THE ROLE OF A REGIONAL BANK IN A SYSTEM OF CENTRAL BANKS

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INTRODUCTION

A modern central bank seeks to maintain a financial environment within which competitive markets support the efficient use of productive resources. The overarching principle is that a central bank should provide the necessary monetary and financial stability in a way that leaves the maximum freedom of action to private markets. In keeping with this principle, monetary policy is implemented by indirect means, with an interest rate policy instrument rather than with direct credit controls. In the banking sphere every effort is made to minimize as far as possible the regulatory burden associated with financial oversight.

The principle that markets should be given free reign wherever possible creates three difficulties of understanding that a central bank must overcome in order to carry out its policies effectively. The presumption that monetary and banking policies are best when they are as unobtrusive as possible creates the first difficulty. Inevitably, central banks seem shadowy and distant from the public's point of view. Yet, to work well, central bank policies need to shape the expectations of households and businesses. Monetary policy encourages economic growth and stabilizes employment over the business cycle by anchoring inflation and inflation expectations. Bank supervision and regulation aims to promote confidence in the banking system.

The need to influence expectations and promote confidence puts a premium on credibility, a commitment to goals, and a central bank's perceived independence and competence to achieve its objectives. Thus, a central bank must create in the public's mind an understanding of the methods by which its objectives can be sustained. This formidable problem has to be overcome in spite of the fact that a central bank operates in the background, with obscure methods and procedures.

The second and third difficulties arise because central bankers must understand markets. Dynamic markets introduce evermore efficient productive technologies and create new goods and services to better satisfy consumer wants. Economic dynamism complicates the measurement of macroeconomic conditions. A central bank seeks to under-

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stand the latest market developments in order to implement monetary and banking policies appropriately. Policy actions are inevitably benchmarked against historical correlations in data. Yet a central bank must be prepared to question its interpretation of data in light of anecdotal and other information that suggests behavior different from historical averages.

The third difficulty of understanding is in the area of economic analysis. Because policies influence economic activity indirectly, central bankers must use economic analysis to think about how their policies are transmitted to the economy. Some sort of quantitative theoretical model must be used to think about how markets respond to monetary and banking policies, and how monetary and banking policies ought to react to the economy.

The role of regional banks in a system of central banks is about creating understanding in the three senses described above. For example, decentralization enhances credibility because the diffusion of power makes it more difficult for outside pressures to be brought to bear on a central bank. The regional presence helps a central bank to get its policy message out and to gather anecdotal and specialized information on regional economies. Information gathering and dissemination are particularly important for central banks such as the Eurosystem and the Federal Reserve System, whose currency areas span large and populous regions. For this reason, the Central Bank of the Russian Federation and the Peoples Bank of China might profitably restructure themselves as a system of regional central banks.[1]

A regional presence also benefits a central bank with responsibilities for bank supervision and regulation, and the power to extend emergency credit assistance to troubled financial institutions. Specialized knowledge of local economies, industries, and businesses is of use to bank examiners and helpful in determining whether a troubled bank deserves emergency credit assistance. Likewise, central banks that play a role in the provision of payments services run far-flung operations through their regional offices.

Last but not least, the diversification of research within a system of central banks brings a variety of analytical perspectives to policy deliberations that is invaluable in our increasingly complex economy. Moreover, a system of regional banks led by the center institution harnesses competitive forces to encourage innovative thinking within the central bank.

The first half of this paper, which includes Sections 1 though 4, highlights the role played by the Reserve Banks in the Federal Reserve System. The remainder of the paper, Sections 5 through 8, offers some observations on the new Eurosystem based on the experience of the Federal Reserve System. There is a short concluding section.

Having spent 20 years as an economist at the Federal Reserve Bank of Richmond, I welcome the opportunity to clarify my thinking on these matters. I hope that my discussion of the Federal Reserve System helps the European national banks and the European Central Bank to think about their respective roles in the Eurosystem. Early in the century the Federal Reserve System looked to European central banks for guidance in designing its institutional structure and operating procedures. The Federal Reserve will be pleased if it can now return the favor.

The improvement over time in communication, information, and transportation technologies has enhanced the role of Reserve Banks in the Federal Reserve System. The United States has seen a deconcentration of metropolitan employment that appears to be the result of urban congestion and technologies that make it increasingly possible to locate businesses away from traditional urban centers.[2] The tendency is toward an equalization of regional economic activity.[3] Think of the growth of California, Florida, and Texas, and the tremendous growth in the South and Southwest. Atlanta, Georgia has become a major commercial center; Charlotte, North Carolina is a major banking center; Seattle is the home of aircraft and software production.

