PA974-001
Monetary Policy & Financial Regulation in a Globalized Economy

Lecture 18
8 November 2010

Instructor: Menzie Chinn
Fall 2010
Structure of Central Banks and the Federal Reserve System

Origins of the Federal Reserve System

- Resistance to establishment of a central bank
  - Fear of centralized power
  - Distrust of moneyed interests
- First U.S. experiments with a central bank terminated in 1811 and in 1836
- 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
**Fig. 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 6 directors for each district; 3 more are appointed by the Board of Governors (BoG)
  - 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 BoG are not allowed to be officers, employees, or stockholders of banks

• Member banks elect 6 directors for each district; 3 more are appointed by the BoG
  - 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 / withdraw currency
- Administer and make discount loans to banks
- Evaluate proposed mergers and applications for banks to expand their activities
- Act as liaisons between business and the FRS
- Examine bank holding companies and state-chartered member banks
- Collect data on local business conditions
- Use staffs of 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)
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 margin requirements
- Sets salaries of president, officers of each FRB, reviews budgets
- Approves mergers, applications for new activities
- Specifies permissible activities of bank holding cos.
- Supervises activities of foreign banks 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

• 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
- “Green Book” forecast
  - Go-round
- Current monetary policy and domestic policy directive
  - “Blue book”
- Presentation on relevant Congressional actions
- Public announcement about the outcome of the meeting
Chairman 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 independent
- Goal independent
- Independent revenue
- Structured by legislation from Congress and accountable for its actions
- Presidential influence
  - Influence on Congress
  - Appoints members
  - Appoints chairman although terms are not concurrent
European Central Bank

• Patterned after the Federal Reserve
• Central banks from each country play similar role as Fed banks
• Executive Board
  ▪ President, vice-president and four other members
  ▪ Eight year, nonrenewable terms
• Governing Council
Differences

- National Central Banks control their own budgets and the budget of the ECB
- Monetary operations are not centralized
- Does not supervise and regulate financial institutions
Governing Council

- 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
ECB Independence

- Most independent in the world
- Long terms
- Determines own budget
- Less goal independent
  - Price stability
- Charter cannot be changed by legislation; only by revision of the Maastricht Treaty
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
Case Against Independence

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