

Central Banks and Federal Reserve System

Economics 301: Money and Banking

Goals and Learning Outcomes

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- Goals:
 - Describe objectives for monetary policy.
 - Describe the structure of Federal Reserve System.
- Learning Outcomes:
 - LO6: Explain the structure of the Federal Reserve System and the mechanisms in which it controls the money supply.

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Reading and Exercises

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- Structure of the Federal Reserve System: Chapter 13, pp. 434-444
- Central bank independence: Chapter 13, pp. 454-460
- **Canvas quiz due Wed 11:59 PM.**
- **Homework/Exercise due Fri 11:59 PM.** We will work together in class on Thursday

Inflation Stability

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- **Inflation Stability:** Overriding goal of most central banks is to maintain a low and stable rate of inflation.
- Why Stability?
 - When overall price level changes unpredictably, it is difficult to interpret changes in prices of individual goods, services, and assets.
 - Leads to sub-optimal decisions for risk averse people, less efficient financial system.
 - Stability essential for long-term planning.
- Why inflation?
 - Unexpected deflation redistributes wealth from borrowers to lenders.
 - Unexpected inflation redistributes wealth from lenders to borrowers.
 - Expectations for deflation decreases current demand for products and services.

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Time Consistency Problem

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- Central bank's desire for price stability may take back seat to concerns over low production, unemployment, etc.
- If central bank regularly abandons long-run price stability objective - people begin to expect that.
- Decreases central bank's credibility that it will control inflation
- Without credibility, Inflation shocks lead people begin to expect higher inflation
- Increases uncertainty, risk, and produces a less efficient economy and financial system.
- Time consistency problem of banking / parenting
- Kydland and Prescott argue, the *less* the Fed does to stabilize the economy, the *more* stable it will be.

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High Level of Employment

5/ 22

- Reasons to aim for a high level of employment:
 - High unemployment leads to idle workers, idle resources, lower GDP.
 - Employment statistics computed on a monthly basis by the Bureau of Labor Statistics.
 - Social cost of unemployment.
- Three types of unemployment:
 - ① Frictional unemployment: causes by normal turn-over in the labor force, normal job/candidate search costs.
 - ② Structural unemployment: unemployment caused by permanent decreases in demand for certain types of labor (perhaps due to changes in international trade or technology).
 - ③ Cyclical unemployment: unemployment associated with downturns in the economy.

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Economic Growth

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- Closely related to goals of high employment / high output.
- This policy implies a long-run goal, not growth from quarter to quarter.
- Policies that promote:
 - Firms to invest in new capital, higher future production possibilities.
 - Consumers to save more (in equilibrium saving = investment).

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Other Goals

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- Financial market stability: financial crisis interferes with the financial market's function to channel saving to people with productive investment opportunities.
- Interest rate stability:
 - Encourages minimal uncertainty regarding bond market capital gains.
 - Encourages long-run investment in capital.
- Stability in foreign exchange markets:
 - Rises in the value of the dollar hurts exporting industries.
 - Decreases in the value of the dollar hurts consumers, industries that depend on foreign factors of production.

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Hierarchical and Dual Mandates

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- **Hierarchical mandate:** explicit statement by a central bank that inflation stability is their first priority.
- Examples: Bank of England, Bank of Canada, European Central Bank, Reserve Bank of New Zealand.
- **Dual mandate:** central banks whose rules allow for multiple objectives.
- United States Federal Reserve has a dual mandate: promote maximum employment and inflation stability.
- Dual mandates can lead to time consistency problems.

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Board of Governors

9/ 22

- Seven members appointed by the president and confirmed by the senate.
- Each has a 14 year term. A new seat comes up every 2 years.
- No re-appointments, unless finishing an incomplete term.
- One chair person, one vice chair person, each with a 4 year renewable term.
- Chair and vice chair are appointed from Board of Governors by president / approved by senate
- Chair person's salary = \$226,300 (2022, set by congress)
- By law, appointments must result in "fair representation of the financial, agricultural, industrial, and commercial interests and geographical divisions of the country"

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Federal Reserve Chair: Current

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Jerome Powell

- Appointed by Pres. Donald Trump (R) in 2018
- Re-appointed by Pres. Joseph Biden (D) in 2022



