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SPEECH

Keynote Remarks for the Commemoration of the Centennial of the Federal Reserve's U.S. Dollar Account Services to the Global Official Sector

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Introduction

Distinguished representatives of the global central banking community and official sector, current and former central bank account operations staff of the Federal Reserve Bank of New York, Federal Reserve System colleagues, I am honored to speak at this commemoration of the 100th anniversary of the opening of the first dollar accounts for central banks around the world on the books of the Federal Reserve.[1] And it is, of course, very apt that we gather here in a room whose namesake, Benjamin Strong, was more than anyone else responsible for their establishment.

On May 3, 1917, the Federal Reserve signed its first reciprocal account agreement with a foreign central bank, the Bank of England, entailing the establishment of nostro[2] and custody accounts on each other's books. This was soon followed by agreements with several other central banks, including the Banque de France, Bank of Italy, and Bank of Japan.

These early agreements were instrumental in helping the newly-established Federal Reserve forge a global role for itself as an institution and for the U.S. dollar as a reserve currency. So as much as the account openings themselves, today we commemorate the symbolism, principles, and values they represent.

Today's event commemorates the start of the Federal Reserve's international operations and involvement in the international arena. It honors the Federal Reserve's past and ongoing support for the principle of the major central banks to provide safe, confidential, and reliable account services in their currencies to the global central banking community in support of financial stability and other central banking mandates. And it acknowledges the value of cooperation among the world's central banks and the role that these initial operational ties played in paving the way for broader and deeper cooperation among central banks.

In doing so, we also recognize the individuals past and present who have played a role, often behind the scenes, in managing the Federal Reserve's dollar account operations for the global official sector.

The Early Years: War, Ambition, and Cooperation

The story of the early years of the Federal Reserve's dollar accounts for foreign central banks is one of war, ambition, and cooperation.

It is no coincidence that the first agreement was signed less than a month after the United States entered the First World War on April 6, 1917. Since the Federal Reserve leaders' very first meeting in 1914, in addition to the weighty task of standing up from scratch a fully functioning central bank, they had to prepare for any eventuality concerning the impact of the Great War on the U.S. and the Federal Reserve's responsibilities.[3] Against this backdrop, Fed leaders foresaw that it would be useful to establish close banking relationships with foreign central banks to facilitate transactions arising from wartime needs and conditions, including payments for war-related U.S. exports, financing of wartime government debt, and gold transfers. It was left to Governor Benjamin Strong of the New York Fed to journey to Europe in the spring of 1916 to personally negotiate the early account agreements, allowing him to forge close personal relationships with European central bankers, most famously with the Bank of England's Montagu Norman, or as Strong would come to call him: "my dear Monty."[4] While these initial discussions in 1916 did not lead immediately to agreements, partly owing to U.S. observance of neutrality, the groundwork had been laid such that by the time the U.S. entered the War in April 1917 the arrangement with the Bank of England could be executed rapidly.

The historical records show that the establishment of this first account agreement with the Bank of England involved a minor diplomatic faux pas, known as the British Treasury bills episode. President Wilson, having won reelection in 1916 on the claim of having kept the U.S. out of the Great War and observing strict neutrality, had directed the Federal Reserve Board in Washington to issue a clear-cut warning to U.S. banks not to invest in a pending large placement of British Treasury bills in the U.S. market. The immediate and worldwide effect of the statement was to give the impression that the U.S. had "broken with Britain," an impression which officials were soon scrambling for ways to counteract.[5] The result was the Federal Reserve Board's decision, contrary to the terms of the account negotiations and to the consternation of the New York Fed, to unilaterally announce to the

public the account agreement with the Bank of England. The whole episode spoke perhaps to the Fed's inexperience in matters of delicate international financial diplomacy. In any event, the Bank of England magnanimously let the matter slide—noting that mistakes "may arise even in the best regulated families"—and the account agreement was executed on May 3, 1917 and operationalized on June 20, 1917.[6,7] Andrew Hauser will provide more insight into this fascinating period in his remarks in a few minutes.

