

# Lecture 10: Central Banking

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- Central Banking
- History of Central Banking
- Goals of Central Banking
- Federal Reserve System
- Central Banks around world

# Central Banking

- **A central bank**
  - ▣ **reserve bank, or monetary authority**
  - ▣ a public institution that usually issues the currency, regulates the money supply, and controls the interest rates in a country.
  - ▣ Central banks often also oversee the commercial banking system of their respective countries.
  - ▣ In contrast to a commercial bank, a central bank possesses a monopoly on printing the national currency, which usually serves as the nation's legal tender.

# Central Banking

- The primary function of a central bank
- to provide the nation's money supply, but more active duties include controlling interest rates (i.e., price fixing), and acting as a lender of last resort to the banking sector during times of financial crisis (e.g., bailouts).
- To have supervisory powers, intended to prevent banks and other financial institutions from reckless or fraudulent behavior.

# Central Banking

- Independence of Central banks
  - ▣ Central banks in most developed nations are independent in that they operate under rules designed to render them free from political interference.
  - ▣ The issue of how much or how desirable is the independence of Central banks

# History of Central Banking

- Monetary systems around 17C
  - ▣ In Europe prior to the 17th century most money was commodity money, typically gold or silver.
  - ▣ Promises to pay were widely circulated and accepted as value at least five hundred years earlier in both Europe and Asia.
  - ▣ The Song Dynasty was the first to issue generally circulating paper currency, while the Yuan Dynasty was the first to use notes as the predominant circulating medium.

# History of Central Banking

- The need for Monetary control
  - ▣ In 1455, in an effort to control inflation, the succeeding Ming Dynasty ended the use of paper money and closed much of Chinese trade.
  - ▣ The medieval European Knights Templar ran an early prototype of a central banking system, as their promises to pay were widely respected, and many regard their activities as having laid the basis for the modern banking system.

# Early Central Banking

- The public bank
  - ▣ The first public bank to "offer accounts not directly convertible to coin" arose.
- the Bank of Amsterdam established in 1609 is considered to be the first central bank.
- The central bank of Sweden ("Sveriges Riksbank" or simply "Riksbanken") was founded in Stockholm in 1664, making it the oldest central bank still operating today.

# Early Central Banking

- Central Bank as a lender to the government
  - ▣ One role of the Swedish central bank was lending to the government,
  - ▣ likewise true of the Bank of England, created in 1694 by Scottish businessman William Paterson in the City of London at the request of the English government to help pay for a war.
  - ▣ The War of the Second Coalition led to the creation of the Banque de France in 1800.



# Central Banks and monetary systems

- Competing monetary systems:
  - ▣ central banks, today generally associated with fiat money, but, the 19th and early 20th centuries central banks in most of Europe and Japan developed under the international gold standard,
  - ▣ , and elsewhere free banking or currency boards were more usual at this time.
  - ▣ Problems with collapses of banks during downturns, was leading to wider support for central banks in those nations which did not yet possess them, esp. in Australia.

# The US Federal Reserve

- The first bank of the United States (1791-1811)
- The 2nd bank of the United States (1816-1832)
- The National Bank Act of 1863
  - ▣ established the Office of the Comptroller of Currency
- The US Federal Reserve
  - ▣ The US Federal Reserve was created by the U.S. Congress through the passing of The Federal Reserve Act in the Senate and its signing by President Woodrow Wilson on the same day, December 23, 1913.

# Central Banks in other countries

- Australia established its first central bank in 1920, Colombia in 1923, Mexico and Chile in 1925 and Canada and New Zealand in the aftermath of the Great Depression in 1934. Brazil developed a precursor thereto in 1945, the present central bank 20 years later.
- Bank of Korea 한국은행
  - ▣ established on June 12, 1950 at Seoul, South Korea.
- Bank of Japan 日本銀行
  - ▣ the Bank of Japan was founded in Meiji 15 (1882) after a Belgian model., reorganized under the Bank of Japan Act of 1942

# Central Banks in other countries

- Peoples' Bank of China 中国人民银行
  - ▣ The People's Bank of China evolved its role as a central bank starting in about 1979 with the introduction of market reforms, which accelerated in 1989 when the country adopted a generally capitalist approach to its export economy.
  - ▣ Evolving further partly in response to the European Central Bank, the People's Bank of China has by 2000 become a modern central bank.

# The Price Stability Goal

- Low and stable inflation
- Inflation
  - ▣ Creates uncertainty and difficulty in planning for the future
  - ▣ Lowers economic growth
  - ▣ Strains social fabric
- Nominal anchor to contain inflation expectations
- Time-inconsistency problem

# Other Goals of Monetary Policy

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- High employment
- Economic growth
- Stability of financial markets
- Interest-rate stability
- Foreign exchange market stability

# Should Price Stability be the Primary Goal?

- In the long run there is no conflict between the goals
- In the short run it can conflict with the goals of high employment and interest-rate stability
- Hierarchical mandate
- Dual mandate

# 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



# U.S. 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

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# Federal Reserve Banks (cont'd)

- Fed 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
- 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

# Why the Chairman 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

# 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



# 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

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- 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
- 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