Structure of Central Banks

Lecture 6

Readings

- Mishkin, chapter 14, 10th edition (or chapter 13, 9th edition)

Plan

- Federal Reserve System
- European Central Bank

Origins of the Federal Reserve System

- Federal Reserve System created by the Federal Reserve Act of 1913, with an eye toward maintaining the same sort of decentralized power and system of checks and balances emphasized in the US Constitution

- In practice it meant:

  – Division of power between the Board of Governors in Washington and the Federal Reserve Banks in 12 other cities

  – Division of power between the Federal Government, the banking industry, the nonbank business interests, and the public

- As a result, within the Federal Reserve System, the Board of Governors, the Federal Reserve Banks, the Federal Open Market Committee (FOMC), the member banks all play separate and important roles

Structure and responsibility for policy tools in the Federal Reserve System

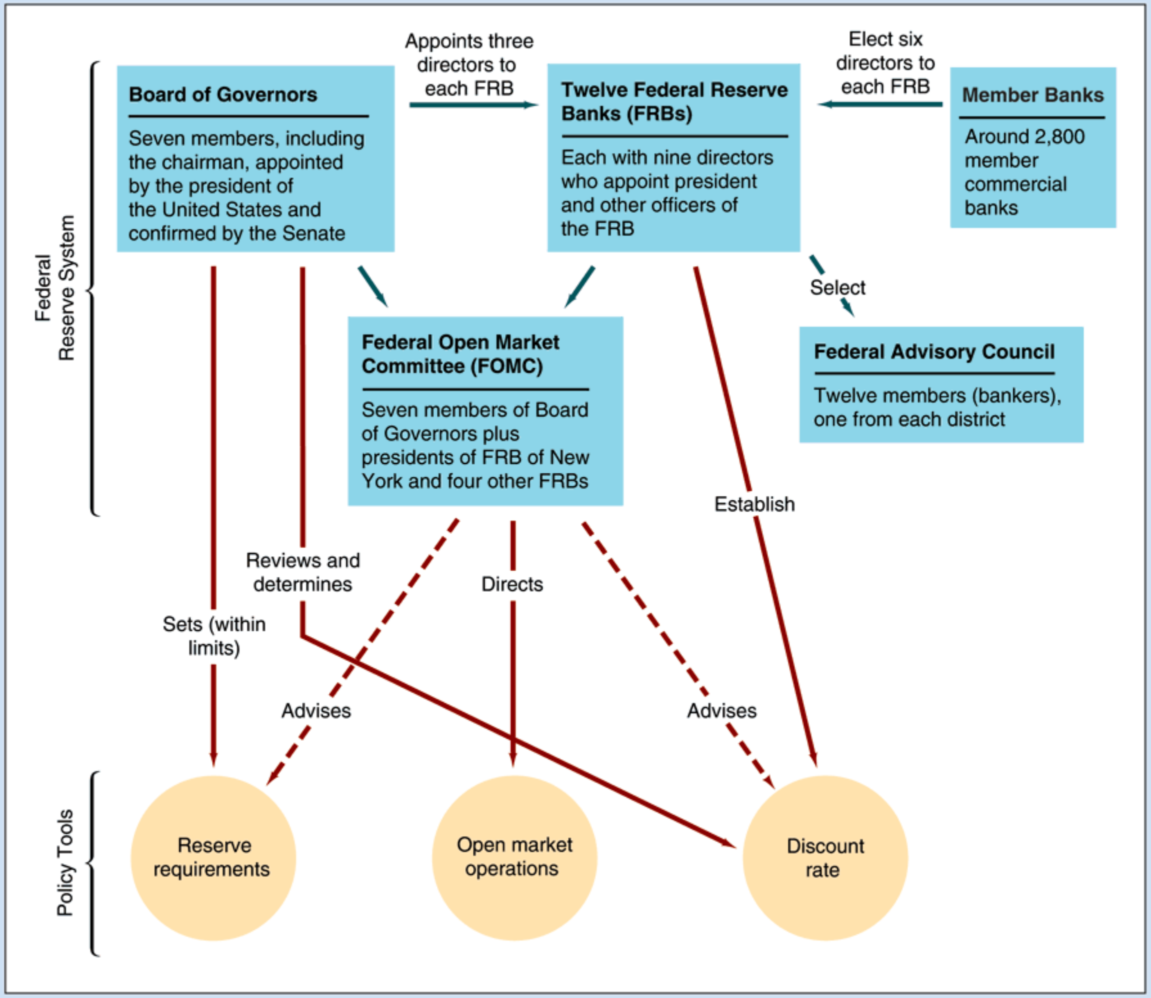


FIGURE 1 **Structure and Responsibility for Policy Tools in the Federal Reserve System**