As expedient as the accounts were for wartime needs, the historical records show they were also motivated by ambitions of the Fed's first leaders to establish the dollar as a major international currency and, for Benjamin Strong, to establish New York as a great international financial center to rival London. They had their work cut out for them. By 1914, while the U.S. was already the world's largest economy and trading nation, its banking system remained curiously parochial and the dollar was not a major international currency.[8] In fact, American firms continued to finance their trade almost entirely with credits from foreign banks, a source of resentment, with Paul Warburg, the first Federal Reserve vice chairman, referring to the annual acceptance fees paid to London banks as a form of "tribute."[9] With the passage of the Federal Reserve Act in 1913, some of the constraints on the emergence of a robust dollar trade financing market were removed and the newly established U.S. central bank could take a more active role in nurturing and backstopping a nascent dollar acceptance market, which it did. These efforts included buying dollar acceptances for foreign central bank accounts at competitive discount rates and providing guarantees, for a small fee, on payments at maturity of acceptances bought for these accounts.[10] These actions helped to spur the dollar's emergence as an important international currency, with dollar acceptances viewed as an attractive reserve asset by the 1920s.

The early accounts also represented tangible links of cooperation among major central banks, with much of this cooperation centered on efforts to maintain or restore the international gold standard in the aftermath of the First World War.[11] The reciprocal relationships enabled central banks to buy and sell foreign exchange to influence credit conditions in each other's markets with the aim of regulating cross-border gold movements. In this, central banks of the time viewed acting through foreign central bank correspondent accounts as preferable to acting through private intermediaries.

Central Banks' Mutual Need for Safe, Confidential, and Reliable Account Services

The need for reciprocal relationships continues to resonate with central banks today even following the demise of the international gold standard and major changes in the international monetary system over the past one hundred years.

Why do central banks value these relationships so highly?

Safety, confidentiality, and reliability are strong motivations for the reciprocal provision of banking and custody services among the world's central banks. In particular, central banks around the world have a mutual need for correspondent banking[12] and custody services to execute on core central banking functions in which the safety, confidentiality, and reliability of service provision is essential. This befits the character and role of central banks as highly risk-averse stewards of national wealth. It reflects the imperative for central banks to maintain untarnished credibility in the formulation and implementation of monetary policy, and an unblemished reputation in the operation and oversight of domestic and cross-border payment systems. And it is driven by central banks' responsibility to safeguard financial stability.

This results in central banks often preferring, and sometimes requiring, foreign reserve managers to use the account services of fellow central banks. This is especially true for liquidity tranches of reserve portfolios where safety and accessibility are critical for the execution of core central banking functions, including FX reserve management, FX intervention, time-sensitive official payments, macro-prudential policy, lender of last resort responsibilities, and other central bank operations that may require the use of foreign assets and currencies.

As stewards of national wealth in their capacity as managers of official foreign reserves, central banks seek to minimize custodial risk in the safekeeping of their foreign reserves.[13] By using a central bank custodian, the risk of loss stemming from insolvency, negligence, or unauthorized disclosure is either removed or significantly reduced. Central banks do not pose counterparty risk and reserve managers' use of fellow central bank account services reduces the risk of disclosure of central banks' trading strategies. Relatedly, the confidentiality of holdings and activities in central bank accounts supports the execution of sensitive operations that may require utmost discretion to avoid setting off market panics or privileging one set of market participants over another. Finally, central banks' use of a fellow central bank's account services allows them to settle in central bank money, with attendant benefits from the standpoint of smooth and reliable settlement.

