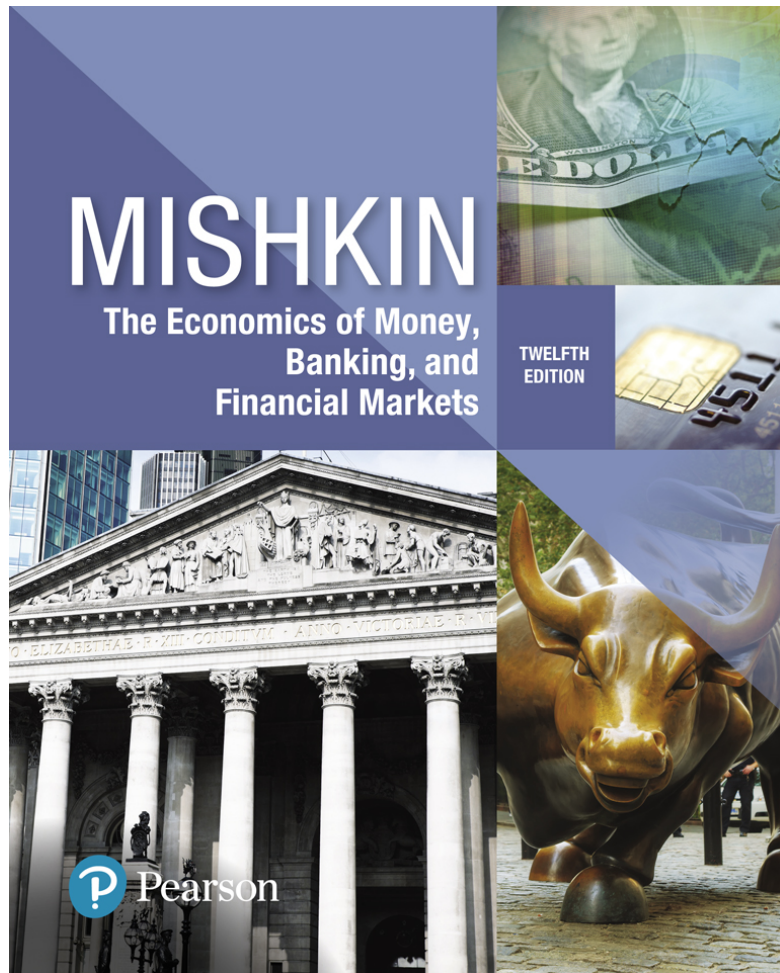


# The Economics of Money, Banking, and Financial Markets

Twelfth Edition



## Chapter 13

### Central Banks and the Federal Reserve System

# Preview

- This chapter considers the structure and activities of central banks focusing primarily on the Federal Reserve System of the United States.

# Learning Objectives (1 of 2)

- Recognize the historical context of the development of the Federal Reserve System.
- Describe the key features and functions of the Federal Reserve System.
- Assess the degree of independence of the Federal Reserve.
- Identify the ways in which the theory of bureaucratic behavior can help explain Federal Reserve actions.

# Learning Objectives (2 of 2)

- Summarize the arguments for and against the independence of the central bank.
- Identify the similarities and distinctions in structure and independence between the European Central Bank and the Federal Reserve.
- Assess the degree of independence of other major central banks around the world.

# 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

(1 of 2)

