

## Chapter 12

### Structure of Central Banks and the Federal Reserve System

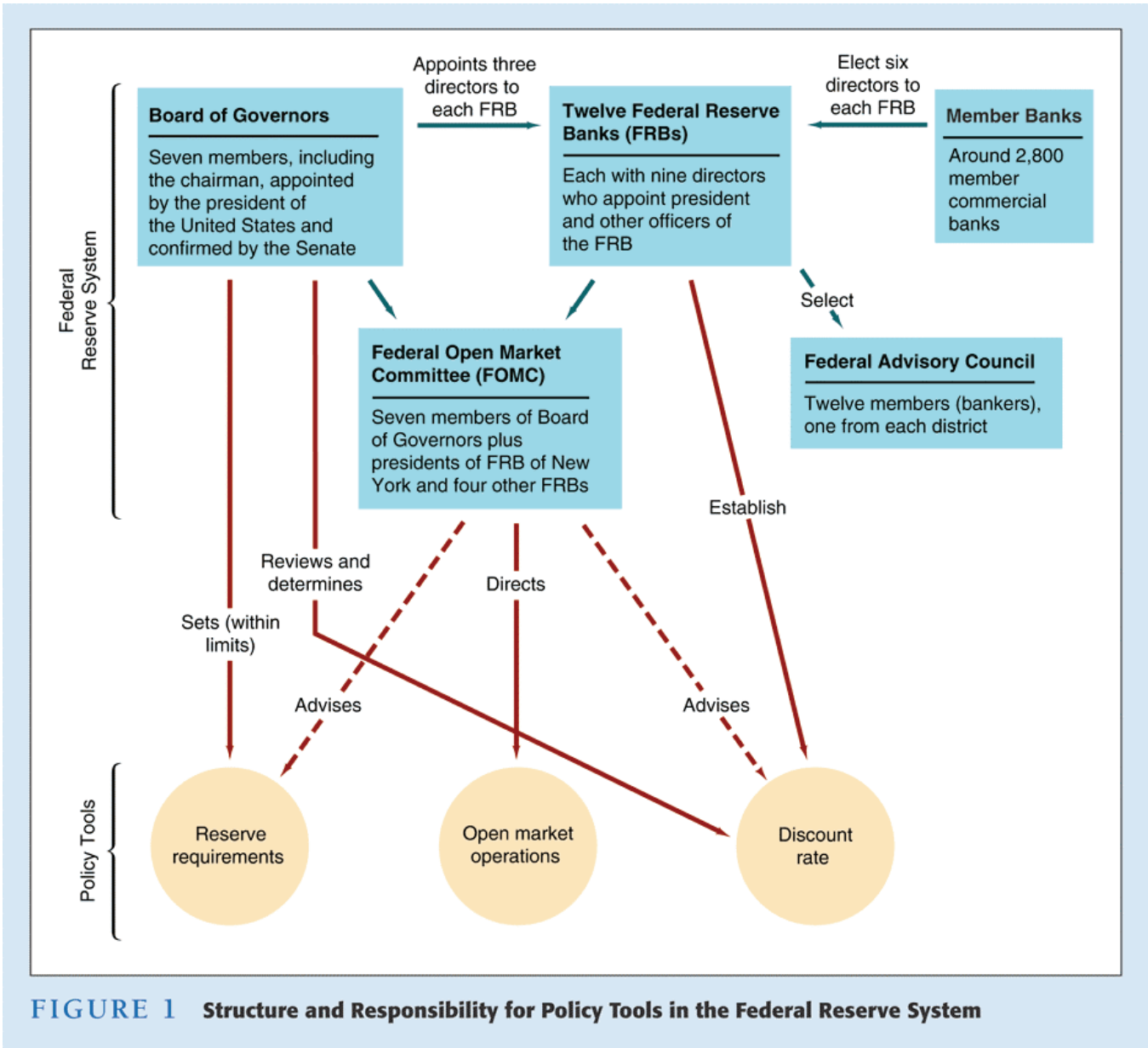
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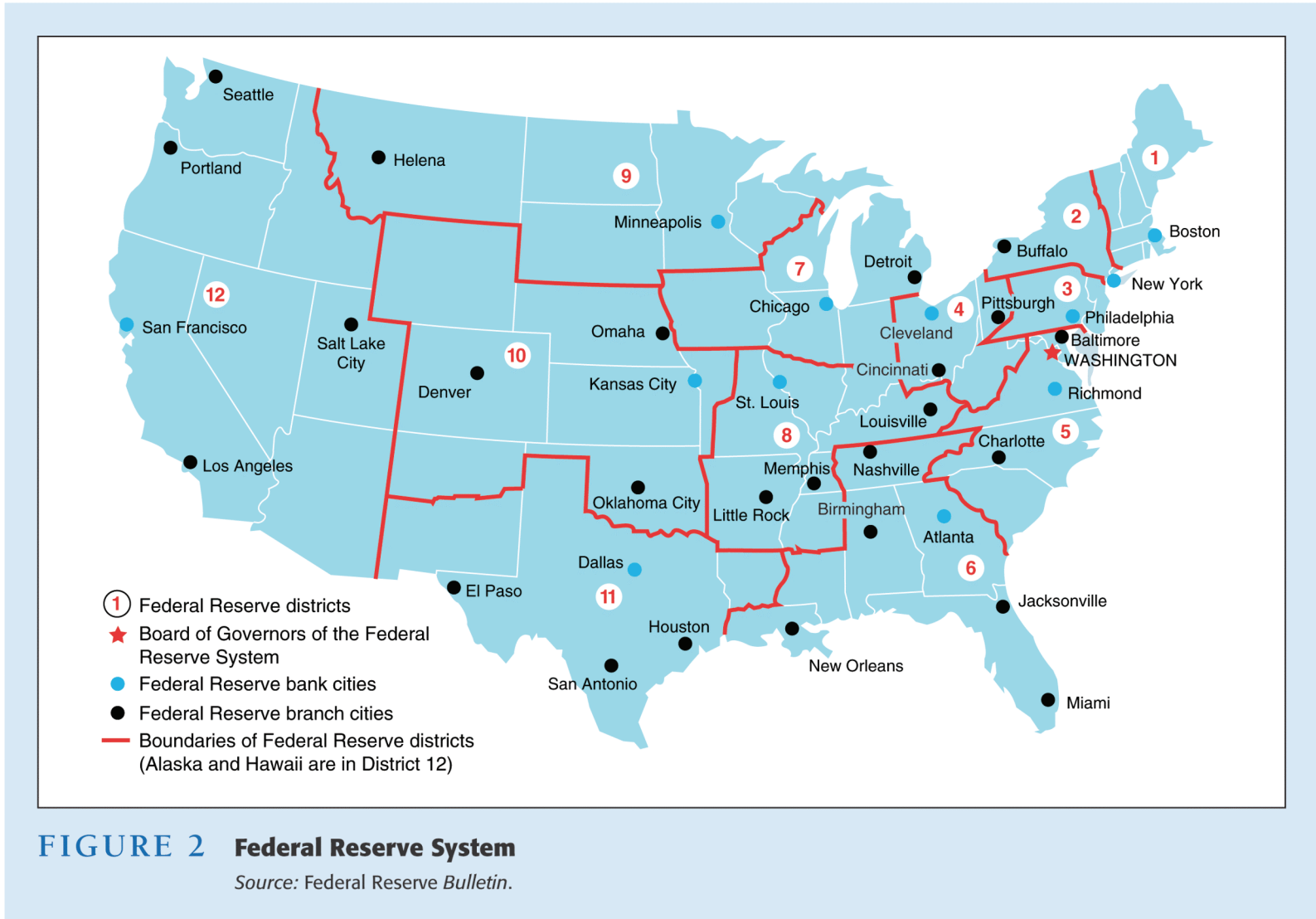


# Origins of the Federal Reserve System

- 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



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





# 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



## 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)



# 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 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
- 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