Central Bank Account Services and Global Financial Stability

In addition to the reciprocal benefits central banks derive from providing each other with account services in support of their mutual needs and common missions, many central banks have long recognized that their provision of account services to the global central banking community is important for supporting global financial stability. For these central banks, the rationale for offering account services to other central banks is grounded in the importance of their currencies for international transactions, cross-border funding, and in official reserve holdings. If a given currency is important internationally, the central bank of issue has a special responsibility to offer account services commensurate with this role to the global central banking community. For reserve

currency-issuing central banks, this has typically meant a range of payment, investment and securities custody services for reserve assets in their currencies.

For the world's major central banks, the maintenance of operational links through reciprocal account relationships is integral to their ability to engage in global financial stability operations. Having accounts, settlement instructions, tested and secure lines of communication, and business processes already in place at the time of or leading up to a crisis enhances major central banks' ability to respond to crises efficiently and flexibly. There are numerous historical examples, both known and unknown to the public, of these account relationships being used to support the stability of the global financial system, perhaps best exemplified historically by the Bretton Woods network of central bank swap lines.[14] More recently, in nearly every major international incident over the past twenty years that has prompted a coordinated response by the world's major central banks—be it coordinated FX interventions by the major central banks in the wake of the 2011 Fukushima disaster, the swap lines established during the 2008 financial crisis, or swap lines in the wake of 9/11—the reciprocal accounts among major central banks formed the backbone for the actual or potential execution of stabilization policies. Without these accounts, coordinated central bank action in pursuit of financial stability objectives would be either severely handicapped or entail high risks in terms of the safety, confidentiality, and reliability of these operations.[15]

The practical reality is that in exigent situations characterized by fast-moving events, incomplete information, and intense pressure, even the best of policies can fall short unless a level of trust, experience, and internal muscle memory exists for operations to be executed effectively. Operational readiness is developed and conditioned through the daily interactions between central bank staffs in the course of managing each other's cash and custody accounts, generating valuable in-house expertise in cross-border central banking operations and a network of inter-personal and institutional relationships in the global central banking community that may otherwise not exist. This knowledge and network of relationships may be leveraged by central banks to better understand the policy context behind global central bank actions, as well as the operating environments and constraints faced by central bank colleagues around the world.

The Federal Reserve's Dollar Account Services

For the Federal Reserve, the dollar's predominant international role confers on it an especially strong interest in providing safe and efficient account infrastructure for the reserve management and cross-border payment needs of the global official sector. [16] The Federal Reserve's account infrastructure for foreign official institutions performs a utility-like function for those institutions wishing to access U.S. fixed income markets and correspondent banking services in order to execute core central banking and official functions in which the safety, confidentiality, and reliability of service provision is essential.

Through the Central Bank and International Account Services area of the New York Fed, the Federal Reserve today offers banking and custody services in dollars to just under 180 foreign central banks and monetary authorities, approximately 18 international multilateral financial institutions, and a number of ministries of finance or national governments. The suite of services offered to these account holders is a basic package of dollar-denominated and gold services in three general areas: transfer and custody services for gold and fixed income securities; dollar-based payment services; and dollar-based cash management and investment services. Every day, New York Fed staff process on average hundreds of billions in transaction volumes on behalf of foreign official account holders. In total, approximately $3.6 trillion of dollar-denominated securities and cash deposits are held by foreign official account holders at the New York Fed, representing about half of the world's official U.S. dollar reserves and one-third of the world's total official FX reserves.

Reflecting the breadth of its foreign official customer base and dollar holdings, the Federal Reserve's account platform is a centralized infrastructure through which dollar-denominated financial transactions between official institutions can occur under a single roof using the same clearing and settlement staff. This provides an important public benefit in terms of control of transactions, efficiency of execution, and confidentiality in two specific ways. First, this centralized account platform has played a critical role in the resolution of international debt crises throughout the 20th and early 21st centuries, such as the Latin American debt crises of the 1980s. Second, the centralized platform sustains a high level of operational readiness for cross-border dollar operations in support of global financial stability. By allowing direct payments between or among account holders on a shared platform, or between the Federal Reserve and account holders, the speed and efficiency of often time-critical official payments is greatly shortened and simplified. Combined with the Federal Reserve's ownership and operation of critical payment systems such as the Fedwire Funds Service and the Fedwire Securities Service, this centralized platform supports the Federal Reserve's crisis response capabilities in a highly dollar-based international financial system.