The growing dispersion of economic activity increases the value of local information that Reserve Bank presidents bring to the Federal Open Market Committee. The presence of Reserve Banks in the midst of the various regional economies makes possible a deeper understanding of these than can be acquired from Washington. Personal contacts built up over time create trusting relationships that facilitate the timely acquisition of information about local businesses and markets. Personal contacts are particularly valuable in periods of financial stress when it is especially difficult to know what is happening in certain sectors. Reserve Banks tend to specialize in knowledge concerning industries concentrated in their respective districts. For instance, the New York Fed follows financial markets generally, the Chicago Fed follows commodity markets and heavy manufacturing, the Dallas Fed follows oil production and developments in Mexico, etc.

Thanks to the progress in information and communication technology, Reserve Banks are no longer at an information disadvantage relative to the Federal Reserve Board or the New York Fed with respect to general market information. All receive news and data instantaneously from everywhere. Reserve Bank presidents, in turn, contribute to policy discussions with speeches and articles transmitted instantaneously around the world by wire services and by the Internet.

Reserve Bank officials are familiar with both their regional private sector world and the world of the Federal Reserve Board. Reserve Banks help bridge the two worlds. Responsibilities and pressures at the Board create a culture very different from the private sector. The Board staff relies on aggregate data and abstract concepts to think about the whole economy. Thinking at the Board reflects consensus beliefs and attitudes, and is cautious in adopting and even considering new ideas. Because the Board has ultimate responsibility for much that is done in the System, it has little trouble attracting hard-working, dedicated, and highly skilled employees. Yet because of the responsibility, the pressure, the need for consensus, and the need to focus on abstractions and aggregates, the Board staff can be distant from the private sector. This is a manifestation of the remoteness described in the introduction that plagues central bankers.

With important exceptions there is less ultimate responsibility for System matters at Reserve Banks. On the other hand, there is opportunity for distinguishing one's Reserve Bank from the others. This is a manifestation of the competitive innovation, described in the introduction, that a system of central banks promotes.

One of the Federal Reserve Board's most important duties is to manage relations with Congress. The Board also handles international relationships and deals directly with large financial institutions and national interest groups. Board members testify and give speeches frequently. While these are critically important responsibilities, such communications are nevertheless rather abstract and remote.

Because of its regional presence and focus, the staff at Reserve Banks is more engaged with the rank and file public. Much of what Reserve Banks do involves direct relations with people in the private sector. For instance, Reserve Bank officials manage relations with their Boards of Directors made up of private citizens. Officials speak to local groups about Federal Reserve policies and current economic conditions. Staff members supervise and examine banks, collect data on banking and regional business conditions, provide financial services, promote economic education, and help facilitate community development. The staff at Reserve Banks understands core policy, regulatory, and operational issues and knows how to explain these to its constituencies. In short, Reserve Banks keep the central bank from becoming disembodied, isolated, and out of touch.

FEDERAL OPEN MARKET COMMITTEE MEETINGS[4]

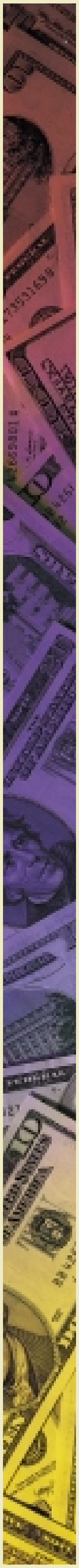
The Federal Open Market Committee (FOMC) meets every six weeks on average at the Federal Reserve Board in Washington. The meetings are attended by the seven governors of the Federal Reserve System, the 12 Reserve Bank presidents, and research directors and other staff members from the Reserve Banks and the Board. The Chairman of the Board of Governors sets the agenda, leads the discussions, shapes the policy decisions, and develops the consensus to support the Committee's policy actions.

The meetings routinely include a report from the open market desk at the Federal Reserve Bank of New York, a briefing by the Board staff on current economic and financial conditions in the United States and abroad, a couple of "go arounds" in which the governors and presidents present their views on the economy and policy, and a discussion and vote on the intended federal funds rate. Normally, an FOMC meeting lasts four to five hours, but twice a year the Committee meets for two days to set annual target ranges for the monetary aggregates and to consider longer-run procedural and strategic issues.

Even though all Reserve Bank presidents but the New York Fed president vote on a rotating basis, all 19 members of the Committee participate on equal terms at every meeting. The time for discussion among the members is, accordingly, limited. More often than not, Committee members influence each other incrementally by revisiting issues as time passes, rather than by exchanging views at any particular meeting. Economic conditions usually do not call for a change in the intended federal funds rate. The Committee uses such occasions to prepare itself for possible future policy actions. Such "down time" affords ample opportunity to consider strategic and procedural questions. All in all, there is time for Committee members to educate and influence each other, and to reach consensus. But, again, much of the back and forth among Committee members takes place over time. In this regard, the verbatim written transcript that is prepared and circulated after each FOMC meeting (but released with a five-year lag) is of great help in enabling members to review each other's statements in detail.