Federal Reserve Banks

- There are 12 Federal Reserve Districts, each with a main Federal Reserve Bank and a number of Federal Reserve Bank branches (see next slide)

- Some details:

  – Largest Federal Reserve Banks in terms of assets: New York, Chicago and San Francisco

  – Federal Reserve Bank of New York largest and most important, reflecting the role of New York as the financial center of the US

  – Each Federal Reserve Bank is a quasi-public institution (government entity with private components) that is owned by commercial banks in its district - called the member banks

  – Member banks hold stocks in the Federal Reserve Bank, which pay a 6% annual dividend; they are not allowed to sell their shares of stocks

  – Each Federal Reserve Bank has 9 directors, classified into 3 categories (all constituencies of public):
    3 Class A directors= bankers, elected by member banks
    3 Class B directors= business leaders in industry, commerce, agriculture, elected by member banks
    3 Class C directors= representatives of nonbank public, appointed by the Board of Governors

  – 9 directors appoint the president of the bank subject to approval by Board of Governors

Federal Reserve System

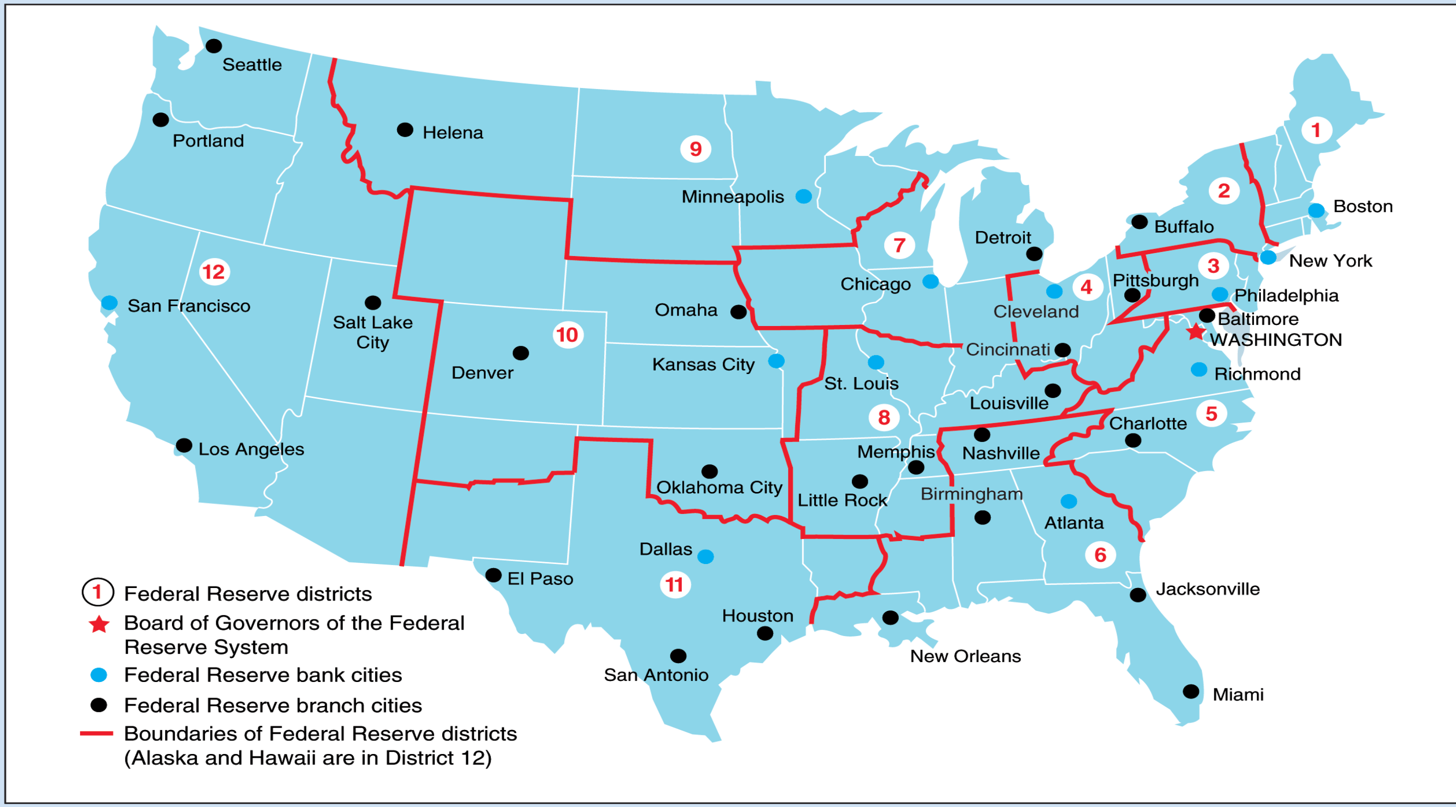


FIGURE 2 **Federal Reserve System**

Source: Federal Reserve *Bulletin*.

Federal Reserve Banks, cont.

- Monetary policy functions of the federal reserve banks:
  - Directors of each bank recommend the discount rate, then approved by Board of Governors
  - Decide which banks can obtain discount loans in their districts
  - 5 of the 12 bank presidents have a vote in the FOMC; the president of the NYFed always has a vote; the other presidents rotate, with annual terms as voting members; the presidents who do not vote still attend FOMC meetings and participates in discussions
  - NYFed runs the trading desk (Open Market Desk), where open market operations are conducted at the request of the FOMC
  - Directors select one banker from each district to serve on the Federal Advisory Council which consults with the Board of Governors and provides information about conditions in the banking industry and the economy as a whole to help conduct monetary policy

Federal Reserve Banks, cont.

- Other functions of the federal reserve banks:
  - Clear checks
  - Withdraw damaged currency from circulation and replace it with new currency
  - Act as liaisons between local business communities and the Federal Reserve System
  - Help regulate banks
  - Collect data on local business conditions
  - Use staff of professional economists to research topics related to the conduct of monetary policy

Member banks

- Member banks = commercial banks that own (hold stock in) the Federal Reserve banks
- National banks (licensed by the Federal Government) are required to be members of the Federal Reserve System