It should also be noted that the New York Fed's long experience as the FOMC's selected bank for open market operations on behalf of the Federal Reserve System confers on it a trusted level of competence, experience, and reliability with foreign official account holders. The same New York Fed front office personnel that purchase and sell Treasuries for the Federal Reserve's own portfolio also execute trades on behalf of foreign official account holders. Moreover, the same New York Fed personnel that perform back office operations for the Federal Reserve's own portfolio also perform back office operations for the transactions of foreign official account holders. This consolidated transactional platform used by both the Federal Reserve and its foreign official account holders

means that the global official community can be assured that the quality of the services it receives from the Federal Reserve meets the same standards as the Federal Reserve sets for the servicing of its own portfolio.

Choreographers of Central Bank Operations

Let me now spend a moment discussing the people behind our account services. In doing so, I wish to recognize staff past and present who have played and continue to play a vital role every day in processing critical transactions on behalf of the global official community.

Your experience in the daily management of the accounts of other central banks produces unique operational knowledge and expertise. Whether for time-sensitive transactions as part of the often intricate choreography of global financial stability operations or for more routine official payments, the insights developed and experiences with the policies, environments, and constraints of other central banks provide the Federal Reserve with enhanced capabilities to formulate and execute policies. The dedication, skill, and expertise of this staff transform on a daily basis the abstract principle of safe, confidential, and reliable service provision into an operational reality.

So, to the current and former staff here today, I pay tribute to your service to the global official community, to the Federal Reserve, and to the U.S. You are worthy heirs to the legacy of Benjamin Strong, Montagu Norman, and other early giants of central bank cooperation.

The Evolving Risk Environment in Cross-Border Payment Operations

Even as we hold this commemoration and celebrate the legacy of central bank cooperation in this most tangible of forms, the evolving risk environment in cross-border payment operations requires us as central bankers to continually rededicate ourselves, in word and deed, to the mission of providing safe, confidential, and reliable services to each other.

As we are all no doubt aware, risks in cross-border payment operations have undergone major shifts in recent years, with cyber threats in particular emerging as one of the most critical security issues facing our community. For financial institutions, while cyber threats may have been regarded as a cost of doing business at one point, it is not an exaggeration to say that they are now viewed as potential existential threats, not just for individual firms but also for the broader financial system and critical infrastructures that support it. As central banks with broad mandates for financial stability, this is certainly a concern for us all.

We recognize the challenges and complexities in strengthening prevention, detection, and incident response regimes around fraudulent payment instructions. Users of financial messaging services such as SWIFT span the full range of IT sophistication and capacity, and remediating deficiencies in prevention and detection may require a substantial re-orientation of priorities and resources for some institutions. Overcoming these obstacles will be no easy task, but so long as there is a weak link in the cybersecurity chain criminals will seek to exploit it. As we face the common challenges of strengthening our cybersecurity defenses and payment controls, the need for cooperation is greater now than ever. The Federal Reserve stands ready to engage in further dialogue and cooperation with both its foreign official accountholders and fellow central bank service providers in addressing these challenges.

Conclusion

In doing so, we as a community can ensure that the provision of account services among central banks continues to bear the hallmarks of safety, confidentiality, and reliability which are essential to the execution of our public mandates.

Let me conclude with some imagery from rural America.

In the traditionalist Amish communities of Ohio, Pennsylvania, and Indiana known for simple living and for shunning modern technology, whenever there is a need for a new barn to be built, the Amish organize what are called barn raisings. In a barn raising, the community comes together to assist in building their neighbors' barns, with the understanding that the favor is eventually returned to other members of the community. The barn raising is a showcase of Amish planning, organization, and manual labor and serves as a practical linchpin of the agriculturally-rooted Amish society. However, while the barn raising fulfills a practical need, it also serves to tie the Amish community together by reinforcing Amish society through a very visible expression of the principle of mutual aid.[17]

In this 100th anniversary year of the first dollar account openings for foreign central banks by the Federal Reserve System of the United States, I can think of no more moving metaphor than this for the benefits that flow from central bank cooperation through the reciprocal provision of account services. Let us work together to preserve it.