The deliberative process works reasonably well in practice. The repeated interaction creates a mutual understanding that enables a variety of geographical and professional perspectives (academic economist, banker, business economist, businessman, financial market professional, government administrator, lawyer, and regulator) to be brought to bear in making policy decisions.

Two related pitfalls have the potential to weaken the FOMC. First, the bonding that takes place as a consequence of repeated meetings can cause Committee members to



begin to think alike. As a result, the FOMC could be blindsided by a risk or side effect of a policy stance that it had not taken into account. To some extent, that risk is diminished by the external community of "Fed watchers" offering professional advice on monetary policy.

The sheer size of the FOMC reduces the likelihood that Committee members will think alike. One of the great strengths of policy made by representatives from a system of regional central banks is the diversity and number of points of view brought to the table. But the size of the FOMC actually creates the second potential pitfall: a free rider problem. Recognizing that their influence in the Committee may be small, members may be inclined to free-ride on the preparations of others more interested, expert, or responsible for monetary policy, such as the Chairman and the Board staff.

The free rider problem is dangerous because it has the potential to make the effective size of the FOMC much smaller than the full Committee. Even worse, free riding is hard to detect because free riders can continue to participate with thoughtful-sounding statements. Widespread free riding would weaken the Committee in much the same way as the tendency to think alike.

The Chairman of the Federal Reserve Board

Even though the Chairman has only one vote in the FOMC, he is preeminent for a number of reasons. The Chairman and the other Board members are appointed by the President of the United States, and the Chairman is named by the President to lead the Federal Reserve System. The Chairman has command of the large staff at the Federal Reserve Board. Most importantly, only he is involved in every key central bank operation (monetary policy, bank supervision and regulation, financial services, foreign exchange operations, relations with Congress and the Treasury, and public relations). The Chairman is the only member of the FOMC fully aware of all the potential interconnections in what the Federal Reserve does. Consequently, no major decision can be taken without the Chairman's assent for fear of not having all the facts. For all these reasons it is difficult to challenge the Chairman's leadership.

By the same token, a good Chairman is aware of the risks of excessively centralizing power in his hands. For the reasons discussed above he must encourage diverse points of view in the FOMC. Central bankers worry about a variety of risks to the economy and the Chairman must encourage Committee members to bring their concerns to the table. The Chairman must help prioritize the concerns and suggest a course of action to achieve the central bank's goals. Finally, the Chairman must mobilize the Committee to action. All in all, the Chairman must use his preeminence to make the most of the diversity in the FOMC while preserving the decisiveness needed to make monetary policy.

Reserve Bank Presidents at the FOMC

Broadly speaking, Reserve Bank presidents contribute to FOMC meetings in two important ways. They make regular reports on their respective regional economies, and they provide their own analysis of the national economy and the policy options.

Regional information compiled by Reserve Banks for the FOMC in the Beige Book is of great importance.[5] But information in the Beige Book can be stale by the time of an FOMC meeting. Presidents bring more timely information to the meeting, including confidential information from personal or other sources not included in the Beige Book. Anecdotal information brought to the FOMC can signal changing sentiment before it becomes evident in aggregate data. Mutually supportive signals from various regions may help to identify or confirm a change in trend or a turning point in the aggregate data. It is particularly important that a central bank recognize and react promptly to turning points in inflation and employment trends.

Besides the Chairman, the Board staff presents the most influential economic analysis at FOMC meetings. The staff's analysis is primarily presented in two briefing documents with which Committee members' views are invariably compared. The Greenbook summarizes national and international economic conditions and presents a forecast; the Bluebook lays out the policy alternatives.

Although the briefing books are comprehensive, the analysis of individual members provides essential perspective. Governors and presidents alike contribute substantively to the interpretation of current economic conditions and the analysis of alternative policy options. Many important possibilities such as the risk of an inflation or deflation scare or the chance of a crisis of confidence in financial markets are particularly difficult to assess and take account of in econometric models. The state of consumer and business confidence is also difficult to assess formally. Such issues are addressed in the statements of Committee members themselves.

Economic analysis is a great equalizer among members of the FOMC. An argument based on economic reasoning that can be challenged and debated in the language of economics is ultimately more influential than an intuitive assertion about the economy or policy, no matter who expresses it and how strongly it is held.

