

Monetary Theory and Policy

Chapter 13: Central Banks and the Federal Reserve System

The Price Stability Goal

- Low and stable inflation
- Inflation
 - Creates uncertainty and difficulty in planning for the future
 - Lowers economic growth
 - Strains social fabric
- Nominal anchor to contain inflation expectations
- Time-inconsistency problem

Other Goals of Monetary Policy

- High employment
- Economic growth
- Stability of financial markets
- Interest-rate stability
- Foreign exchange market stability

Should Price Stability be the Primary Goal?

- In the long run there is no conflict between the goals
- In the short run it can conflict with the goals of high employment and interest-rate stability
- Hierarchical mandate (ECB)
- Dual mandate (FED)

Origins of the Federal Reserve System

- Resistance to establishment of a central bank
 - Fear of centralized power
 - Distrust of moneyed interests
- No lender of last resort
 - Nationwide bank panics on a regular basis
 - Panic of 1907 so severe that the public was convinced a central bank was needed
- Federal Reserve Act of 1913
 - Elaborate system of checks and balances
 - Decentralized

Structure of the Federal Reserve System

- This initial diffusion of power has resulted in the evolution of the Federal Reserve System to include the following entities:
 - The Federal Reserve banks
 - The Board of Governors of the Federal Reserve System
 - The Federal Open Market Committee (FOMC)
 - The Federal Advisory Council
 - Around 2,900 member commercial banks

FIGURE 1 Structure and Responsibility for Policy Tools in the Federal Reserve System

