

The Federal Reserve and Global Central Banking

Statement by Athanasios Orphanides before the Subcommittee on Monetary Policy and Trade of the Committee on Financial Services, United States House of Representatives

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I appreciate the opportunity to testify at this hearing on “What’s Central about Central Banking? A Survey of International Models.” As requested, my testimony examines differences and similarities of the Federal Reserve with other central banks, and in this respect I will focus on the European Central Bank (ECB) and the Eurosystem that comprises the ECB and the National Central Banks (NCBs) of the member states of the European Union (EU) that have adopted the euro as their common currency.

The 100th year anniversary of the Federal Reserve is an apt occasion for reflecting on the structure of the institution compared to other central banks around the world. Over the past century, the United States has evolved into the most powerful nation on earth. In terms of politics, the United States has been the most potent global force for defending and promoting democracy. In terms of economics, the United States has been a global engine of innovation and growth. Historical experience suggests that a well-functioning monetary system is a prerequisite for the greatness of any nation, and it is hard to imagine that the United States could have achieved and maintained its power to the same degree, had the Congress not created the Federal Reserve System 100 years ago.¹

Since its founding, the Federal Reserve has evolved into the most powerful central bank of the world and serves a leading role in global central banking. As early as the 1920s, it was recognized as a pioneer in global monetary affairs. As a public institution, the Federal Reserve is unparalleled in the professional integrity, technical expertise, dedication to public service, and collegiality that has characterized its staff and leadership. But central banking has always been and remains an activity where knowledge is acquired by experience. Uncertainty is a defining characteristic of a dynamic and continuously evolving market-based economy. Our knowledge of the workings and interrelations of the macroeconomy, banking and finance will never become perfect. From time to time crises materialize and central banks are called to deploy the power of their balance sheets to contain adverse consequences. The only common element in handling crises over time is insufficient knowledge when policy decisions have to be made. Miscalculations and misjudgments are unavoidable, even with the best of intentions. Room for improvement, for making the framework more robust, always remains.

¹ The historical significance of the founding of the Federal Reserve on the eve of the Great War could be put into perspective when the experience of the Government is contrasted with that during the War of 1812, when the United States did not have a central bank. A consequence of the failure to renew the charter of the First Bank of the United States (the nation's first central bank) in 1811 was the difficulty of the Government to meet its war financing needs the following year. Unlike 1812, the Government could fully utilize the powers of the Federal Reserve to facilitate the war effort after its founding.

In its first 100 years, the Federal Reserve has contributed to the welfare of the nation but has not always managed to avoid major errors. The Great Depression of the 1930s and the Great Inflation of the 1970s are the most notable examples. Historians will undoubtedly debate for years to come the causes and handling of the most recent crisis. In my view, the Federal Reserve's actions in late 2008 and 2009 were decisive for averting what could have become an economic collapse of Great Depression dimensions. Easy money policies proved a potent medicine. But while some risks to monetary stability abate, other risks emerge. Easy money policies can prove as addictive as other potent medicines. The unprecedented expansion of the central bank's balance sheet and the associated continued easing of policy have generated new challenges.

The institutional framework governing a central bank is a critical factor on how well it can preserve monetary stability and how effectively it can handle crises. The mandate of the institution, its decision-making structure, the appointment process of its decision-making bodies, the mechanisms defining its independence and accountability, all jointly influence the probabilities of ensuring better outcomes. In the international community, countries learn from others' experiences about the effectiveness of institutions, and there has been considerable cross-fertilization of ideas in the institutional design of central banks.

Experience from the functioning of the Federal Reserve has influenced other central banks, including the European Central Bank that was established in June 1998, directly and indirectly. Some of the characteristics in the structure of the ECB (and more broadly the Eurosystem) draw on the structure of the Federal Reserve. The ECB setup also drew on the structure of the central bank of the Federal Republic of Germany (the Bundesbank) that in turn was influenced by the Federal Reserve when it was set up in the 1950s.

I would like to draw attention to three elements of the institutional arrangements of the Federal Reserve System and the Eurosystem: Their decentralized nature, the independence of their decision-making bodies, and their mandates.

One common characteristic of the Eurosystem and the Federal Reserve System is their decentralized nature and decision-making structure. This inclusiveness and incorporation of regional perspectives ensures that monetary policy better reflects the needs of the economy as a whole. The 12 regional Federal Reserve Banks in the United States have a role that is similar in some respects to the NCBs in the euro area, and the Board of Governors has similarities to the ECB. The ECB has an Executive Board with 6 members who are based in Frankfurt, similar to the 7 Governors of the Board of Governors based in Washington, DC. Monetary policy decisions for the United States are taken by the FOMC with the participation of members of the Board and the Presidents of the 12 district banks. For the euro area, such decisions are taken by the Governing Council of the ECB that comprises the ECB Executive Board members and the Governors of the NCBs. In both cases, the broad committee setup ensures regional representation and the incorporation of a rich set of views into policy discussions. However, the Federal Reserve is relatively more centralized. In the case of the ECB, the decision-making body for all matters is the Governing Council where NCB governors have more votes than members of the Executive Board. By contrast, in the case of the Federal Reserve, the Board retains a majority of votes on the FOMC and

has decision-making powers on its own on many matters, without representation of the Reserve Banks. Another important difference is that in the United States no individual state has control of a Reserve Bank and each Reserve Bank represents an area that covers multiple states. This ensures better integration and makes it far more likely that Reserve Banks will be serving the interests of the United States as a whole compared to the Eurosystem where the jurisdiction of each NCB coincides with the borders of an individual state. This limitation to integration, in the case of the Eurosystem, reflects a more fundamental limitation in the structure of the European Union and the euro area. In contrast to the United States, the European Union remains a confederation of sovereign states that lacks a strong common government.