ECONOMIC RESEARCH AT FEDERAL RESERVE BANKS

Reserve Bank research departments are staffed with an average of 15 or so research economists (except for the New York Fed, which has more than twice as many). Economists graduate from top schools where they acquire the latest analytical skills and an appreciation of how to think about macroeconomics, monetary policy, and banking policy. For the most part, there is a belief in the power and practical value of economic theory and empirical work, and a drive to use economics to make good policy.

Reserve Banks are able to attract and retain good economists because they offer a unique combination of opportunities. Above all, there is the opportunity to prepare the bank president for FOMC meetings. In their role as policy advisors, Reserve Bank economists acquire an intimate empirical understanding of the macroeconomy and a broad understanding of policy issues. Economists produce policy essays for the Bank's *Economic Review* and may be encouraged to publish articles in professional economics journals. The best of these essays may influence the way that the Federal Reserve, other central banks, and academic economists think about policy. It is possible for a Reserve Bank economist to become increasingly effective as a policy advisor while acquiring a research reputation in the economics profession at large.

Reserve Bank research departments need not specialize. The expression of alternative points of view is an important strength of a system of central banks. Nevertheless, Reserve Bank research departments often develop a specialization. A Reserve Bank president may encourage research of one type or another; or a particularly skillful economist may happen to make a department strong in a particular sort of research.

A Bank may also exploit a feature of its regional economy or its operational responsibilities to develop a research advantage.

Differences of opinion among Federal Reserve economists are discussed at regular System research meetings. From time to time, there are differences of opinion involving essays in a Reserve Bank *Economic Review*. Reserve Banks send review articles to the Board for a prepublication review. Ordinarily essays benefit from comments by the Board staff. On occasion, the Board staff may recommend against publication because an article is thought to be technically flawed or because the article takes a position regarded as inconsistent with System policy. Conflicts arise because the Board staff prepares speeches and testimony for the Chairman and other Board members in which the Federal Reserve explains current policies to Congress and others. Policy essays published by a Reserve Bank that implicitly or explicitly question current policies may be a nuisance or worse from the perspective of the Board.

Obviously, Reserve Bank economists could be prevented from publishing essays critical of current policy. But that would deny the public the work of economists most knowledgeable about central banking. It would leave the field wide open to others less familiar with the subject. Besides, policy essays reveal a healthy open debate within the Federal Reserve System. In keeping with the mission of a central bank to worry about the economy and policy, it is helpful to have policy questioned by enterprising economists at the Reserve Banks. Furthermore, the best essays facilitate policy advances by suggesting alternatives.

Ultimately, a Reserve Bank has both the incentive and the ability to discipline the output of its economists. The Reserve Bank itself has the most to lose by publishing a poor essay in its *Review*. Reserve Bank research is regularly presented at Federal Reserve System committees and at academic conferences and seminars. Research directors have ample opportunity to judge the professional reception of a particular piece of research prior to publishing it in the Bank's *Review*.

PUBLIC INFORMATION

The modern era of monetary policy at the Federal Reserve began when Chairman Paul Volcker took responsibility publicly for inflation in the early 1980s, and subsequently brought it down. This was a watershed event because before that Federal Reserve officials and much of the public, too, generally blamed inflation on a variety of causes beyond the central bank's control. Since then, the public has come to understand that Federal Reserve monetary policy determines the trend rate of inflation over any substantial span of time.

The acceptance of the responsibility for low inflation by the Federal Reserve greatly elevated the importance of public information and communication in the policy process. Previously, the Federal Reserve preferred to operate in the background and out of the limelight. The public thought that important economic policy decisions were made elsewhere, and the Fed felt relatively little need to communicate with the public about its policy intentions. All that changed after the disinflation initiated by Chairman Volcker, for two reasons. First, the Fed thrust itself into the limelight with inflation-fighting policy actions that raised interest rates and weakened economic activity in order to bring down inflation. Second, the Fed realized that bringing down inflation and maintaining price stability would be easier if the Fed had credibility for low inflation. Thus, the public became more interested in what the Fed was doing, and Fed officials came to see communication with the public as a tool useful for building credibility.

The Fed has two primary public information objectives with respect to monetary policy.[6] A consensus has emerged among monetary economists and central bankers that some sort of explicit mandate for low inflation is beneficial. Yet, Congress has not mandated in a clear way that the Fed place a priority on low inflation. Consequently, Fed officials bear the burden of responsibility for educating the public about the benefits of low inflation. Second, the guiding tactical principle of monetary policy is to preempt inflation, or deflation for that matter. A well-timed preemptive increase in the intended federal funds rate is nothing to be feared. For instance, the 1994 monetary tightening was almost certainly necessary to keep inflation from ending the business expansion. If the Fed is to successfully maintain price stability, it must create an understanding of the need for policy to be preemptive; and the Fed must build a consensus for specific preemptive policy actions when they are needed.