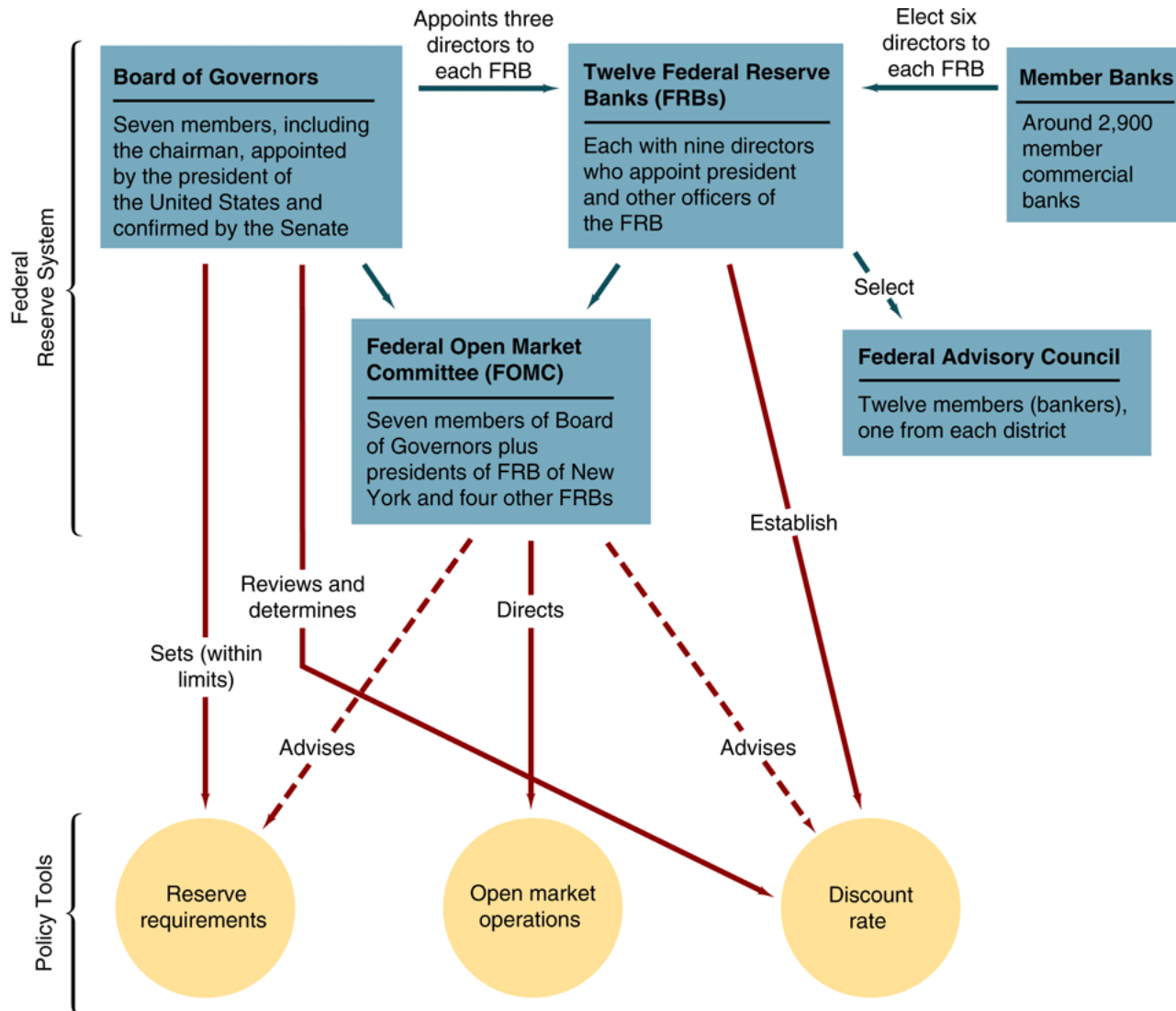


FIGURE 2 Federal Reserve System



Source: Federal Reserve *Bulletin*.

Federal Reserve Banks

- Quasi-public institution owned by private commercial banks in the district that are members of the Fed system
- Member banks elect six directors for each district; three more are appointed by the Board of Governors
 - Three A directors are professional bankers
 - Three B directors are prominent leaders from industry, labor, agriculture, or consumer sector
 - Three C directors appointed by the Board of Governors are not allowed to be officers, employees, or stockholders of banks

Federal Reserve Banks (cont'd)

- Member banks elect six directors for each district; three more are appointed by the Board of Governors
(cont'd)
 - Designed to reflect all constituencies of the public
- Nine directors appoint the president of the bank subject to approval by Board of Governors

Functions of the Federal Reserve Banks

- Clear checks
- Issue new currency
- Withdraw damaged currency from circulation
- Administer and make discount loans to banks in their districts
- Evaluate proposed mergers and applications for banks to expand their activities