Independence from short-term political influences is one of the most important characteristics defining the ability of a central bank to serve a nation's best interests over time. Independence enables a central bank to resist short-sighted political pressures that invariably create inflationary biases and compromise monetary stability. Both the Federal Reserve and the ECB are independent central banks but with notable differences. When comparing the influence of the political decision-making bodies of the common currency area as a whole, the ECB is considerably more independent and arguably less accountable than the Federal Reserve. In the United States, the Federal Reserve reports to Congress and its powers are subject to change by law. By contrast the European Parliament has relatively little power over the ECB. The legal framework of the ECB is governed by the Treaties of the European Union and as such cannot be modified by any single government or by the European Parliament. With respect to the influence of individual member states, the relatively greater role of the NCBs in the Eurosystem, and their tight correspondence to individual member states, suggests a greater threat of political interference by individual member states in the euro area compared to the United States.

Once appointed, decision makers are independent from governments both in Europe and in the United States. However, differences in the length of the term and the potential for reappointment suggest differences in the potential for political influence on the decision-making bodies. In the ECB, all members of the Executive Board, including the President and Vice President of the ECB, are appointed for 8-year non-renewable terms. This ensures maximum independence following an appointment and relatively infrequent political battles relating to appointments. In the case of the Federal Reserve, whereas in theory Board members could serve 14-year non-renewable terms, in practice this is rarely observed. Most members serve incomplete terms and if a member leaves before the end of a 14-year term, a new member is only appointed for the remainder of that term. When appointed to serve an incomplete term, a governor can be reappointed for a full 14-year term once the remainder is completed. The chair and vice chair positions also require separate renomination and reconfirmation after each 4-year term in those positions. This structure implies that most Board members, and certainly the chair and vice chair of the Board, must face a potentially bruising reappointment process once or multiple times to serve for several years. Since the prospect of reappointment may make Board members, and especially the chair and vice-chair, more sensitive to political influence, the independence of the Federal Reserve could be strengthened if all Board members were appointed for 8-year non-renewable terms, as is the current practice for the Executive Board of the ECB. The independence of the Federal Reserve would also be strengthened if the remuneration of

Board members were adjusted to better reflect the level of responsibility associated with their position. This should reduce the high turnover rates that have been observed in all positions other than that of the chair over recent decades. As an example, my understanding is that the salary of the Chairman of the Federal Reserve is less than half that of the President of the ECB. In my view, it does not serve the interests of the nation well to underpay members of the Board, especially in light of the expanded responsibilities envisioned for the Federal Reserve System in the aftermath of the crisis.

Perhaps the most significant difference between the ECB and the Federal Reserve is in the legal text regarding their mandates. The ECB's mandate focuses on one objective, while the Federal Reserve's statute states multiple goals and does not offer precise guidance on their relative importance. The comparative lack of clarity leaves open the interpretation of its mandate and poses challenges for the Federal Reserve.

Reflecting best practice following the experience with inflation and disinflation from the 1960s to the 1980s in numerous developed economies, the mandate of the ECB, which was originally formulated as part of the EU Treaty in 1992, has a hierarchical nature defining price stability as the primary objective of the institution. Price stability is the primary mandate of the European System of Central Banks (ESCB) which comprises the ECB and all the NCBs of the EU. In contrast, the Federal Reserve has a so called "dual mandate" that assigns comparable importance to maximum employment. Specifically, the Federal Reserve should "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

An important reason for this difference is the timing of the adoption of the legal text. The current statutory mandate of the Federal Reserve reflects revisions to the Federal Reserve Act in 1977-78, before the crystallization of the modern consensus regarding the primacy of price stability as the most important contribution that a central bank can make to social welfare in the context of modern democracies. A historical digression can help explain the significance of the timing. Prior to the 1980s, rather than focus on price stability, the statutory mandates of numerous central banks emphasized multiple objectives including references to full employment as an explicit goal. As an example consider the following interpretation of the Federal Reserve's objectives, as stated by the Board in the first edition of *The Federal Reserve System: Its Purposes and Functions*, published in 1939: "The purpose of Federal Reserve functions, like that of Governmental functions in general, is the public good. Federal Reserve policy can not be adequately understood, therefore, merely in terms of how much the Federal Reserve authorities have the power to do and how much they have not the power to do. It must be understood in the light of its objective—which is to maintain monetary conditions favorable for an active and sound use of the country's productive facilities, full employment, and a rate of consumption reflecting widely diffused well-being." Although such wide-ranging interpretations of the objectives of a central bank may have been well-intentioned, they did not generally serve as an indicator of good performance. The lack of clarity also made the central bank less accountable. The painful experiences with inflation and disinflation from the 1960s to the 1980s highlighted that the demand to deliver full employment in addition to price stability overburdened central banks, leading to poor performance on both fronts. This led to significant change and/or clarification and/or reinterpretation of central bank mandates towards highlighting the

