Central Banks and the Federal Reserve System

This lecture examines how central banks and the Federal Reserve work.

The Origins of the Federal Reserve System

A. Fear of centralized power was a source of resistance to a central bank in the United States.

   1. The First Bank of the United States was disbanded in 1811, while the charter for the Second Bank of the United States expired in 1836.

   2. After 1836, the U.S. had no lender of last resort that could provide reserves to the banking system to avert a banking panic.

   3. Between 1836 and 1907, banking panics occurred every 20 years or so.

4. The banking panic of 1907 resulted in widespread bank failures and substantial losses to depositors that finally convinced the public the U.S. needed a central bank.

B. Hostility towards banks and opposition to centralized authority led to a compromise that created the unique structure of the Federal Reserve System.

The Structure of the Federal Reserve System

A. Federal Reserve Banks

1. There are 12 distinct Federal Reserve districts with one main Federal Reserve Bank in each district, but each bank can also have branches in other cities in the district.

2. Each Federal Reserve Bank is a quasi-public institution owned by the commercial banks in its district and is a member of the Federal Reserve System.

3. Member banks are required to purchase shares of their district Federal Reserve Bank and receive a dividend limited by law to 6% annually.
4. Each Federal Reserve Bank has nine directors.
    a. The three class A directors are bankers elected by the member banks.
    b. The three class B directors are prominent leaders in industry, agriculture, or the consumer sector who are elected by member banks.
    c. The three class C directors are appointed by the Board of Governors of the Federal Reserve System and are not allowed to be employees or stockholders of banks.
5. The directors oversee the activities of the district banks while class B and C directors appoint the bank president subject to the approval of the Board of Governors.

6. The 12 Federal Reserve Banks perform many functions.
    a. Their directors legally “establish” the discount rate.
    b. They decide which banks can obtain discount window loans and then administer those loans.
    c. One banker from each district is elected by Federal Reserve Bank to serve on the Federal Advisory Council, which consults with the Board of Governors on the conduct of monetary policy.
    d. They clear checks and issue new currency.
    e. Each Bank acts as a liaison between the business community and the Federal Reserve System.
    f. They collect and report data on local business conditions.

B. Member Banks

1. All federally-chartered banks are part of the Federal Reserve System, while state banks are not required to be members.

2. Regardless of membership, all commercial banks

   a. are required to keep deposits at the Fed that are subject to reserve requirements.

   b. have access to the Federal Reserve facilities such as the discount window and Fed check clearing.

C. Board of Governors of the Federal Reserve System

1. The seven member Board of Governors is headquartered in Washington, DC.

   a. The president nominates and the senate confirms each governor to one full, nonrenewable 14-year term.

b. One of the seven governors is nominated by the president and confirmed by the senate to serve a four-year term as chair of the Board of Governors.

2. The Board of Governors is involved in monetary policy in several ways.

   a. All seven governors are members of the Federal Open Market Committee (FOMC) and vote on the conduct of monetary policy.

   b. The Board of Governors sets the reserve requirements.

   c. It approves or disapproves the discount rate "established" by the Federal Reserve Banks.

3. The Board of Governors has other duties that are not directly related to the conduct of monetary policy.

    a. The Board sets margin requirements (i.e., the minimum amount of the purchase price of a security that must be paid for in cash).

    b. The salaries of the Federal Reserve Bank presidents and officers are set by the Board, and it also approves the budget of each Federal Reserve Bank.

    c. It approves bank mergers, specifies permissible activates of bank holding companies, and supervises the activities of foreign banks in the United States.

D. Federal Open Market Committee (FOMC)

1. The FOMC meets eight times a year to make decisions about the conduct of monetary policy.
2. The FOMC consists of 12 members.
    a. The seven members of the Board of Governors.
    b. The president of the Federal Reserve Bank of New York.
    c. The presidents of four of the remaining 11 Federal Reserve Banks on a rotating basis (but all Bank presidents participate in the FOMC meetings).
3. The FOMC "advises" the Board on setting the discount rate and reserve requirements.
4. The FOMC issues directives to the trading desk at the New York Fed on the implementation of its policy decisions.

E. The Chair of the Board of Governors

1. He/She is advises the President on economic policy, testifies before Congress, and speaks to the media on behalf of the Federal Reserve.

2. The chair of the Board also serves as the chair of the FOMC and sets the agenda for the Board and FOMC meetings.

3. The Board’s staff of economists and advisors are supervised by the chair.

The Fed has a Fair Amount of Independence from the Legislative and Executive Branches

A. The Fed's independence is enhanced because it makes a profit from its operations (which it returns to the U.S. Treasury), so it does not need Congressional appropriations.

B. The General Accounting Office also cannot audit either the Fed's monetary policy operations or its foreign exchange market functions.

C. Its independence, however, is not unlimited because Congress always has the option at any time to pass legislation to take away power from the Fed.

D. The President can influence the Fed because he/she can appoint (with the approval of the senate) several governors since most governors do not serve full terms.

Should the Fed be Independent?

A. The Case for Independence

1. Subjecting the Fed to political pressures would impart an inflationary bias to monetary policy.

    a. Politicians prefer short-run policies that stimulate output before elections even if it will result in higher inflation later.

    b. Countries with central banks that are easily influenced by politicians usually have higher inflation rates than central banks that are more independent.

2. Having the Fed under the control of the Treasury could also introduce an inflationary bias because the Treasury could force the Fed to buy government bonds as a way to finance government budget deficits.

3. The economic consequences could be severe if politicians, who do not have expertise in monetary policy, are directing Fed policy.

B. The Case against Independence

1. An independent Fed is accountable to no one.
2. Historically, the Fed has not used its freedom successfully. For example, the Fed did not provide emergency liquidity during the Great Depression, and it allowed inflation to accelerate during the 1960s and 1970s.
3. The Fed’s independence may encourage it to pursue policies in its self-interest rather than the public’s interest.

The European System of Central Banks (The Central Bank System for the European Union)

A. National Central Banks

1. The National Central Bank in each country operates like a Federal Reserve Bank.

2. Each country's National Central Bank controls its own budgets along with the European Central Bank's budget.

3. Monetary operations in the Eurozone are conducted by the National Central Banks.

B. The European Central Bank (ECB)

1. The ECB is located in Frankfurt, Germany and operates like the Board of Governors in the U.S.

2. Its Executive Board is comprised of a president, a vice-president, and four other members who serve eight-year nonrenewable terms.
3. The Executive Board Members are appointed by a committee made up of the heads of state of all of the countries that are part of the European Monetary Union
4. The ECB is not involved with the supervision and regulation of financial institutions. That job is conducted by member countries.

C. Governing Council

1. The Governing Council operates like the FOMC.
2. It is comprised of the heads of the 18 National Central Banks and the six Executive Board Members.
3. The Governing Council does not take votes, but instead, operates by consensus.

D. The European System of National Banks is the most independent central bank in the world.

1. Executive Board Members and the heads of the National Central Banks hold long terms. (Heads of the National Central Banks serve at least five year terms.)
2. The budgets of the ECB and National Central Banks are not determined by politicians.
3. The long-term goal of the ECB is to promote price stability.
4. Unlike the Fed, the Eurosystem cannot be changed by legislation, but instead, can only be changed by treaty.