- State banks (licensed by State Governments) are not required but may choose to be members
- Before 1980 only member banks were required to keep reserves as deposits at the Federal Reserve Banks and member banks had privileged access to certain Federal Reserve facilities (such as the discount window)
- 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 on an equal basis
- After 1980 reduced distinction between member and nonmember banks

Board of Governors of the Federal Reserve System

- Head of Federal Reserve System
- Often called the Federal Reserve Board
- Consists of 7 Governors, led by the Chairman (Jerome Powell)
- Headquartered in Washington DC
- Each governor is appointed by the US President and confirmed by the US Senate for a nonrenewable 14-year term
- No more than one governor can come from each Federal reserve district to prevent interests of one region to be over-represented
- The governor who is chosen as chairman serves as chairman for a renewable 4-year term

Board of Governors of the Federal Reserve System, cont.

- All 7 governors are voting members of the FOMC (they have majority of votes)
- Board of Governors sets reserve requirements, within limits established by US Congress
- Board of Governors sets bank regulations
- Board of Governors selects the discount rate among the Reserves Banks recommendations
- The chairman advises the president on economic policy, testifies in Congress, speaks for the Federal Reserve System to the media, may represent the US in negotiations with foreign governments on economic matters
- Board of Governors has a staff of professional economists providing economic analysis that the Board uses in making monetary policy decisions

Federal Open Market Committee (FOMC)

- Meets 8 times a year

- The FOMC consists of:
  - all 7 members of the Board of Governors
  - the president of the NYFed and 4 other Reserve Bank presidents

- The 7 Reserve Bank presidents who do not vote are technically not on the FOMC, but still attend meetings and participate in discussions

- Chairman of the Board of Governors is also chair of the FOMC

- The FOMC principal role is to make decisions regarding the conduct of open market operations and ssue directives to the trading desk at the NYFed

FOMC meeting

- Report by the manager of the trading desk on open market operations and other related issues
- Presentation of the national economic forecast of the Board staff - the “Green Book” - by the director of the Research and Statistics Division at the Board
- Go-rounds: each bank president presents an overview of economic conditions in his district - “Beige Books” - and his assessment of the national outlook
- Presentation of three alternative scenarios (called A, B and C) for the stance of monetary policy - the “Blue Book” - by the director of the Monetary Affairs Division at the Board

FOMC meeting, cont.