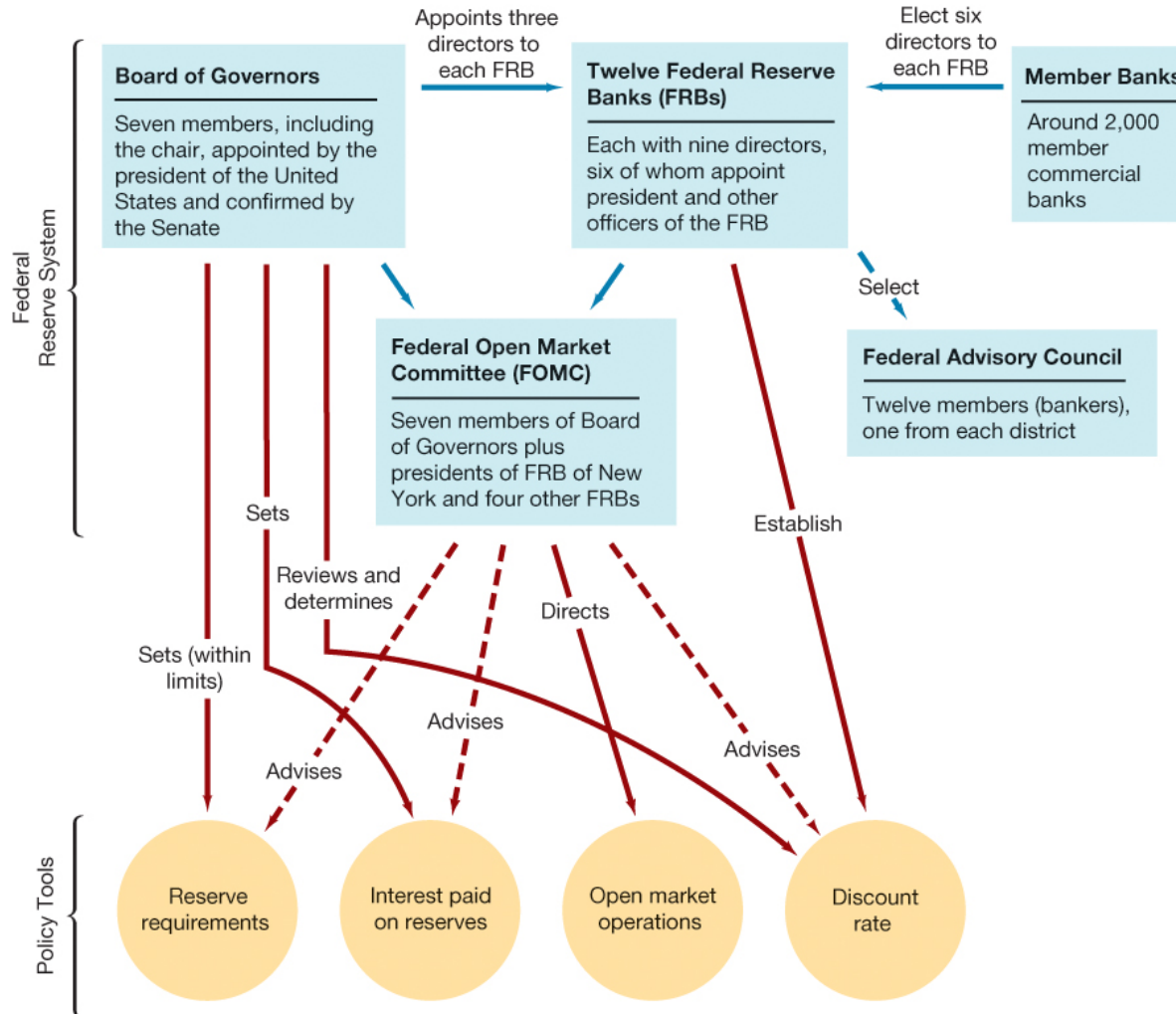
- The writers of the Federal Reserve Act wanted to diffuse power along regional lines, between the private sector and the government, and among bankers, business people, and the public.