The regional presence of the Reserve Banks is a great advantage in getting the Fed's message out to the public. The participation of Reserve Bank presidents in the FOMC puts them in great demand as speakers in their districts. Economists and other staff members at the Reserve Banks also carry the Fed's message to the public. Reserve Banks produce a variety of literature aimed at educating the public about the Federal Reserve. There are extensive economic education programs through which the staff at Reserve Banks explains monetary policy to schoolteachers and college professors.

Sometimes market participants complain that speeches by members of the FOMC complicate the business of understanding the Fed's current thinking. As mentioned above, the great strength of the Federal Reserve System is that it brings a number of different points of view to the FOMC. There is no reason why the public should not hear these diverse views.

Markets know that the Chairman, and only the Chairman, speaks for the whole FOMC, and the Chairman's rhetoric is understood to represent the current consensus thinking of the FOMC on policy. The Chairman makes use of his numerous appearances before Congress and elsewhere to update or elaborate upon the current thinking of the FOMC. Moreover, the FOMC announces any change in its intended federal funds rate immediately after any meeting in which the rate is changed. Minutes of each FOMC meeting, released shortly after the following meeting, give a fairly comprehensive idea of the concerns and inclinations of Committee members, though without individual attribution. Included with the minutes is the policy directive from the FOMC to the open market desk. The directive contains "symmetry language" that indicates any inclination on the part of the Committee as a whole to be more concerned with the risk of inflation or recession over the next few weeks. The minutes also contain the voting record and any statements of dissent expressed by members of the FOMC.

The public does not seem to mistake the personal views of individual members for information about the FOMC as a whole. Transparency of a Committee member's views, rather than secrecy, seems more likely to build understanding and credibility for the Federal Reserve over time. Not to air differences among Committee members would deprive markets of useful information, and it would put the public at a permanent disadvantage in understanding monetary policy.

It is worth emphasizing that the Federal Reserve's most effective voice is that of its Chairman. The great respect accorded the Fed Chairman is largely due to his own analytical ability and experience, and the informational and analytical support of the capable Board staff. A good measure of credit is no doubt due to recent monetary policy successes. But an important source of the Chairman's personal credibility probably comes from the fact that he represents the views of the diverse members of the FOMC. If the public were to believe that the Chairman was acting alone, the public would be more inclined to worry that the Chairman could be co-opted, i.e., that he might take policy actions for political rather than economic reasons. The Chairman's credibility and influence would suffer accordingly. Even here, the regional nature of the Federal Reserve System plays an important role. The Federal Reserve Chairman needs the FOMC as much as the Committee needs its Chairman.

THE EUROSYSTEM[7]

The Eurosystem shares the basic structure of the Federal Reserve System. The Eurosystem consists of the European Central Bank (ECB) headquartered in Frankfurt am Main, more or less the equivalent of the Federal Reserve Board, and 11 national central banks (NCBs), which are like the 12 Federal Reserve Banks. Monetary policy in the Eurosystem is made by the Governing Council (the equivalent of the FOMC). The Governing Council includes six members of an Executive Board housed at the ECB (the rough equivalent of the seven-member Board of Governors of the Federal Reserve System) and the governors of the 11 national central banks. The President of the ECB chairs the Governing Council, playing a role similar to the Chairman of the Board of Governors.

Power in the Eurosystem is more decentralized than in the Federal Reserve System. First of all, the governors of the NCBs all vote on policy matters in the Governing Council on each occasion. The seven members of the Board of Governors and the New York Fed president vote all the time in the FOMC, but the other 11 Reserve Bank presidents have only four votes on a rotating basis. As is the case in the FOMC, policy decisions in the Governing Council require a simple majority vote.

Secondly, the Board of Governors exercises more power in the Federal Reserve System than the ECB does in the Eurosystem. For instance, the Board of Governors exercises general supervision over the Reserve Banks: the Board approves Reserve Bank budgets, approves the appointment of Reserve Bank presidents, and appoints three of nine directors at each Reserve Bank, including the chairman. In contrast, the Maastricht Treaty gives the NCB governors control over the terms and conditions of employment of the staff at the ECB. The NCBs are financially independent of both the ECB and their respective national governments. Decentralized control, the so-called principle of subsidiarity, is enshrined in the preamble of the Maastricht Treaty.