- Chairman sets the stage for the following discussion by presenting his views on the economy and making a recommendation for what monetary policy actions should be taken

- Each FOMC member, plus the nonvoting presidents, expresses his view on monetary policy

- Chairman summarizes the discussion and proposes a statement for directive on target FFR

- Members of FOMC vote on proposed statement

  - Voting by simple majority
  - Decisions may not be unanimous and dissenting views are made public
  - Chairman's vote always on the winning side

- Public announcement about the outcome of the meeting: whether target FFR has been raised, lowered or left unchanged and an assessment of the balance of risks in the future (toward a higher inflation or a weaker economy)

Structure and responsibility for policy tools in the Federal Reserve System

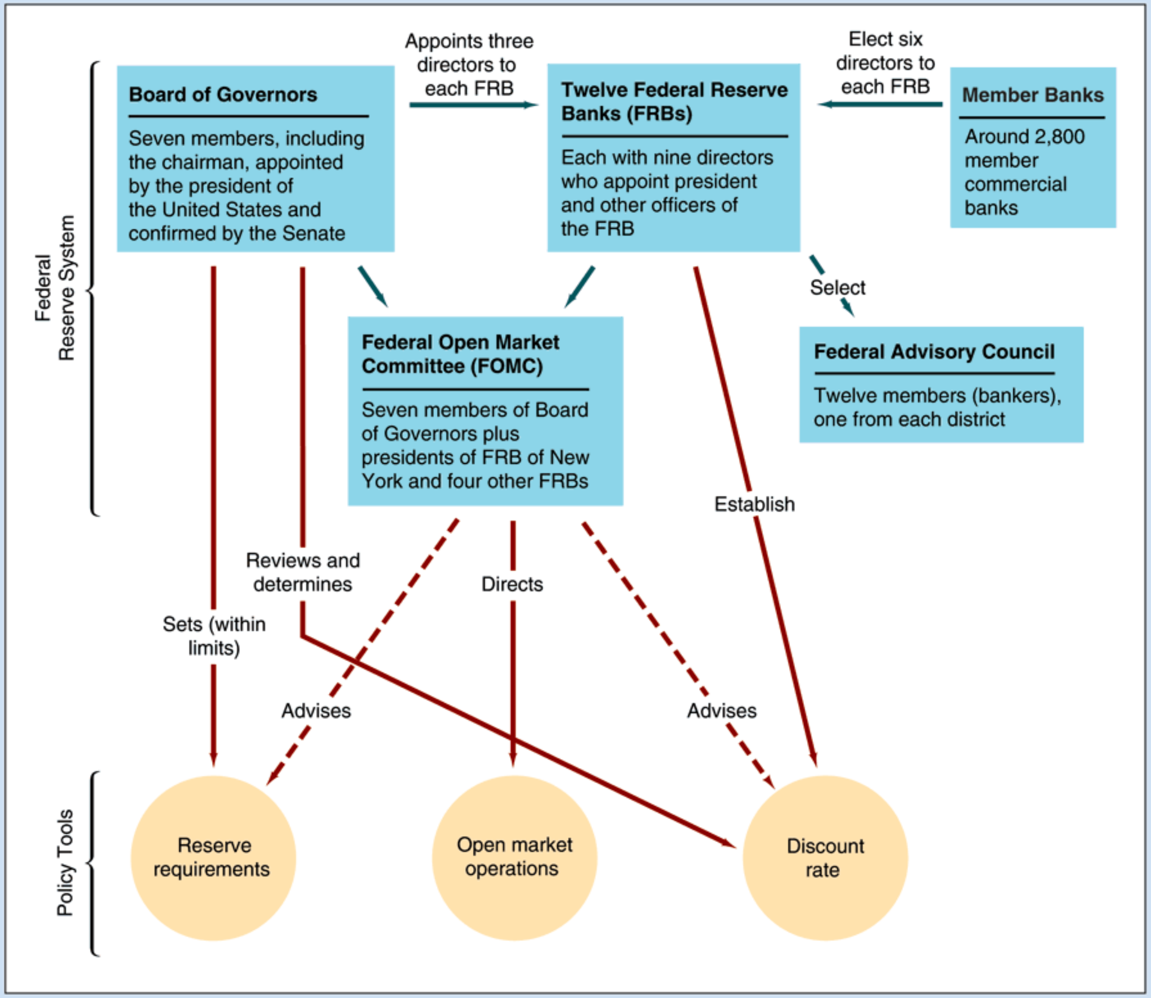


FIGURE 1 Structure and Responsibility for Policy Tools in the Federal Reserve System

How independent is the Fed?

- How free is the Fed from presidential, congressional or other outside pressures?
- Two different type of independence of central banks:
  - Instrument independence: ability of CB to set monetary policy instruments to achieve a given goal
  - Goal independence: ability of the CB to set the goals of monetary policy

  Fed has both types of independence; in other countries, only instrument independence

- Some measures of independence
  - Fed controls its own budget (interest on government securities and fees charged to banks for a number of services)
  - Fed has the authority to make monetary policy decisions not reversible by outside parties (interest rate changes can be implemented immediately and can be changed only by the FOMC)
  - Fed authorities appointed for long term (governors appointed for 14 years not renewable, Federal Reserve Bank presidents for 5 years and not even appointed by politicians)

Arguments against independence

- In a democracy, monetary policy should be subject to the same accountability process as any other policy affecting the well-being of the citizens
- Fiscal policy is controlled by elected politicians

Arguments in favor of independence

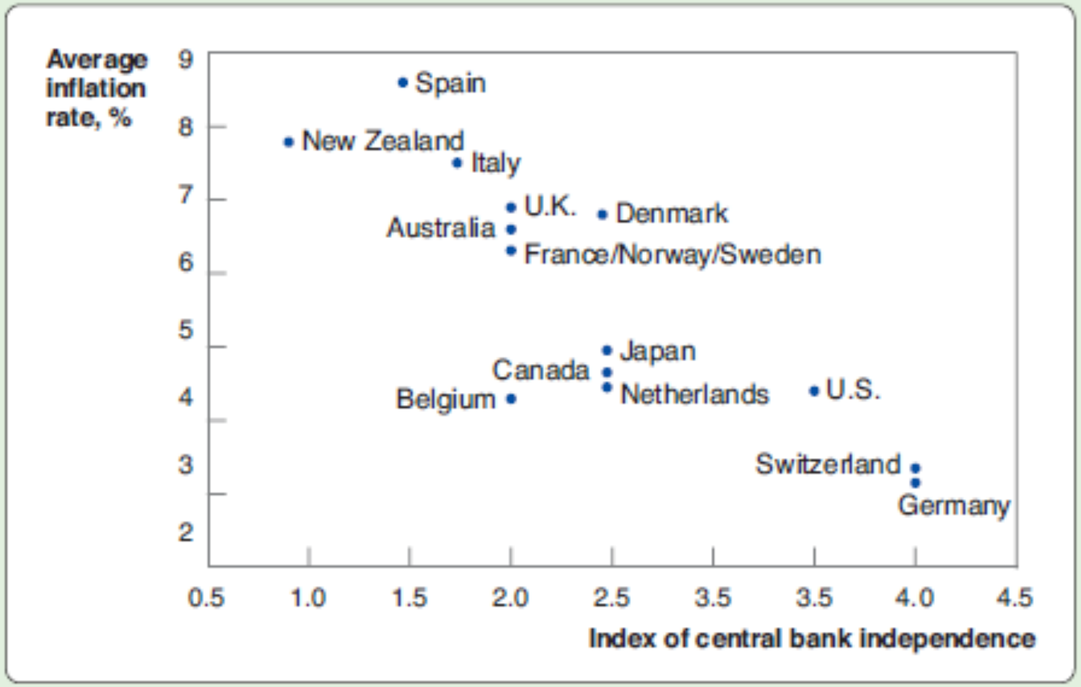
Political pressures may lead to inflationary monetary policy by