# Structure of the Federal Reserve System

(2 of 2)

- 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





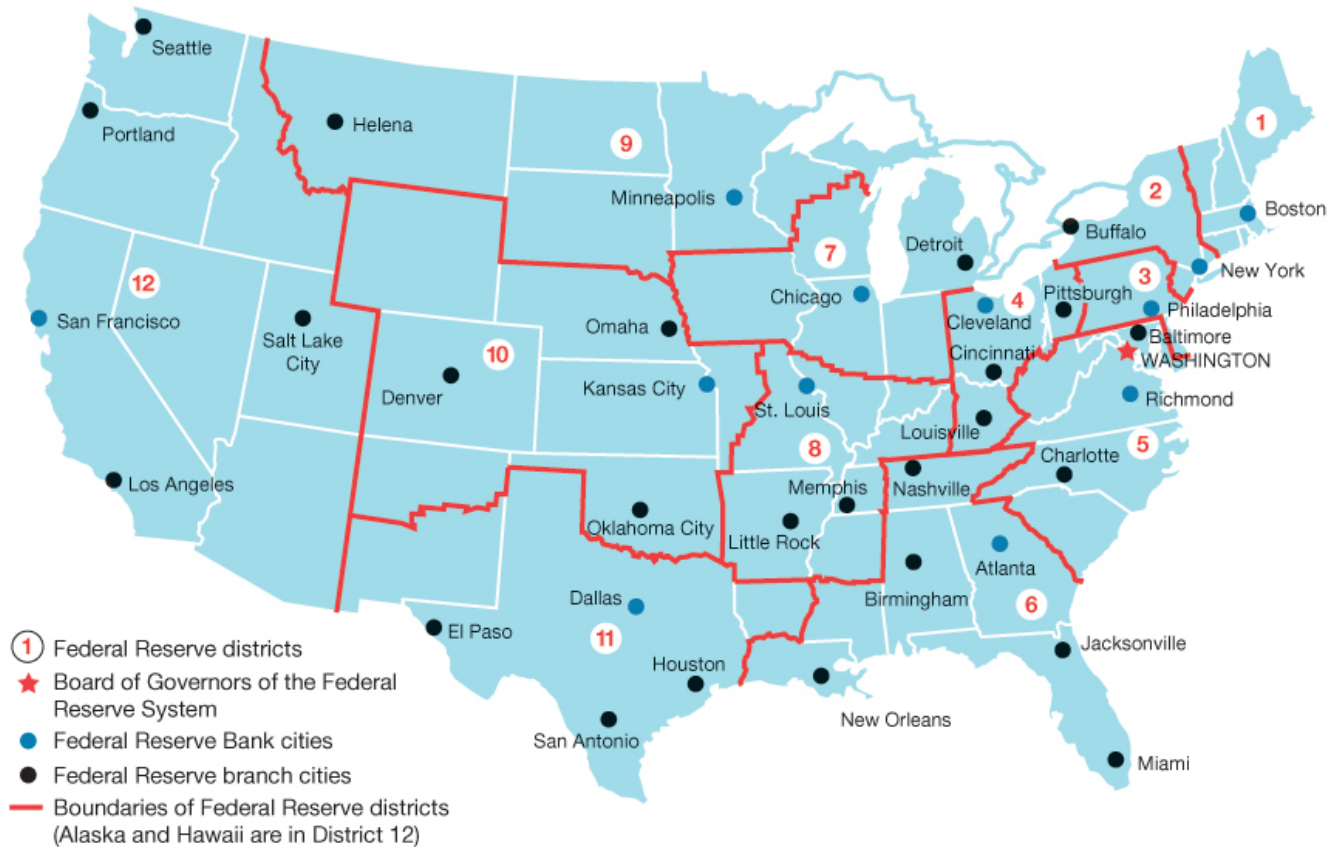
# Federal Reserve Banks (1 of 2)

- Quasi-public institution owned by private commercial banks in the district that are members of the Fed system

# Federal Reserve Banks (2 of 2)

- 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
  - Designed to reflect all constituencies of the public
- Nine directors appoint the president of the bank; subject to approval by Board of Governors

# Figure 2 Federal Reserve System



Source: Federal Reserve *Bulletin*

# Functions of the Federal Reserve Banks (1 of 2)

- 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

# Functions of the Federal Reserve Banks (2 of 2)

- 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

# On the Special Role of the Federal Reserve Bank of New York (1 of 2)

- The Federal Reserve Bank of New York plays a special role in the Federal Reserve System for several reasons.
  - First, its district contains many of the largest commercial banks in the United States, the safety and soundness of which are paramount to the health of the U.S. financial system.
  - The second reason for the New York Fed's special role is its active involvement in the bond and foreign exchange markets.

