Chapter 12

Structure of Central Banks and the Federal Reserve System
Among the most important players in financial markets throughout the world are central banks, the government authorities in charge of monetary policy.

Central banks’ actions affect interest rates, the amount of credit, and the money supply, all of which have direct impacts not only on financial markets, but also on aggregate output and inflation.

To understand the role that central banks play in financial markets and the overall economy, we need to understand how these organizations work.

Who controls central banks and determines their actions? What motivates their behavior? Who holds the reins of power?
Origins of the Federal Reserve System

- Resistance to establishment of a central bank
  - Fear of centralized power
  - Distrust of moneyed interests, the most prominent symbol of which was a central bank
- 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 (occurring every 20 years or so)
  - 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 which created the Federal Reserve System with its 12 regional Federal Reserve banks
  - Decentralized
**Figure 1** Structure and Responsibility for Policy Tools in the Federal Reserve System

- **Board of Governors**
  - Seven members, including the chairman, appointed by the president of the United States and confirmed by the Senate.
  - Appoints three directors to each FRB.

- **Twelve Federal Reserve Banks (FRBs)**
  - Each with nine directors who appoint president and other officers of the FRB.
  - Elect six directors to each FRB.

- **Member Banks**
  - Around 2,800 member commercial banks.

- **Federal Open Market Committee (FOMC)**
  - Seven members of Board of Governors plus presidents of FRB of New York and four other FRBs.
  - Reviews and determines Reserve requirements.
  - Directs Open market operations.
  - Advises Discount rate.

- **Federal Advisory Council**
  - Twelve members (bankers), one from each district.
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
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