- shifting the focus from long-run objectives (price stability) to short-run objectives (providing short-term solutions to high unemployment and low growth) even if those short-run objectives have undesirable consequences for long-run objectives
- leading to a political business cycle (with expansionary policies implemented before elections and reversed after the election)
- favoring monetary financing of fiscal deficits (by buying government securities)

without gains in other dimensions

CB independence and inflation

FIGURE 16.4 **Central Bank Independence and Inflation, 1955–1988**



A comparison of central bank independence and average inflation among 16 countries reveals that countries with more independent central banks have lower inflation.

Source: Adapted from Alberto Alesina and Lawrence H. Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," *Journal of Money, Credit, and Banking*, May 1993, vol. 25, pp. 151–162.

European Central Bank and Euro area

- On the 1st of January 1999, the European Central Bank assumed responsibility for monetary policy in the euro area

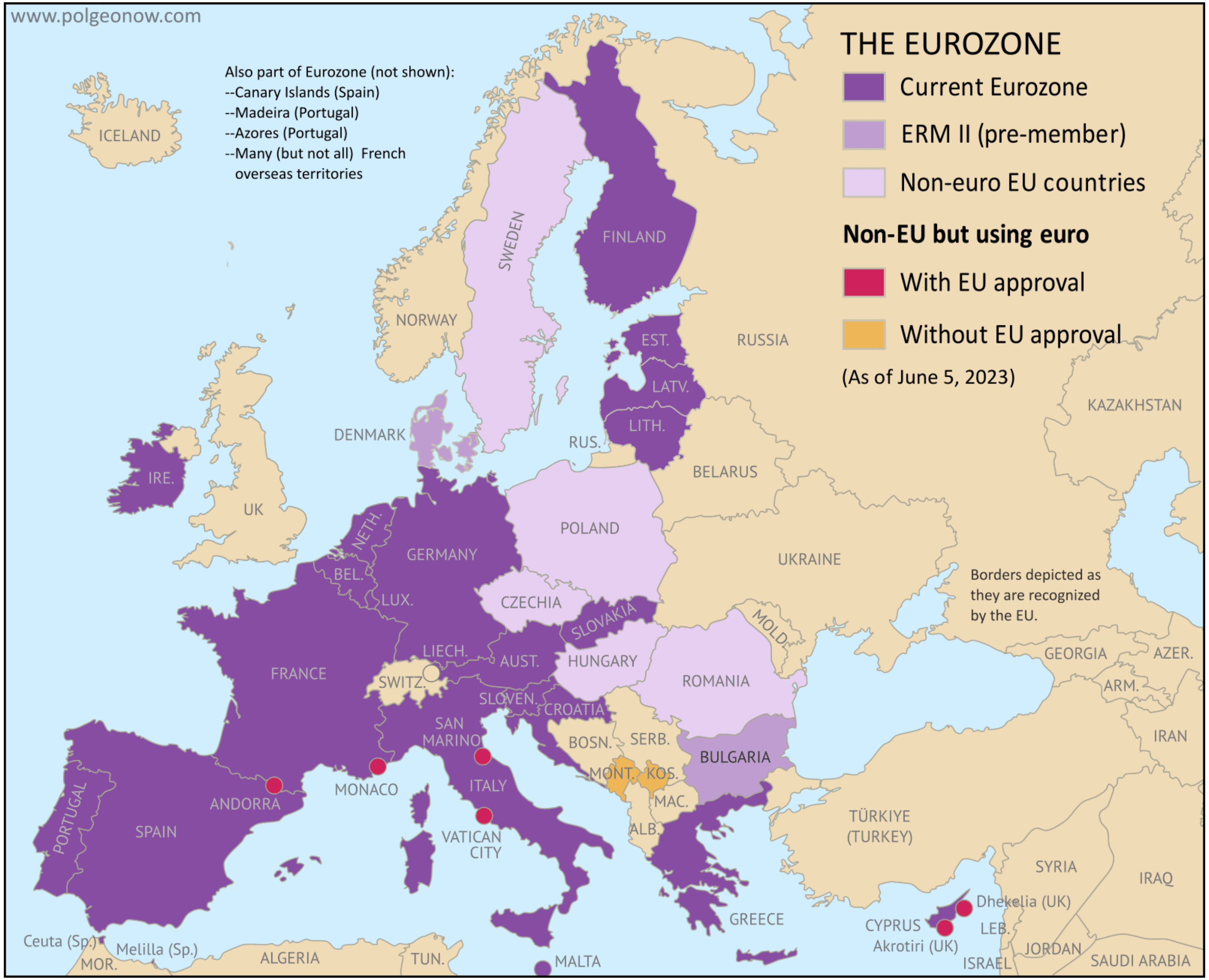
- Euro area comprises the European Union member states that have adopted the euro