# On the Special Role of the Federal Reserve Bank of New York (2 of 2)

- The third reason for the Federal Reserve Bank of New York's prominence is that it is the only Federal Reserve Bank to be a member of the Bank for International Settlements (BIS).
- Finally, the president of the Federal Reserve Bank of New York is the only permanent voting member of the FOMC among the Federal Reserve Bank presidents, serving as the vice-chair of the committee. Thus, he or she and the chair and vice-chair of the Board of Governors are the three most important officials in the Federal Reserve System.

# 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 (1 of 2)

- 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 and officers of each Federal Reserve Bank and reviews each bank’s budget

# Duties of the Board of Governors (2 of 2)

- 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 United States.

# 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 United States in negotiations with foreign governments on economic matters

# The Role of the Research Staff

- The Federal Reserve System is the largest employer of economists not just in the United States, but in the world.
- The most important task of the Fed's economists is to follow the incoming economic data from government agencies and private sector organizations and provide guidance to the policy-makers on the direction in which the economy might be headed and the potential impact of monetary policy actions on the economy.

# 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 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

# Inside the Fed: The 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



# Green, Blue, Teal, and Beige: What Do These Colors Mean at the Fed?

- Up until 2010, a detailed national forecast for the next three years was placed between green covers and was thus known as the “green book.” Projections for the monetary aggregates along with typically three alternative scenarios for the stance of monetary policy (labeled A, B, and C) were contained in the “blue book.” Starting in 2010, the green and blue books were combined into the “teal book.” The “beige book,” is produced by the Reserve Banks and details evidence gleaned either from surveys or from talks with key businesses and financial institutions on the state of the economy in each of the Federal Reserve districts.

# Why the Chairman of the Board of Governors 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

# Styles of Federal Reserve Chairs: Bernanke and Yellen Versus Greenspan

- Every Federal Reserve chair has a different style, and these styles affect how policy decisions are made at the Fed. There has been much discussion of how two recent chairs of the Fed, former chair Ben Bernanke and current chair Janet Yellen, differ from Alan Greenspan, who was the chair of the Federal Reserve Board for 19 years, from 1987 to 2006.

# 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

# Should the Fed Be Independent?

- **The Case for Independence**

- The strongest argument for an independent central bank rests on the view that subjecting it to more political pressures would impart an inflationary bias to monetary policy.

- **The Case Against Independence**

- Proponents of a Fed under the control of the president or Congress argue that it is undemocratic to have monetary policy (which affects almost everyone in the economy) controlled by an elite group that is responsible to no one.

# The 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

# The Case Against Independence

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

# Explaining Central Bank Behavior (1 of 2)

- One view of government bureaucratic behavior is that bureaucracies serve the public interest (this is the *public interest view*). Yet some economists have developed a theory of bureaucratic behavior that suggests other factors that influence how bureaucracies operate.
- The theory of bureaucratic behavior may be a useful guide to predict what motivates the Fed and other central banks.



# Explaining Central Bank Behavior (2 of 2)

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

# Inside the Fed: The Evolution of the Fed's Communication Strategy

- The Fed has dramatically increased its transparency in recent years
  - Following the January, April, June, and November FOMC meetings, the Chair of the Board of Governors holds a press conference to clarify monetary policy communications.
  - Greater transparency has been provided with the announcement of a specific numerical target for the inflation rate.

# Structure and Independence of the 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 Between the European System of Central Banks and the Federal Reserve System

- 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
- Nineteen 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.

# How Independent Is the ECB?

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

# Structure and Independence of Other Foreign Central Banks

- Bank of Canada
  - Essentially controls monetary policy
- Bank of England
  - Has some instrument independence.
- Bank of Japan
  - Recently (1998) gained more independence
- The trend toward greater independence

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