

The Federal Reserve (3/8/2011)

Econ 310-008

Definitions

- **central bank** – regulates a nation’s depository institutions and controls the quantity of money
- **Federal Reserve (“the Fed”)** – central bank in the United States
- **Federal Reserve banks (FRB)** – 12 regional banks responsible for the regulation of the commercial banks within their own particular district
- **Board of Governors (BoG)** – main governing body of Federal Reserve System
- **Federal Open Market Committee (FOMC)** – main policy-making group in the Federal Reserve System
- **discount rate** – interest rate to borrow funds from Federal Reserve
- **federal funds rate** – interest rate to borrow from other banks
- **required reserve ratio** – required percentage of liabilities banks must keep as reserves
- **open market operations** – purchase or sale of securities by the Federal Reserve in the open market
- **service fees** – profit that results from fees charged for miscellaneous services performed
- **price stability** – low and stable inflation
- **instrument independence** – ability of the central bank to set monetary policy instruments
- **goal independence** – ability of the central bank to set goals of monetary policy

William Jennings Bryan

- presidential candidate (Democrat)
 - 1896, 1900, 1908
- “cross of gold” speech
- populist for farmers
- disliked gold standard
- wanted free silver coinage
- hated big banks
- Secretary of State under Wilson

Nelson Aldrich

- chair of Senate finance committee
- sponsor: 16th Amend. (income tax)
- sponsor: Aldrich–Vreeland Act of 1908
- wrote Aldrich plan
 - studied European central banks
 - met with bankers on Jekyll Island
 - basis of Federal Reserve Act
- grandfather of VP Nelson Rockefeller

Fed history

- precipitated by panic of 1907
- Aldrich–Vreeland Act of 1908
 - National Monetary Commission
- Aldrich plan floated
- Federal Reserve Act of 1913
 - introduced by Glass
 - Woodrow Wilson signed
 - William Jennings Bryan supported

Federal Reserve Banks

- 12 regional banks
- Board of Governors
 - 7 governors
- Federal Open Market Committee
 - 7 board governors
 - 1 FRB of NY president
 - 4 other FRB presidents (rotating)
- Federal Advisory Council
 - 12 bankers (1 from each district)

FRB of NY

- Federal Reserve bank
- district with largest commercial banks
- houses open market desk
 - open market operations for Fed
- houses foreign exchange desk
 - foreign exchange interventions
- member of BIS (with Fed chair)
 - Bank for International Settlements
- repository for \$100 billion of gold
- permanent voting member of FOMC

Federal Reserve Banks

- 3 class A directors
 - professional bankers
 - elected by member banks
- 3 class B directors
 - industry, labor, agriculture leaders
 - elected by member banks
- 3 class C directors
 - represent public interest
 - appointed by Board of Governors
 - Bank President must be class C

Roles of federal reserve banks

- clear checks
- issue new currency
- withdraw damaged currency
- discount loans to banks in districts
- evaluate proposed mergers
- liaisons for business community
- examine bank holding companies
- examine state-chartered member banks
- collect data on local economy
- research monetary policy

Member banks

- nationally chartered banks must join
- state chartered banks may join
- all depository institutions
 - must keep reserves at Fed
 - subject to reserve requirements
- member banks
 - associate with 1 FRB (district)
 - invest 6% of capital in FRB stock
 - get 6% dividends on FRB earnings
 - vote on 6/9 FRB directors

Board of Governors

- 7 governors
 - all from different FRB districts
 - 14 year non-renewable terms
 - staggered expiring every 2 years
 - appointed by President
 - confirmed by Senate
- chairman and vice-chairman
 - selected from governors
 - 4 year renewable terms
 - appointed by President

Federal Reserve Chairman

- controls agenda of the Board
- directs board staff
- Federal Reserve spokesperson
- point of contact for
 - President
 - Congress
 - foreign central banks

Federal Open Market Committee

- meets every 6 weeks
- BoG has a majority (7/12)
- formulates monetary policy
- decides open market operations
- sets reserve requirements
- reviews discount rates
- voting members
 - 7 governors from BoG
 - 1 FRB of NY president (permanent)
 - 4 other FRB presidents (rotating)
- chair of BoG chairs the FOMC

Monetary policy tools

- traditional tools
 - required reserve ratios
 - discount rate
 - open market operations
- additional (new) tools
 - interest on reserves
 - term auction facility
 - primary dealer credit facility
 - term securities lending facility

Open market operations

- policy decided by FOMC
- implemented by FRB of NY
- open market desk sells or buys
 - with primary dealers (18 banks)
 - buying increases money supply
 - selling decreases money supply