- In January 1999 the euro area included 11 countries: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal and Finland

- Greece joined in January 2001; by 2009, Slovenia, Slovakia, Malta and Cyprus also joined;
  Estonia in 2011, Latvia in 2014, Lithuania in 2015 and Croatia in 2023
  The euro is the currency of 20 countries (see the next slide)

- From the 1st of January 2002 the euro has replaced national currencies

Map of the Euro area (2023)



ECB, ESCB and Eurosystem

- Agreement to form a European Monetary Union formalized in the Treaty of Maastricht signed in 1992

- The Treaty initiated a lengthy process that led ultimately to the creation of:

1. The European System of Central Banks (ESCB), composed of:
   - the European Central Bank (ECB) in Frankfurt
   - the National Central Banks (NCBs) of all countries in the European Union

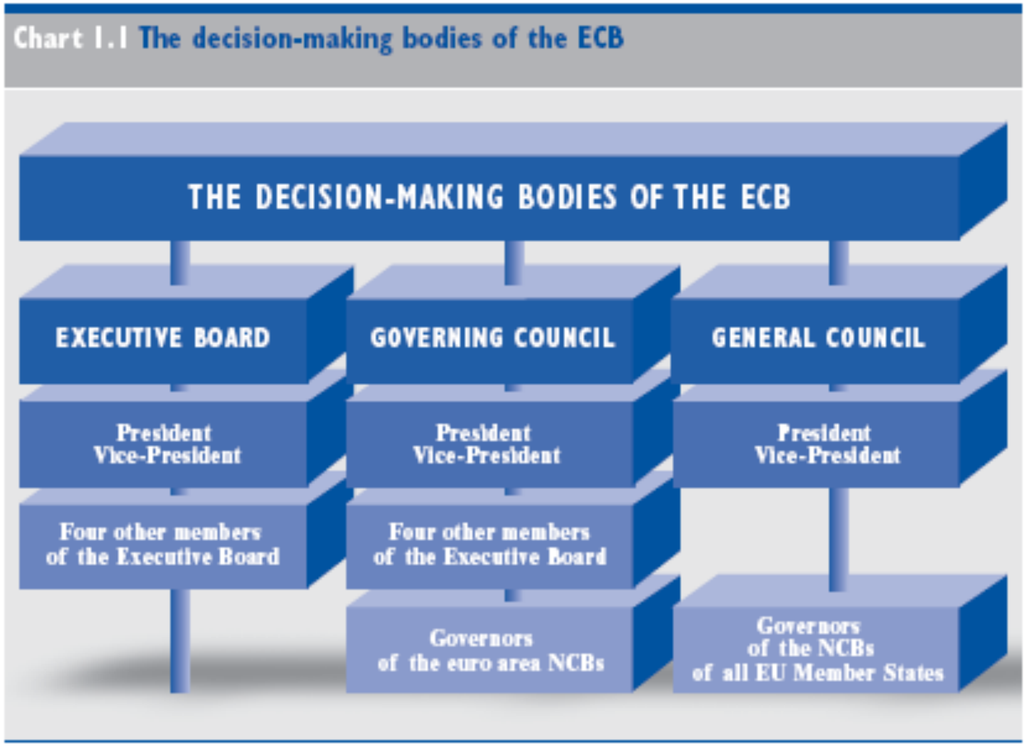
2. The Eurosystem, composed of:
   - the European Central Bank in Frankfurt
   - the National Central Banks (NCBs) of the 20 countries that have adopted the euro and participate in the monetary union and share a common monetary policy

