Reserve System in 1913. The first was chartered in

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1791, the second in 1816. Each bank remained in operation for twenty years. A look at this bit of history is useful to understanding our central banking system today.

The First Bank of the United States emerged in the aftermath of the revolutionary war. The Continental Congress, lacking the power to tax and needing means to finance an army, was dependent on the individual states to meet its

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requests for funds as well as on the largesse of Great Britain's enemies at the time. France was particularly important to the United States in this period. A remark by Alexander Hamilton in 1780 about Benjamin Franklin, then our minister in Paris, tells it all. "Franklin," Hamilton is supposed to have said, "having drawn lightning from the clouds, was expected to draw money from the coffers of the King of France with the same ease and whenever it was required."

Ten years later, as Secretary of the Treasury, Hamilton was able to persuade President Washington and Congress to charter such an institution. The advantages of a national bank were clear, Hamilton argued. First, it would augment "the active or productive capital of a country,...as it is a well-established fact, that banks in good credit, can circulate a far greater sum than the actual quantum of their capital in gold and silver." Second, a national bank would allow the central government "greater facility...in obtaining pecuniary aids, especially in sudden emergencies." And third, it would facilitate the payment of taxes.

The charter for the First Bank of the United States was signed in February 1791. The first central bank was, as the Federal Reserve System is today, a mix of public and pri-

vate interests. While serving as the government's bank, the First Bank, unlike the Federal Reserve, was also allowed to conduct commercial business. It was capitalized at \$10 million, of which one-fifth was subscribed by the government and the balance by private shareholders. Its demand notes were made receivable in all payments to the government, although at the time the only media of exchange the Consti-

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tution considered legal tender were gold and silver or specie. The First Bank was managed by twenty-five directors chosen by the shareholders, who also selected one director as president. When its charter lapsed in 1811, it was not renewed.

The Second Bank of the United States, which was chartered in 1816, mirrored the structure and functions of the First Bank, except that five of its twenty-five directors were chosen by the President with the approval of the Senate. The Second Bank was formed largely because a widespread run on the state-chartered banks in 1814 had resulted in their suspending payment for their notes in specie. Although the state banks continued to remain in business, Congress concluded that a new central bank was needed, if for no other reasons than to marshal the banking system back onto specie payments and restore a uniform currency.

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Neither the First nor the Second Bank of the United States was without controversy. The proponents of the First Bank supported the views of Alexander Hamilton. They were primarily merchants and entrepreneurs who valued paper money and easy access to credit as means to improve their business and wealth. They looked to a strong federal government and the central bank to help them achieve these goals.

The opponents of the First Bank, and the main cause of its failure to have its charter renewed in 1811, were the

farmers, or agrarians, who dominated the population at the time and whose spokesperson was Thomas Jefferson. To the agrarians, political independence and a strong central government were incompatible. Economically, they were conservative. Their precepts were frugality and the avoidance of debt, and their preference was for metallic, as opposed to paper, money. They mistrusted the central bank, seeing in it both a subordination of the states' prerogatives and a federal government that was exceeding its powers. Thus, they challenged its constitutionality.

The agrarians also opposed the Second Bank of the United States. Under the leadership of Andrew Jackson, who became President in 1829, they were determined to destroy the Second Bank. Jackson did so by vetoing the renewal of the bank's charter.

The failure to replace the Second Bank of the United States when its charter was not renewed in 1836 "ushered in a generation of bank anarchy and monetary disorder," according to one historian of the period. It was not until repeated financial crises with their associated business bankruptcies and general economic contractions, notably the panic of 1907, that the need for a central banking system found support in Congress.

The Federal Reserve Act was passed by Congress in 1913 with the goals of providing for a safer and more flexible banking and monetary system. Its original purposes were to provide the country with an elastic currency, establish facilities for discounting commercial credits, and improve the supervision of the banking system. More

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broadly, in establishing the Federal Reserve System, Congress sought to create an institution that would combine the benefits of public and private outlooks while insulating its functions from day-to-day political pressures.

The central banking system Congress put in place reflects the country's historic concerns, traceable to its early experiments with central banking, about a centralized government monopoly of the creation of money and the desire to disperse that control through a system incorporating regional diversity and private sector involvement. The Federal Reserve today is thus a regionally dispersed insti-

tution with both government and private interests represented in its ownership and control, a testament to the long-standing belief that formal involvement by the private sector is essential to the credibility and management of the nation's central bank.

Initially, the government was represented on the seven-member Board of Governors by the Secretary of the Treasury and the Comptroller of the Currency. In 1935, Congress removed these two officials from the Board in an effort to strengthen the Federal Reserve's independence from political pressures within the government. The seven governors who now comprise the Board are appointed by the President with the approval of the Senate. Each must come from a different geographic region, or district. Originally, Board members were appointed for ten-year terms so as to insulate them from short-term political pressures, the terms were increased to fourteen years in 1935.