primacy of price stability. Characteristic of this norm has been the advent of Inflation Targeting (IT), a framework originally adopted by the Reserve Bank of New Zealand (RBNZ) in 1989. The main distinguishing characteristics of inflation targeting are the adoption of a numerical definition of price stability and its recognition as the primary objective of the central bank. As Don Brash, the Governor who first implemented IT at the RBNZ noted later, the multiple goals facing the central bank before the adoption of IT created conflicts that generated instability and inflation. “The legislation under which we operated required us, in formulating our advice, to have regard for the inflation rate, employment, growth, motherhood, and a range of other good things” (Brash, 1999). He then went on to explain how abandoning the multiple-goal approach and recognizing the primacy of price stability helped reestablish stability in New Zealand.

The difficulty associated with too literal an interpretation of a multiple-goal mandate was also recognized by the Federal Reserve. Starting in 1979, under the leadership of Chairman Volcker, and continuing under Chairman Greenspan, the Federal Reserve effectively interpreted price stability as a necessary primary goal for attaining other objectives. As explained in the 9th edition of the Federal Reserve’s *Purposes and Functions*, published in 2005: “Stable prices in the long run are a precondition for maximum sustainable output growth and employment as well as moderate long-term interest rates.” In 2004, Chairman Greenspan pointed to the primacy of price stability in explaining the success of Federal Reserve policy since 1979. As he explained, this resulted from “maximizing the probabilities of achieving our goals of price stability and the maximum sustainable growth that we associate with it” (Greenspan, 2004).

With this interpretation of the Federal Reserve’s mandate, closer comparison with that of the ECB suggests more similarities than differences. This is because while the mandate of the ECB explicitly recognizes the primacy of price stability, it does not ignore other objectives. To the extent feasible, the central bank could be expected to contribute to the attainment of other goals, but only if that did not compromise its primary objective. Thus, the EU Treaty specifies: “The primary objective of the ESCB shall be to maintain price stability. Without prejudice to that objective, it shall support the general economic policies in the Union in order to contribute to the achievement of the latter’s objectives.” And with regard to these objectives, the Treaty states: “The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.” Thus, full employment is one of numerous other objectives the ECB should support, as long as this does not compromise price stability.

The similarity in the interpretations of the mandates of the ECB and the Federal Reserve that had been in place since 1979 is noteworthy, but more recent developments highlight that the lack of clarity in the case of the Federal Reserve comes at a cost. As part of its response to the crisis, the Federal Reserve has sought to improve its communications and provide a numerical definition of price stability. The effort to better anchor inflation expectations over time in this manner has been a welcome development. In light of the wording of its statutory mandate, however, the FOMC also introduced a numerical operational guide for maximum employment. Specifically, in January 2012 the FOMC

adopted a “Statement on Longer-Run Goals and Monetary Policy Strategy,” which was reaffirmed in January of this year. The statement defines the FOMC’s understanding of price stability as consistent with a 2 percent inflation goal and provides numerical estimates of the longer-run normal rate of unemployment that the FOMC views as an operational guide for maximum employment, while recognizing that these estimates may change over time. In addition, the statement suggests that the FOMC would take a “balanced approach” in seeking to mitigate deviations of inflation from 2 percent and deviations of unemployment from its longer-run normal rate.

With the adoption of this language, the FOMC seems to have moved away from its earlier interpretation that placed greater importance on the attainment of price stability. While the new language is closer to a literal interpretation of the Federal Reserve’s statutory mandate, it engenders the same risks faced by the Federal Reserve before 1979, the earlier period in its history when a similar literal interpretation of multiple goals with elevated attention to maximum employment was in effect.

In light of the earlier historical experience, the risks of overburdening the Federal Reserve with multiple conflicting goals should be well known. The tensions associated with an overly literal interpretation of the Federal Reserve’s mandate were also highlighted in a recent speech by Chairman Volcker: “I know that it is fashionable to talk about a ‘dual mandate’ – that policy should be directed toward the two objectives of price stability and full employment. ... Asked to do too much ... [the Federal Reserve] will inevitably fall short. If in the process of trying it loses sight of its basic responsibility for price stability, a matter which is within its range of influence, then those other goals will be beyond reach” (Volcker, 2013).

These risks, which are caused by the lack of clarity of the statutory mandate of the Federal Reserve, could be mitigated by Congress. A clarification explicitly recognizing the primacy of price stability as an operational goal for the FOMC would be the best defense of monetary stability over time. Subject to maintaining price stability, the Federal Reserve could be instructed to contribute as possible to other objectives, including maximum employment, similar to current practice in Europe. In addition, and in light of the greater authority the Federal Reserve has gained over banking and financial regulation, financial stability should be more clearly highlighted in the mandate.

References

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