Federal Reserve Chair: Past

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Janet Yellen

- In office: 2014-2018
- Appointed by Pres. Barack Obama (D) in 2014



Federal Reserve Chair: Past

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Alan Greenspan

- In office: 1987-2006
- Appointed by Pres. Ronald Reagan (R) in 1987
- Reappointed by Pres. George Bush (R) in 1992
- Reappointed by Pres. Clinton (D) twice in 1996 and 2000
- Reappointed by Pres. George W. Bush (R) in 2004



Federal Reserve Chair: Past

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Paul Volcker

- In office: 1983-1987
- Appointed by Pres. Jimmy Carter (D) in 1979
- Reappointed by Pres. Ronald Reagan (R) in 1983
- In his tenure, raised interest rates to historical levels to combat historically high inflation



Federal Reserve Chair: Past

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George William Miller

- Who?
- In office: 1978-1979
- Appointed by Pres. Jimmy Carter in 1978 (D)
- Resigned in 1979



Federal Reserve Chair: Past

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Arthur Burns

- In office: 1970-1978
- Appointed by Pres. Richard Nixon (R) in 1970
- Reappointed by Nixon in 1974
- Very high inflation. The CPI rose by 74% during his tenure.



Federal Open Market Committee

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- Board of governors (7 appointees)
- President of the New York Federal Reserve district bank
- Four presidents of the other regional Federal Reserve district banks (rotate)
- This group of 12 makes decisions for monetary policy
- Meet every six weeks
- Website: <https://www.federalreserve.gov/monetarpolicy/fomccalendars.htm>
(Includes meeting schedule, official statements, subsequent press conferences, meeting minutes)

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- Federal Reserve District Banks are **not** part of the government
- Private non-profit corporations owned by member banks
- Profits are donated to the U.S. Treasury at the end of every year
- New York Fed implements monetary policy

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- Federal Reserve District Banks are **not** part of the government
- Private non-profit corporations owned by member banks
- Profits are donated to the U.S. Treasury at the end of every year
- New York Fed implements monetary policy

Federal Reserve Districts

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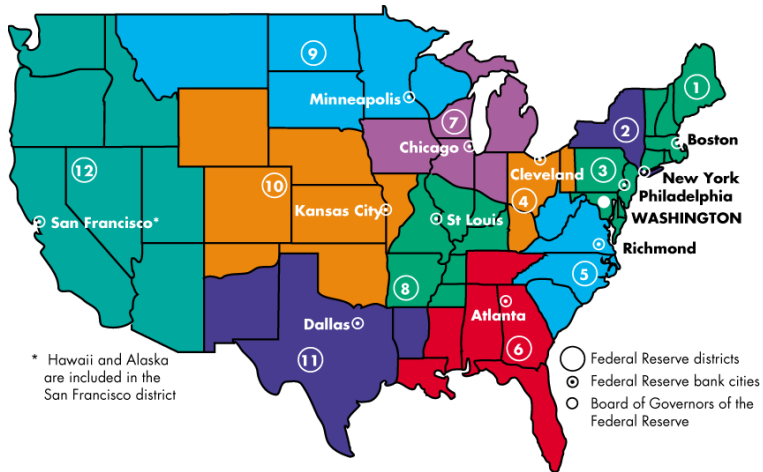
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Federal Reserve Districts

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Federal Reserve Districts

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Functions of Federal Reserve Banks

20 / 22

- Provide Automatic Clearing House (ACH), wire transfers, and check clearing services
- Issue new currency / Withdraw damaged currency.
- Provide discount loans to banks in their district.
- Supervise commercial banks within their district.
- Evaluate proposals for bank mergers and expansion of services.
- Collect data and report on local and national economic conditions.
- Hold reserve deposits for banks in their district.
- Each is overseen by board of directors from their region. The members contribute regional business experience, community involvement, and leadership.

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Central Bank Independence

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- Federal Reserve is largely independent from whims of politicians.
- Board of governors are appointed by President and approved by Senate
- Board of governors have long terms (14 years).
- FOMC includes Federal Reserve District Presidents, which are not government appointees or employees.
- Fed does not use tax dollars - earned more than \$108 billion in 2021.
- Legislation that structures Fed was written by Congress, they can change it.
- Case for independence:
 - Policy for successfully meeting *long-term* goals can negative *short-term* consequences.
 - Possible pressure to finance Federal Government budget deficits.

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Reading and Exercises

22/ 22

- Structure of the Federal Reserve System: Chapter 13, pp. 434-444
- Central bank independence: Chapter 13, pp. 454-460
- **Canvas quiz due Wed 11:59 PM.**
- **Homework/Exercise due Fri 11:59 PM.** We will work together in class on Thursday