Even the ECB itself is more decentralized than the Board of Governors. For instance, the Economic and Research Directorates, which employ the bulk of the ECB's professional economists, do not report to the President of the ECB but to another member of the Executive Board. The fact that there is no Chief Executive of Europe to give his assent to the President of the ECB and other Executive Board members, as in the United States, probably makes for a weaker ECB within the Eurosystem. The NCB governors are appointed by their respective national governments, without approval of the Executive Board.

On the objectives for monetary policy, the Maastricht Treaty states unambiguously that the primary objective of the Eurosystem shall be to maintain price stability. Although the treaty obliges the Eurosystem to support the general economic policies of the European Union, that support is to be without prejudice to the objective of price stability.

Accordingly, the Eurosystem mandate is considerably more definite than the objectives given in the Federal Reserve Act.

The Maastricht Treaty safeguards the independence of the Eurosystem. The Eurosystem charter is an international treaty that cannot be revoked without unanimous consent of the signatories. Moreover, the treaty itself actually tells the Eurosystem not to take instructions from other institutions in the European Union. The greatest threat to the Eurosystem's independence and the pursuit of price stability could come from the ambiguity in the treaty on exchange rate policy, which is to be established by the European Council. It is not completely clear how a conflict between exchange rate and price stability objectives would be settled.

On transparency, the Maastricht Treaty mandates that the ECB publish quarterly and annual reports. Executive Board members have signaled their willingness to testify regularly before the European Parliament. The ECB intends to keep the public informed of its policy actions and thinking through press conferences, speeches, and other regular publications. The President of the ECB holds a press conference to discuss monetary policy immediately after one of the two Governing Council meetings held each month. Notably, the treaty specifies that the proceedings of the meetings shall be confidential, but that the Governing Council may decide to make the outcome of its deliberations public.

For now, the Eurosystem does not coordinate and centralize bank supervision and regulation, or emergency credit provision. NCBs carry on in these areas according to their respective national policies. This, of course, differs from Federal Reserve practice, where the Board exercises control over emergency credit assistance and over the supervision and regulation of banks.

DECENTRALIZATION IN THE EARLY FEDERAL RESERVE: Implications for the Eurosystem

The decentralized Governing Council described above is reminiscent of the early Open Market Committee of the Federal Reserve System. Established informally in 1922 with five of the 12 Reserve Banks represented, the Committee's membership was broadened to include all 12 banks in 1930. The FOMC took its modern form with the Banking Act of 1935, which gave the seven members of the Federal Reserve Board a vote in open market policy for the first time, and reduced the Reserve Bank votes to five.

As is well known from the account by Milton Friedman and Anna Schwartz, the decentralized structure of the Open Market Committee in the 1920s depended for its decisiveness on the leadership of Benjamin Strong, Governor of the Federal Reserve Bank of New York.[8] Governor Strong's powers of persuasion, personal courage, and good judgment gave coherence and purpose to Federal Reserve policy. After Governor Strong died in October 1928, the Open Market Committee became unworkable. Without Strong's leadership the decentralized Open Market Committee made for drift and indecisiveness in Federal Reserve policy.

The Governing Council of the Eurosystem appears to be susceptible to the same indecisiveness as was the early Open Market Committee. A closer look, however, shows why this is not likely to be the case.

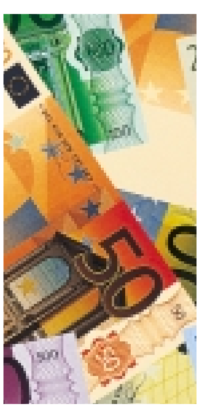
First, the objectives of Federal Reserve monetary policy in the early years were ambiguous. The United States was on a gold standard, and the Fed was committed to defend the dollar price of gold. Yet for much of the 1920s Governor Strong sterilized gold flows and instead tried to stabilize the price level.[9] In large part, Strong's personal discretion substituted for the lack of an agreed objective. The Eurosystem's price stability mandate should go a long way toward preserving the decisiveness of the Governing Council.

Second, it will take some time for the Eurosystem to develop and become familiar with euro-area data. But on the whole, much better macroeconomic data exist today than were available to the early Fed. This, too, should make the Governing Council more decisive than the early Open Market Committee.

Third, today's central banks can draw on the considerable theoretical and practical knowledge that economists have accumulated since the early years of the Fed. Central bankers have accumulated a good deal of practical knowledge themselves. The early Fed had little experience in managing monetary policy and very little in the way of analytical skills at its disposal to help guide policy.