Personal Check

2400

_____ 19 _____ 91-548/1221

PAY TO THE ORDER OF _____ \$

_____ **DOLLARS**

FOR _____

⑆ 122 105278 ⑆ 672430 1068 ⑆ 2400 ⑆

Routing Number

Account Number

Check Number

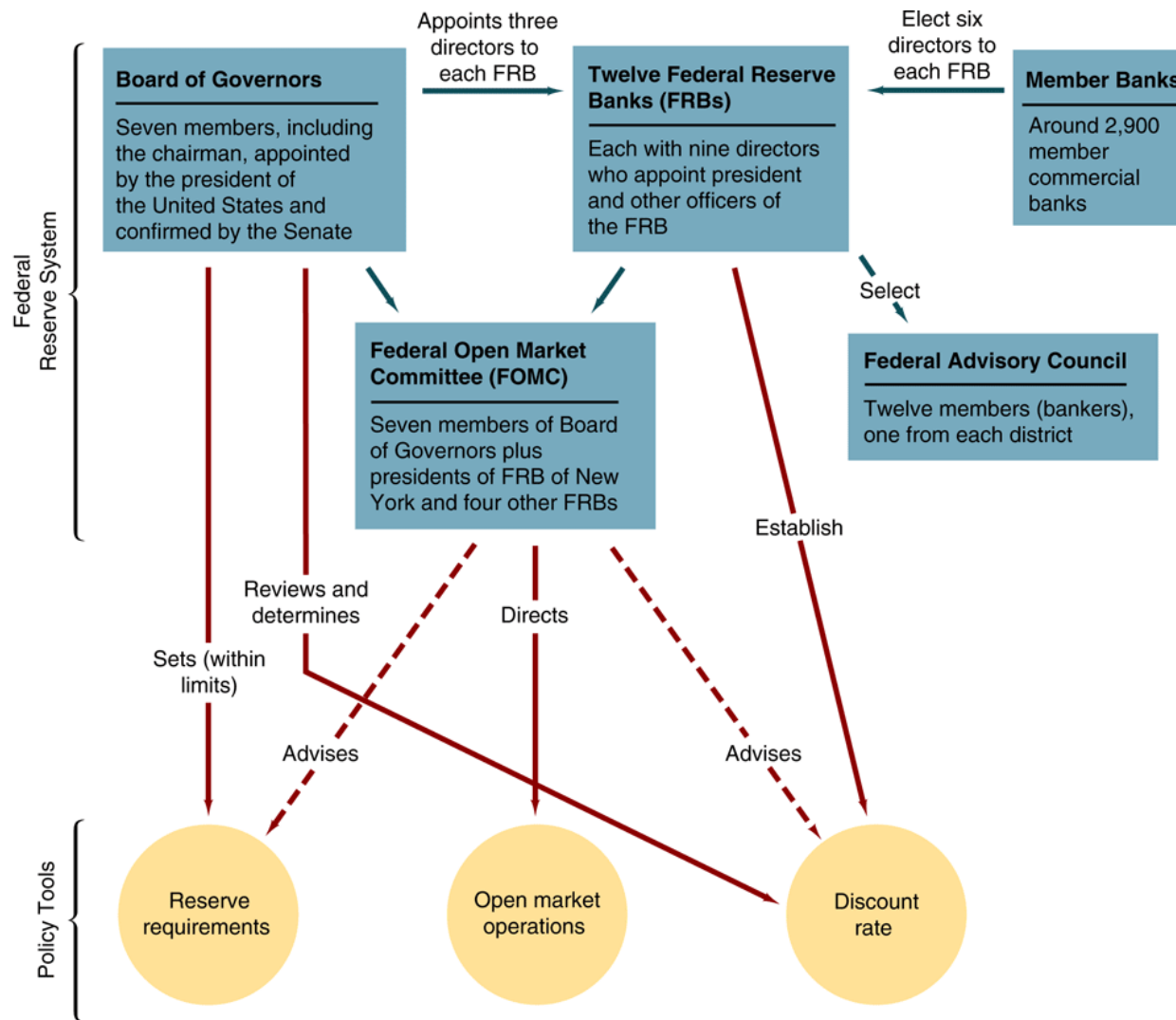
Functions of the Federal Reserve Banks (cont'd)

- Act as liaisons between the business community and the Federal Reserve System
- Examine bank holding companies and state-chartered member banks
- Collect data on local business conditions
- Use staffs of professional economists to research topics related to the conduct of monetary policy

Federal Reserve Banks and Monetary Policy

- Directors “establish” the discount rate
- Decide which banks can obtain discount loans
- Directors select one commercial banker from each district to serve on the Federal Advisory Council which consults with the Board of Governors and provides information to help conduct monetary policy
- Five of the 12 bank presidents have a vote in the Federal Open Market Committee (FOMC)

FIGURE 1 Structure and Responsibility for Policy Tools in the Federal Reserve System



Member Banks

- All national banks are required to be members of the Federal Reserve System
- Commercial banks chartered by states are not required but may choose to be members
- Depository Institutions Deregulation and Monetary Control Act of 1980 subjected all banks to the same reserve requirements as member banks and gave all banks access to Federal Reserve facilities

Board of Governors of the Federal Reserve System

- Seven members headquartered in Washington, D.C.
- Appointed by the president and confirmed by the Senate
- 14-year non-renewable term
- Required to come from different districts
- Chairman is chosen from the governors and serves four-year term

Duties of the Board of Governors

- Votes on conduct of open market operations
- Sets reserve requirements
- Controls the discount rate through “review and determination” process
- Sets salaries of president and officers of each Federal Reserve Bank and reviews each bank’s budget

Duties of the Board of Governors (cont'd)

- Approves bank mergers and applications for new activities
- Specifies the permissible activities of bank holding companies
- Supervises the activities of foreign banks operating in the U.S.