   (NCBs play many of the same roles as the Federal Reserve Banks at the Fed)

Decision-making bodies of the ECB

- Two decision-making bodies of the ECB are responsible for the preparation, conduct and implementation of the single monetary policy:
  - the Governing Council of the ECB (analog of the FOMC at the Fed)
  - the Executive Board of the ECB (analog of the Board of Governors at the Fed)
- A third decision making body is the General Council of the ECB
- Decisions in the Eurosystem are taken in a centralized manner by the ECB, but implemented via the NCBs in a decentralized way

Decision-making bodies of the ECB



Governing Council

- Analog of the FOMC at the Fed
- Composed of:
  - the six members of the Executive Board
  - the governors of the euro area NCBs
- Chaired by ECB President (Lagarde) and, in his absence, Vice-President (Guindos)
- Meets twice a month; operates by consensus (no formal vote); statement and press conference after each meeting
- Main responsibilities:
  - formulate monetary policy in the Euro area by taking decisions on key interest rates (first meeting of the month)
  - establish guidelines for implementation of these decisions and takes decisions related to other tasks of the ECB (second meeting of the month)

ECB monetary policy decisions:
Press release, 5 September 2013

- At today's meeting the Governing Council of the ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.50%, 1. 00% and 0.00% respectively

- The President of the ECB will comment on the considerations underlying these decisions at a press conference starting at 2.30 p.m. CET today

Executive Board

- Analog of the Board of Governors at the Fed

- Composed of:
  - the President and Vice-President
  - four other members appointed by common agreement of the Heads of State or Government of the euro area countries

- Chaired by ECB President (Lagarde) and, in his absence, Vice-President (Guindos)

- Main responsibilities:
  - run the ECB
  - prepare meetings of the Governing Council
  - implement monetary policy in accordance with the guidelines and decisions of the Governing Council and, in so doing, give instructions to the Euro area NCBs
  - assume some regulatory powers

General Council

- Composed of:
  - the President and Vice-President
  - the governors of the NCBs of all EU Member States
- Chaired by ECB President (Lagarde) and, in his absence, Vice-President (Guindos)
- Main responsibilities:
  - no responsibilities for monetary policy
  - carry out tasks related to the fact that not all Member States have adopted the euro (strengthen coordination of monetary policies, collect statistical information, perform preparations for countries that will adopt the euro,...)

Voting modalities in the Governing Council

- Monetary policy decisions are taken by consensus

- When taking decisions, members of the Governing Council do not act as national representatives but in a fully independent, personal capacity and with a euro area perspective

- Future enlarged euro area:
  - need to continue taking decisions in a timely and efficient manner
  - if number of euro area countries exceeds 18, consensus replaced by a two-third majority rule
  - rotation scheme for NCB governors, maintaining permanent vote for the 6 members of the Executive Board and allowing NCBs of larger countries to vote more often
  - all governors will participate to meetings irrespective of whether they hold a voting right at that time

- The accession of Lithuania to the euro area on 1 January 2015 triggered the system under which National Central Bank Governors take turns holding voting rights on the Governing Council

How independent is the ECB?

- Treaty (of the EU) establishes that ECB is independent from political influence

  When exercising the powers and carrying out the tasks and duties conferred upon them, neither the ECB not the NCBs, nor any member of their decision-making bodies, are allowed to seek or take instructions from community institutions or bodies, from any government of the Member States or from any other body

  → Irreversible policy decisions

- Other key aspects safeguarding independence of Eurosystem and ECB are:

  – ECB financial arrangements separate from those of European Community (ECB has his own budget, and its capital is subscribed and paid up by euro area NCBs)

  – Long-term offices for members of Governing Council and rule stipulating that members of Executive Board cannot be re-appointed (Executive Board member serve 8 years terms and governors of NCBs appointed for a minimum of 5 years)

How independent is the ECB? cont.

- Maastricht Treaty specifies that overriding long-term goal of ECB is price stability → goal for Eurosystem more clearly specified than it is for the Fed System

  However, Treaty has not specified exactly what "price stability" means, but Eurosystem defined quantitative goal to be inflation rate of about 2%

  Weakens goal-independence of the ECB

- Eurosystem charter cannot be changed by legislation, only by Treaty revision