Fourth, professional central bank watchers today provide external advice and discipline.[10] This, too, should act against policy indecision. Fifth, the Fed did not yet have the tradition of making the Chairman of the Board of Governors the Chairman of the FOMC. In effect, the Fed then lacked an institutional leader designated by the President of the United States. This was a great weakness in a decentralized structure such as the Open Market Committee. The President of the ECB is the designated leader. He is appointed by the European Council and confirmed by the European Parliament. In any case, it should be pointed out that centralization of power in the FOMC such as occurred with the Banking Act of 1935 did not guarantee good monetary policy, as the Great Inflation from the late 1960s to the early 1980s showed.

To sum up, the analogy with the early Fed is far from conclusive. With the help of the support systems described above, the Governing Council should be able to strike a reasonable balance between decentralization and decisiveness.



SUBSIDIARITY AND ECB STAFFING

One problematic issue facing the Eurosystem is the nature of the control that the NCBs will exercise over the staffing budget of the ECB according to the principle of subsidiarity. This is critical because, as the discussion of the Federal Reserve System makes clear, the Eurosystem cannot function effectively without a sufficiently strong ECB. The ECB must perform certain tasks. For instance, the ECB must represent the Eurosystem in its external relationships. Presumably, only the President of the ECB can speak for the Governing Council. Also, the ECB is the natural home for economists following the euro-area economy as a whole. The ECB is a natural repository for euro-area data, and its economists will assume primary responsibility (though by no means an exclusive one) for following and interpreting these data for the Eurosystem.

In addition, the ECB needs a staff with analytical capabilities sufficient to support the President in his role as leader of the Eurosystem. Among other things, the ECB's staff, working with the staff at the NCBs, must devise an analytical framework that can help the President of the ECB guide the members of the Governing Council in their monetary policy deliberations.

The funding of the ECB staff must be authorized by the NCB governors. Yet the NCBs lack the experience to judge the ECB's priorities and needs. The problem is two-fold. First, NCBs know relatively little about managing independent monetary policy. Second, NCBs have little experience as regional banks in a system of central banks. The division of labor between the NCBs and the ECB will have to be worked out gradually over time.

One hopes that the NCBs will agree to build up staff at the ECB fast enough to provide the leadership that the Eurosystem needs. The analogy with the Fed system makes clear that critical responsibilities should be borne by the ECB. NCBs have responsibilities and comparative advantages of their own that they should exploit for the benefit of the Eurosystem.[11]

NATIONAL CENTRAL BANKS AND THE CREDIBILITY OF THE EUROSYSTEM

The Eurosystem will establish full credibility for low inflation over time by satisfying three conditions. First, the Eurosystem must manage monetary policy competently. Second, the NCB governors and Executive Board members on the Governing Council must learn to work together. Third, the Eurosystem must build on its price stability mandate to broaden the public's support for price stability and the preemptive policy actions necessary to sustain it. The NCBs play a central role in seeing that these three conditions are satisfied.

Competence

It seems fair to say that the Eurosystem's expertise in maintaining price stability derives in large part from the Bundesbank, which has had a long and successful track record in managing independent monetary policy.[12] Other NCBs have less experience because for the most part they have chosen to fix their exchange rates to the Deutsche Mark. The Eurosystem adopted many of the Bundesbank's operational procedures to facilitate the transfer of the Bundesbank's monetary policy credibility to the Governing Council.

One significant difference between the Eurosystem and its fixed exchange rate system predecessor led by the Bundesbank is that monetary policy will now take account of euro-area aggregate data. Since those data are only recently being created, little is known about their historical behavior or their relationship to euro-area monetary policy. Until the Eurosystem becomes more familiar with the new area-wide aggregates, the Governing Council needs to rely on anecdotal regional information and the intimate knowledge that NCBs possess of their own country's data.

Finally, the NCBs have relatively large research departments compared to the ECB and extensive operational experience in financial and banking markets. The competence of the Eurosystem will depend on the ability of the ECB to draw on the talents of staff at the NCBs, as need be, for the good of the system as a whole.

Working Relationships on the Governing Council

Despite the safeguards in the Maastricht Treaty, the independence of the Eurosystem is at risk because the regional members of the Governing Council represent countries. Members could be influenced by their governments. Votes on the Governing Council could be traded for those on other governing bodies of the European Union. As mentioned above, the ambiguity on exchange rate policy opens the door to political interference in monetary policy. Politically motivated disputes could greatly complicate the business of the Governing Council. Such conflicts could cause indecisiveness, inconsistent policy actions, and a loss of credibility.

FOMC experience suggests a number of additional measures to prevent the politicization of the Governing Council. First, a macroeconomic framework should be developed to guide policy deliberations. The framework should be rich enough to encompass a wide variety of views and sufficiently coherent to provide the basis for prioritizing concerns and building a consensus for policy actions. The Governing Council should utilize economic arguments disciplined by the

price stability objective to smoke out and defuse political rhetoric. Economic reasoning is, to repeat, a great equalizer.