Chairman of the Board of Governors

- Advises the president on economic policy
- Testifies in Congress
- Speaks for the Federal Reserve System to the media
- May represent the U.S. in negotiations with foreign governments on economic matters

Federal Open Market Committee (FOMC)

- Meets eight times a year (every six weeks)
- Consists of seven members of the Board of Governors, the president of the Federal Reserve Bank of New York and the presidents of four other Federal Reserve banks
- Chairman of the Board of Governors is also chair of FOMC
- Issues directives to the trading desk at the Federal Reserve Bank of New York

FOMC Meeting

- Report by the manager of system open market operations on foreign currency and domestic open market operations and other related issues
- Presentation of Board's staff national economic forecast
- Outline of different scenarios for monetary policy actions
- Presentation on relevant Congressional actions
- Public announcement about the outcome of the meeting

Why the Chairman Really Runs the Show

- Spokesperson for the Fed and negotiates with Congress and the President
- Sets the agenda for meetings
- Speaks and votes first about monetary policy
- Supervises professional economists and advisers

How Independent is the Fed?

- Instrument and goal independence.
- Independent revenue
- Fed's structure is written by Congress, and is subject to change at any time.
- Presidential influence
 - Influence on Congress
 - Appoints members
 - Appoints chairman although terms are not concurrent
- Chairperson's style

European Central Bank

- Patterned after the Federal Reserve
 - January 1999 with the Maastricht Treaty
 - European System of Central Banks (ESCB)
 - European Central Bank (ECB)
- Central banks from each country
 - 27 European Union (EU) countries
 - National Central Banks (NCB)
- The Eurosystem: decided in a centralized manner by ECB but implemented via the NCBs in a decentralized way.

ECB Decision Making Process

- Governing Council
- Executive Board
- General Council

Governing Council

- Supreme decision-making body of ECB
- Monthly meetings at ECB in Frankfurt, Germany
- Twelve National Central Bank heads and six Executive Board members
- Operates by consensus
- ECB announces the target rate and takes questions from the media
- To stay at a manageable size as new countries join, the Governing Council will be on a system of rotation

Executive Board

- Consists of the president, vice-president, and four other members appointed by common agreement of the Heads of States of the Euro area countries
- Ensure the day-to-day implementation of the monetary policy by giving detailed guidelines to all NCBs according to the Governing Council

General Council

- Includes the president and vice president of the ECB, representatives of the 16 Euro area countries and the 11 non-euro zone EU Member States
- A transitional body
- Provides advisory tasks to the ECB, collects statistical information and standardizes the operations of NCBs.

ECB vs. NCBs

- NCBs have five core tasks that they jointly perform with the ECB
 - Implement the Eurosystem monetary policy as laid down by the treaty; NCBs do not have right to issue currency notes, only after authorization of the ECB
 - Perform the main function of clearing house for member banks; The ECB does not have the task of supervising banks
 - Acts as the State's banker and the government's fiscal agent
 - Manages the currency reserves
 - Cooperate with other international institutions to maintain a stable financial system

ECB Independence

- Most independent in the world
- Members of the Executive Board have long terms
- Determines own budget
- Charter cannot be changed by legislation; only by revision of the Maastricht Treaty

Structure and Independence of Other Foreign Central Banks

- Bank of Canada
 - Directors: appointed by the government to three-year terms
 - Directors elect the governor who has a seven-year term
 - Governing council: governor and four deputy-governors
 - Essentially controls monetary policy
 - Less goal dependence

Structure and Independence of Other Foreign Central Banks

- Bank of England
 - Before 1997: least independent, no decision power on interest rate
 - In 1997: granted the power to determine the interest rate
 - Not granted total instrument independence (government can overrule the bank in certain cases)
 - Less goal-independent than Fed (inflation target)