Thank you for listening.

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[1] I would like to thank Mark Choi for his assistance in the preparation of these remarks and colleagues in the Federal Reserve System for their insightful comments and suggestions.

[2] A cash account that a bank holds with another bank in a foreign currency.

[3] The first Federal Reserve Board was sworn in on August 10, 1914. The First World War lasted from July 28, 1914 to November 11, 1918. The United States entered the First World War on April 6, 1917.

[4] See Correspondence with Great Britain: Montagu Norman, Governor, Bank of England, Pt. 1, 1927.

[5] President Wilson worried that relations with both Great Britain and Germany were "delicate, and, seeking to avoid further complication from "unnecessary financial transactions," he therefore directed the Board to issue the warning to U.S. banks. See Henry Willis, *The Federal Reserve System: Legislation, Organization, and Operation* (New York: The Ronald Press Company, 1923), 1096. This episode is also described in Lester V. Chandler, *Benjamin Strong, Central Banker* (Washington D.C.: The Brookings Institution, 1958) and Lawrence E. Clarke, *Central Banking under the Federal Reserve System* (New York: The MacMillan Company, 1935).

[6] See Correspondence with Great Britain: Letters from Montagu Norman, Deputy Governor, Bank of England, 1916-1920: "There is no occasion to say any more about the announcement of the Federal Reserve Board . . . We quite realise [*sic*] your position and its happening, and, knowing that mistakes may arise even in the best regulated families, the incident must be looked upon as closed."

[7] This account opening was made possible in part by a 1916 amendment to Section 14(e) of the Federal Reserve Act, which permitted Federal Reserve Banks to open and maintain accounts on their own books for their own foreign correspondents and agencies, with the consent of the Federal Reserve Board of Governors. In 1933, Section 14(g) was added to the Federal Reserve Act to empower the Board to prescribe specific regulations regarding a Federal Reserve Bank's foreign relationships, and in that same year the Board issued Regulation N - Relations with Foreign Banks and Bankers - which specifically addresses the Board's "special supervision" over this area that is required by the Act. As originally drafted in 1933, Regulation N required, among other things, the consent of the Board prior to entering into any negotiation or agreement with any "foreign bank or banker." In 1941, Congress expanded the Reserve Banks' 14(e) authority to include holding foreign accounts for institutions other than its own foreign correspondents and agencies; this was done by adding "foreign banks or bankers, or foreign states" to the account eligibility list. The Board subsequently amended Regulation N to cover relationships with "foreign states" as well. Overall, the regulation provides a basis for the Board's role in overseeing the New York Fed's foreign official account activities.

[8] Economic historians have cited several factors for this situation, including regulatory restrictions on foreign branching by U.S. banks, prohibitions on U.S. banks from offering dollar trade financing, and until 1914 the absence of a central bank with market making authority. Inertia from the long-standing dominance of London banks and the pound sterling under the gold standard is also cited. See Barry Eichengreen and Marc Flandreau, "The Federal Reserve, the Bank of England, and the Rise of the Dollar as an International Currency, 1914–1939," *Open Economies Review* 23, no. 1 (2012): 57-87.

[9] In his report on the discount system in Europe, Paul Warburg wrote that the "annual tribute to Europe resulting from our primitive financial system is not merely a waste of money, but reflects upon the dignity of a nation and economic importance of the United States." See Paul Warburg, *The Discount System in Europe* (Washington: Government Printing Office, 61st Congress, 2nd Session, Senate Doc 402, 1910), 9.