Second, the ECB President's role in the Governing Council should be strengthened so that he can guide the debate within the agreed upon framework. The ECB President should act against free riding by encouraging members of the Governing Council to prepare thoroughly and to participate actively. The effectiveness of members would be enormously enhanced if each were allowed to bring an economist advisor to the meetings. A verbatim transcript of the meetings should be produced, if only for internal use, to facilitate the give and take that must occur over time.

Third, the macroeconomic framework should be explained to the public in some detail so that Eurosystem watchers can more readily exercise professional discipline on the internal debate.[13] Minutes without individual attribution, published shortly after each Governing Council meeting would help focus Eurosystem watchers on issues of concern to policymakers. Over the long run, greater transparency can serve as a powerful safeguard against political interference.

Admittedly, the FOMC never had the potential for internal international disputes that exists in the Governing Council. However, FOMC experience suggests that the above-mentioned practices would facilitate the development of productive professional working relationships in the Council.

Broadening Public Support for the Eurosystem

The Bundesbank has an admirable monetary policy record in large part because it always had the full support of the German public for its price stability objective. That support was there because the Bundesbank was associated in the public's mind with the postwar economic miracle that began in the late 1940s at the time that the Deutsche Mark and the Bundesbank were created.

The European public has little natural affinity for the new Eurosystem. As was the case for the Federal Reserve System, the Eurosystem will have to earn the public's confidence. If anything, public relations will be more difficult for the Eurosystem than they have been for the Federal Reserve System because the euro area is made up of 11 different countries whose citizens speak many different languages. The Eurosystem should make extensive use of the regional presence of its NCBs to broaden the understanding of its mission and methods, much as the Fed uses the Reserve Banks.

The Eurosystem has one big advantage over the Fed in explaining itself to the public. In contrast to the Fed, whose mandate only exists in the Federal Reserve Act and is ambiguous at that, the Eurosystem's price stability mandate is unambiguous and part of one of the founding documents of the European Union.

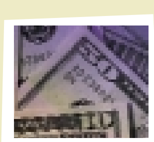
SUMMARY

The main message of this paper is that regional (national) banks play an especially important role in central banks whose currency areas span a continent, such as the Eurosystem and the Federal Reserve System. A regional presence facilitates the acquisition of specialized information on the economy and positions the staff to reach out to the public with an explanation of the central bank's policy objectives and practices. Presidents (governors) of regional central banks bring analytical diversity to the monetary policy committee. Above all, a system of central banks promotes a healthy competition that stimulates innovative thinking on operational, regulatory, research, and policy questions.

Federal Reserve experience teaches that a decentralized system needs a strong center. Staff at the center needs to be large enough to support a strong Chairman (President) of the system. The Chairman must be strong enough to encourage diverse views in the policy committee and to build a consensus for decisive and timely policy actions. The Chairman should exploit diversity and promote decisiveness.

The key to success in the Eurosystem, in addition to the above-mentioned points, is to establish good working relationships on the Governing Council. To facilitate this, the staff at the center should take the lead in developing a macroeconomic framework within which diverse policy views can be expressed and debated productively. Personal advisors should accompany members to the policy meetings. Verbatim transcripts should be prepared for internal use to facilitate an exchange of views over time. Minutes without individual attribution should be published to present opposing views clearly, to focus central bank watchers, and to guard against the potential for politically motivated policy mistakes.

The Eurosystem and the Federal Reserve System will succeed in the long run by broadening the public's understanding and support for low inflation and the preemptive policy procedures to maintain price stability. The way to do that is to involve the Reserve Bank presidents (national central bank governors) and their advisors fully in the policymaking process, and to utilize the system's regional presence to take the central bank's monetary policy message to the public.



ENDNOTES

1. In late 1998, the Peoples Bank of China announced its intention to establish nine provincial branches.

2. See, for example, Chatterjee and Carlino (1998).

3. Barro and Sala-í-Martin (1992) present evidence of convergence within the United States.

4. See Meyer (1998).

5. See Balke and Petersen (1998).

6. See Goodfriend (1997).

7. *European Union* (1995) contains the Maastricht Treaty, which, in turn, contains the language governing the structure, administration, and objectives of the Eurosystem. Wynne (1999) summarizes the documentation authorizing the establishment of the Eurosystem.

8. See Friedman and Schwartz (1963).

9. See Hetzel (1985).

10. See, for example, Begg et al. (1998).

11. See, for instance, Liebscher (1998).

12. See Deutsche Bundesbank (1999).

13. See Issing (1998).

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