Structure and Independence of Other Foreign Central Banks

- Bank of Japan
 - Before 1998, not formally independent of the government
 - Recently (1998) gained more independence to maintain price stability
 - The Ministry of Finance controls part of the Bank's budget unrelated to monetary policy

Structure and Independence of Other Foreign Central Banks

- People's Bank of China (PBC)
- Established on December 1, 1948, based on the consolidation of the Huabei Bank, the Beihai Bank and the Xibei Farmer Bank
- 1950-1978: the only bank in China, responsible for both central banking and commercial banking operations.
- In the 1980s, the commercial banking functions of the PBC were split off into four independent but state-owned banks

Central Bank in China

- In 1983, the State Council promulgated that the PBC would function as the central bank of China, which was legally confirmed on March 18, 1995 by the 3rd Plenum of the 8th National People's Congress.
- In 1998, provincial and local branches were abolished; nine regional branches opened, whose boundaries did not correspond to local administrative boundaries.

Central Bank in China

- The top management of the PBC
 - The governor and a certain number of deputy governors
 - The governor is appointed into or removed by the National People's Congress or its Standing Committee.
- The PBC is required to report its decisions to the State Council with regards to the monetary policy, interest rate, money supply, and foreign reserves.

Central Bank in China

- Hong Kong Monetary Authority (HKMA)
 - The central banking institution in Hong Kong
 - Regulating and supervising banks; Maintain the stability of currency at 7.8 Hong Kong dollars to 1 US Dollars; oversee a robust and diverse financial infrastructure
 - HKMA only issues 10 dollar notes and authorize three commercial banks to issue other bank notes

Central Bank Behavior

- Theory of bureaucratic behavior:
 - objective is to maximize its own welfare which is related to power and prestige
 - Fight vigorously to preserve autonomy
 - Avoid conflict with more powerful groups
- Does not rule out altruism

Case for Independence

- Political pressure would impart an inflationary bias to monetary policy
- Political business cycle
- Could be used to facilitate Treasury financing of large budget deficits: accommodation
- Too important to leave to politicians—the principal-agent problem is worse for politicians

Political Business Cycle

| President | YEAR OF TERM | | | |
|----------------------------|--------------|--------|-------|--------|
| | First | Second | Third | Fourth |
| Democratic Administrations | | | | |
| Truman | -0.6 | 8.9 | 7.6 | 3.7 |
| Kennedy/Jonson | 2.3 | 6.0 | 4.3 | 5.8 |
| Johnson | 6.4 | 6.6 | 2.5 | 4.8 |
| Carter | 4.6 | 5.5 | 3.2 | -0.2 |
| Clinton I | 2.7 | 4.0 | 2.7 | 3.6 |
| Clinton II | 4.4 | 4.4 | 4.2 | 5.0 |
| Obama I | -2.8 | 2.5 | 1.6 | 2.3 |
| Obama II | 2.2 | 2.4 | | |
| Average | 2.4 | 5.0 | 3.7 | 3.6 |
| Republican Administrations | | | | |
| Eisenhower I | 4.6 | -0.7 | 7.1 | 2.0 |
| Eisenhower II | 2.0 | -1.0 | 7.2 | 2.5 |
| Nixon | 3.0 | 0.2 | 3.3 | 5.4 |
| Nixon/Ford | 5.8 | -0.6 | -0.4 | 5.6 |
| Reagan I | 2.5 | -2.0 | 4.3 | 7.3 |
| Reagan II | 3.8 | 3.4 | 3.4 | 4.2 |
| Bush (Senior) | 3.5 | 1.8 | -0.5 | 3.0 |
| Bush (Junior) I | 1.0 | 1.8 | 2.8 | 3.8 |
| Bush (Junior) II | 3.3 | 2.7 | 1.8 | -0.3 |
| Average | 3.3 | 0.6 | 3.2 | 3.7 |

Case Against Independence

- Undemocratic
- Unaccountable
- Difficult to coordinate fiscal and monetary policy
- Has not used its independence successfully