To balance central oversight in Washington with regional and private sector input, Congress created twelve Federal Reserve district banks, each serving a geographic region. The creation of the district banks as separate corporate entities with local boards of directors and member banks as stockholders was a key aspect of the Federal Reserve Act. The Reserve Bank directors, then as now, are one of the primary means by which the Federal Reserve Banks interact with the private sector on an ongoing basis. Six of the nine directors of each district bank are elected by the member banks; three are appointed by the Board of Governors. Of the nine directors, three represent banks and six represent the public, with particular consideration to the interests of agriculture, commerce, industry, services, labor, and consumers. The Reserve Bank presidents are appointed by the directors, subject to Board approval.

In the early decades of the Federal Reserve, responsibility for formulating and implementing monetary policy was not centralized in the Federal Open Market Committee, or FOMC, as it is today. Instead, the twelve district banks undertook open market operations and set the discount rate for banks in their areas, which required the Board's approval. In 1922, the district banks created their own committee to coordinate their open market activities. Since 1935, the FOMC has existed in its current form.

The debate surrounding the creation of the FOMC pitted some members of Congress who wanted only the Presidentially-appointed governors in Washington to set monetary policy against others who wanted the regional Reserve Banks to continue control of the Committee. The compromise reached allows all seven governors and the president of the Federal Reserve Bank of New York a permanent vote on the Committee but only four of the remaining eleven district bank presidents a vote at any time. This compromise reflects that delicate tension of checks and balances on centralized authority that lies at the core of the Federal Reserve System today.

This brings me to consider the basic functions and goals of central banks in democratic countries. We all recognize that the ways central banks choose to carry out their functions and the importance they attach to specific instruments or tools to achieve their goals vary across countries. The degree of independence central banks have within their governments also varies across countries. These differences are to be expected. They reflect each country's individual history, traditions, financial market structures, and legal frameworks

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Nonetheless, I do believe that central banks in democracies the world over share certain basic functions and goals in common. What are these? First and foremost, a central bank's most time-honored duty is to formulate and implement monetary policy—with its twin goals of promoting domestic price stability while stimulating real growth. These goals remain at the core of central bank policy

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Integral to achieving price stability is the need for central banks to avoid the direct financing of government budget deficits. Central banks can't indulge in this practice and simultaneously hold inflation in check. Such financing runs the clear risk that the central bank's balance sheet can become weighted down with low-quality assets. In such circumstances, confidence in the financial integrity of the central bank can only suffer.

At the same time, central banks must strive to maintain positive real interest rates, which tend to increase private savings and discourage investments with low expected returns, thereby promoting growth in the economy. As a further task, central banks must work with their governments to help keep real exchange rates competitive if their countries are to increase exports, finance external debt, and build reserves

Central banks implement monetary policy by affecting the growth of money and credit in the economy in response

to deflationary or inflationary pressures as they arise. Central banks alter monetary policy through the use of a set of instruments, or tools. In the United States, these tools are grouped into three broad categories: 1) setting reserve requirements for banks, 2) setting the lending rate and making loans to commercial banks, and 3) buying and selling government securities or other government-guaranteed instruments. As lenders of last resort, central banks also stand ready to use the available policy instruments to forestall national liquidity crises and financial panics

Another major responsibility of central banks is to oversee, or have some participation in the oversight of, their banking and financial systems. A sound banking and financial structure is essential for an effective monetary policy. Confidence in the soundness of the banking and financial system is what mobilizes a society's savings, allows the savings to be channeled into productive investments, and encourages economic growth.

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Supervision of the banking system gives central banks the knowledge and ability to respond to and head off financial disruptions before they result in economic crises. The regulatory role of central banks strengthens their ability to act as ultimate providers of liquidity to the financial system. Moreover, because monetary policy involves judgments about conditions in financial markets and financial institutions, including a detailed working knowledge of those markets and institutions, a major ingredient in the decision-making process comes from the direct, hands-on knowledge central banks gain through interaction with institutions under their supervision. I am firmly convinced that the Fed-

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The third major function of central banks is to oversee the payments mechanism. A payments mechanism that is

dependable and allows the efficient clearing and settlement of interbank transactions is crucial to a well-functioning financial system. Commercial banks participate directly in a country's payments system, extending short-term credit in their role as financial intermediaries in the payment, transfer, and settlement of financial instruments, including interbank deposits and government securities. Central banks participate directly in the payments system as well, in part because numerous types of payments, including large-value interbank transfers and check clearing settlements, are likely to occur across their books.