Reserve banks issue notes

- Department of Treasury prints notes
 - Bureau of Printing & Engraving
- notes made of cloth, not paper
- old: marked by issuing reserve bank
- new: generic federal reserve notes

Federal Reserve revenue

- revenue
 - seigniorage
 - service fees
- fund all operations
- rebate excess to Treasury

Monetary policy goals

- price stability
- high employment
- economic growth
- financial market stability
- interest-rate stability
- foreign exchange stability

Independence

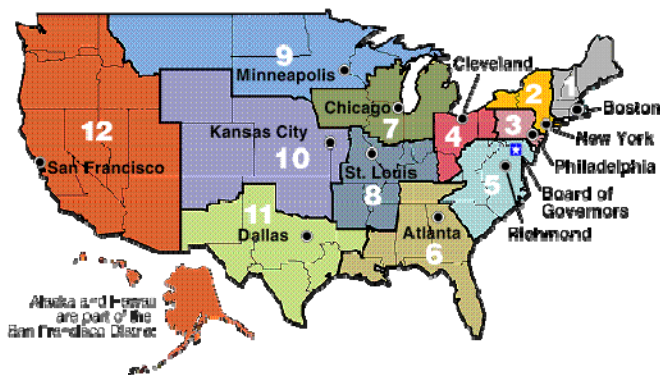
- independent
 - long terms for BoG
 - determines own budget
 - instrument and goal independence
- not independent
 - Congress can amend Fed legislation
 - President appoints BoG and chair
- overall: very independent
- independence leads to lower inflation
 - less political business cycles

European central bank

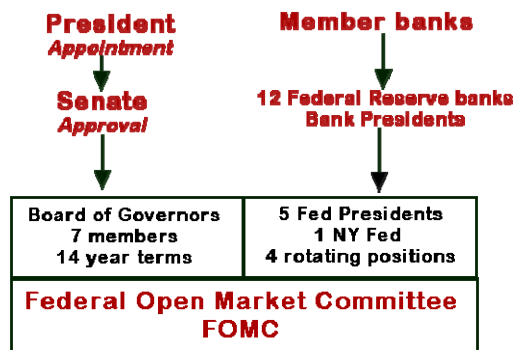
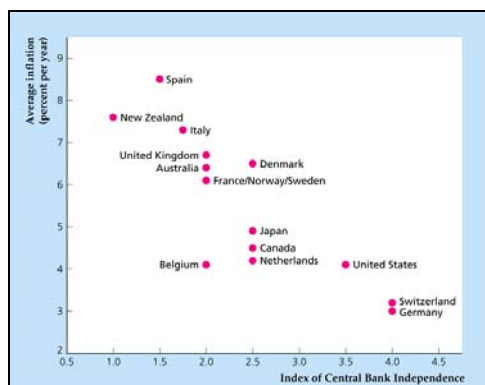
- patterned after Federal Reserve
- national central banks (NCBs)
- executive board (EB)
- governing council (GC)
- NCBs similar to Fed banks
- EB similar to Fed BoG
- GC similar to FOMC
- NCBs control own budgets
- monetary operations not centralized
- doesn't regulate financial institutions
- monthly meetings (Frankfurt, Germany)

Federal Reserve districts

- Boston – A
- New York – B
- Philadelphia – C
- Cleveland – D
- Richmond – E
- Atlanta – F
- Chicago – G
- St. Louis – H
- Minneapolis – I
- Denver – J
- Dallas – K
- San Francisco – L



= E = 5th district = Richmond



Paul Volcker

- Federal Reserve chairman 1979-1987
 - appointed by Carter
 - reappointed once by Reagan
 - “fired”: didn’t support de-regulation
 - ended 1970’s stagflation
 - caused 1981 recession
 - targeted monetary aggregates
- previously FRBNY president
- Economic Recovery Advisory Board chair



Alan Greenspan

- Federal Reserve chairman 1987-2006
 - appointed by Reagan
 - re-appointed by Bush, Clinton, & Bush 2
 - very stable economy / low inflation
 - obfuscated his words
 - acted first at FOMC meetings
 - policy in 2000’s caused housing bubble?
- chair of Council of Economic Advisers (Ford)
- economic consulting firm (numbers guy)
- friend of objectivist philosopher Ayn Rand



Ben Bernanke

- Federal Reserve chairman 2006-present
 - appointed by Bush 2
 - re-appointed by Obama
 - scholar of Great Depression
 - big on transparency
 - speaks clearly
 - acts last at FOMC meetings
- economics professor (Stanford, Princeton)
- Federal Reserve Governor 2002-2005
- chair of Council of Economic Advisers (Bush 2)