[10] For the guarantee, from 1921 until 1974 when the New York Fed discontinued the guarantee option on banker's acceptances, the New York Fed charged 1/8th of 1% on the face amount of banker's acceptances purchased on behalf of foreign central bank accountholders. Dollar banker's acceptances became a favored investment instrument by foreign central banks in the days before the introduction of the first regularly issued U.S. Treasury bill in 1929.

[11] The maintenance of gold vaults and reciprocal gold custody accounts among major central banks provided significant operational advantages for the functioning of the international gold standard. In addition to the safety of storing gold with another central bank, through the practice of earmarking central banks could settle accounts with one another without the need to physically deliver gold bullion. This was especially useful in periods, such as wartime, when navigation of sea lanes could be impeded. The New York Fed has maintained a gold vault used to store the gold reserves of foreign central banks since 1924 when construction of its main building was completed. Prior to 1924, the New York Fed held gold in custody for foreign central banks in other nearby vaults, such as the one maintained by the New York Clearing House.

[12] Defined in general terms as "an arrangement under which one bank (correspondent) holds deposits owned by other banks (respondents) and provides payment and other services to those respondent banks." See the glossary of terms used in payments and settlements, published by the Committee on Payments and Market Infrastructures of the Bank for International Settlements.

[13] Perhaps the most vivid historical example of this involved large-scale flight-to-safety flows of European central bank gold reserves to the vaults of the New York Fed during the Second World War. In addition to safeguarding their gold reserves from the Axis powers, inflows of gold were used by Allied nations to finance their purchases of war supplies from the U.S.

[14] The Federal Reserve's Bretton Woods swap lines with foreign central banks were first established in 1962 and used extensively until the collapse of the Bretton Woods fixed exchange rate system in the early 1970s.

[15] The mechanics of currency swap operations among central banks is a case in point. With respect to the Federal Reserve's current dollar swap lines, for example, when a foreign central bank draws on its swap line with the Federal Reserve, the foreign central bank sells a specified amount of its currency to the Federal Reserve in exchange for dollars at the prevailing market exchange rate. The Federal Reserve holds the foreign currency in an account at the foreign central bank. The dollars that the Federal Reserve provides are deposited in an account that the foreign central bank maintains at the New York Fed. When the foreign central bank lends to institutions in its jurisdiction the dollars it obtains by drawing on its swap line, the dollars are transferred from the foreign central bank's account at the Federal Reserve to the account of the bank that the borrowing institution uses to clear its dollar transactions. By using its account on the books of the Fed to receive swap proceeds and distribute them, rather than accounts at private-sector bank, the central bank avoids much of the risk of public identification of its borrowers and itself avoids the credit risk, and other risks (operational, reputational, etc.) of a private sector bank account. Moreover, the overall size and ramping up of potential liquidity operations can be virtually unlimited, subject only to the policy limitations set by the central bank counterparties themselves.

[16] For example, approximately two-thirds of the world's FX reserves are in U.S. dollars (See International Monetary Fund Currency Allocation of Foreign Exchange Reserves (COFER) database), and the dollar also plays a preponderant role in international debt issuance and FX turnover. The Federal Reserve's provision of safe, confidential, and reliable services in dollars helps to support and promote the international role of the dollar and of foreign official holdings of U.S. Treasury securities. The provision of basic custodial services in U.S. government debt securities is consistent with broader U.S. official sector encouragement of foreign official investment in U.S. capital markets. Foreign official investments in U.S. capital markets and the broader international roles of the dollar are generally believed to be a net positive for the U.S. economy through seignorage revenue and reduced funding costs for the U.S. government, households, and corporations. To the extent that these services help foreign official investors to access U.S. capital markets, they support the dollar's continued international role and are beneficial for the U.S. economy.

[17] See Gene Logsdon, "The Barn Raising", in *Amish Roots: A Treasury of History, Wisdom, and Lore*, ed. John A. Hostetler (Baltimore: Johns Hopkins University Press, 1989), 78.