The central bank's participation in the payments system and its role as supervisor of the system enhance its ability to foresee and prevent or moderate financial disruptions. The payments system is a source of major credit risk because of the lags in time during which the processing of transactions takes place. During these intervals, one party extends credit to another pending the receipt of funds. These lags between the payments associated with both sides of a financial obligation, which can vary from hours to days, result in large, interwoven extensions of credit among financial institutions.

A payments gridlock or other financial disruption can arise from numerous sources, including the sudden failure of a major participant, credit concerns by some participants which make them reluctant to release payments, and various technical interruptions. Because a gridlock can spread rapidly throughout the financial system, central banks have a keen interest in avoiding a payments system disruption and ensuring that participants in the system manage their credit risks properly.

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In carrying out our functions as central bankers, we must ask ourselves why it is desirable that central banks in democracies have an important degree of political independence within government. I think we would all agree that central banks neither can nor should be fully independent of government, since it is governments—and not central banks—that hold final responsibility for the economic and financial policy of the country. Nevertheless, some degree of central bank independence is critical. Why is this so?

Basically, the greater the independence the central bank has, the less subject it is likely to be to short-term political pressures. Central banks under the direct day-to-day control of governments seem inevitably to be tempted to pro-

mote easy credit policies, particularly when elections are in view, or, even worse, to finance government budget deficits directly. While these policies may relieve certain short-term problems, such as high unemployment or difficulties in financing fiscal deficits, they ultimately result in higher infla-

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tion and the need for severe credit tightening in the future. Independence is also helpful to central banks in carrying out their supervisory responsibilities, by enabling them to resist pressures to relax or strengthen regulatory standards depending on political winds.

A number of studies in recent years have found some empirical basis for the desirability of central bank independence as well. Although these studies cannot prove causality, they do find that the greater the independence of the central bank, the lower the average level of inflation the country experiences and the less volatile the inflation rate.

In my view, controlling inflation is particularly important at this juncture, not simply for the United States but also for other industrial countries in particular. Like a number of these other countries, the United States has reached the point at which the level of its public sector debt and its persistently large budget deficit are such that fiscal policy is no longer available as a tool of macroeconomic policy. If fiscal policy is unavailable to address some of the social needs that now confront so many of our economies, it becomes especially important for inflation to remain under control, largely because of its regressive tax aspects. In the current environment, price stability is therefore critical not only for the classic economic reasons but also because it takes on a greater social importance as well.

But, we may reasonably ask, what exactly do we mean by central bank independence and how do we know it when we see it, recognizing, of course, that *de jure* measures of independence may not fully reflect *de facto* independence? Without being exhaustive, let me suggest a few answers and how they apply to the Federal Reserve System today.

One way to assess independence is to determine the extent to which the central bank enjoys freedom from the government in formulating and implementing its policies, particularly monetary policy. A key component of this measure of independence is the degree of freedom the central bank has to change official interest rates and select the mix of policy instruments and techniques it uses in undertaking

open market operations. In these respects, I believe that Congress has provided the Federal Reserve with considerable scope for independently exercising its best judgment as to what monetary policy should be.

Another way to assess independence is to look at the procedures in place for central bank leaders to be nominated and dismissed. In the case of the Federal Reserve, staggered fourteen-year terms for governors clearly insulate the leadership from short-term political pressures and fears of falling out of grace politically. Moreover, once appointed, governors can be removed only for cause.

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Still another way to measure independence has to do with the way the central bank finances itself. In the United States, the Federal Reserve System is self-financing, its earnings stemming principally from interest income on the portfolio of government securities it holds to conduct open market operations. Financing itself internally means that the Federal Reserve is not dependent on Congress for annual appropriations and is therefore insulated from pressures that might otherwise flow from the "power of the purse."

Whatever their degree of independence, central banks typically are nonetheless created by and accountable to

legislatures. In the United States, the Federal Reserve is accountable to Congress, which has delegated to it specific powers Congress is granted by the Constitution. Congress thus retains the authority to oversee and instruct the Federal Reserve as it sees fit.

The Federal Reserve accounts to Congress in numerous formal and informal ways. There are continuous contacts between officials in the Federal Reserve and the government. Twice a year, the Federal Reserve reports to Congress on its monetary policy targets and its senior officials routinely appear before congressional committees and subcommittees.

Over the years, as at present, Congress and the Administration have periodically sought to alter certain elements of the Federal Reserve. These efforts have contributed to many changes in the Federal Reserve's procedures and authority, in many cases allowing the Federal Reserve to evolve and keep pace with the needs of changing times. At the same time, it is important to recognize that, even in the current debate, the fundamental independence of the Federal Reserve is not in jeopardy. The Federal Reserve's basic independence today is a widely shared value, which no one questions.

In reviewing the experience of central banking in the United States, I cannot help but conclude that ultimately the only way central banks can achieve their goals is if their integrity is without question and people have confidence in the policies they pursue. At the end of the day, it is public confidence that is a central bank's most precious commodity in a democracy.