# Central Banks and Federal Reserve System

Economics 301: Money and Banking

# Goals and Learning Outcomes



- Goals:
  - Learn about possible objectives for monetary policy.
  - Learn about 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



- Hubbard & O'Brien, Chapter 13.

# Inflation Stability



- **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



- 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.
- Increases uncertainty, risk, and produces a less efficient economy and financial system.
- Time Consistency Problem of parenting:
  - Long-term policy - don't reward bad behavior.
  - Short-term concern - give kid what he wants to shut him up.
- Kydland and Prescott argue, the *less* a government does to stabilize the economy, the *more* stable it will be.

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## High Level of Employment



- 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: 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



- 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



- 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



- **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 long-run output growth and inflation stability.
- Dual mandates can lead to time consistency problems.

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# Board of Governors



- 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 = \$201,700 (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



**Jerome Powell**
Appointed by Pres. Donald Trump in 2018

# Federal Reserve Chair: Past



**Janet Yellen**

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

# Federal Reserve Chair: Past



**Alan Greenspan**

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

# Federal Reserve Chair: Past



**Paul Volcker**

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

# Federal Reserve Chair: Past



**George William Miller**

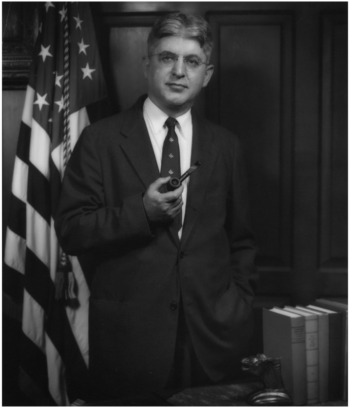
- Who?
- In office: 1978-1979
- Appointed by Pres. Jimmy Carter in 1978
- Resigned in 1979

# Federal Reserve Chair: Past



**Arthur Burns**

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



# Federal Open Market Committee



- Board of governors
- 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/monetarypolicy/fomccalendars.htm
  (Includes meeting schedule, official statements, subsequent press conferences, meeting minutes)

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# Federal Reserve Districts



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- Twelve Federal Reserve Districts, each with a federal reserve bank
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- New York Fed implements monetary policy

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- Twelve Federal Reserve Districts, each with a federal reserve bank
- Federal Reserve District Banks are **not** part of the government
- Private corporations owned by member banks
- New York Fed implements monetary policy

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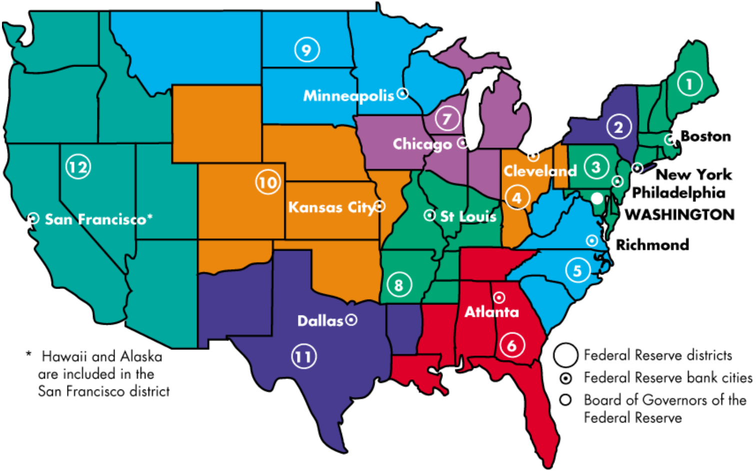

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# Functions of Federal Reserve Banks



- Check clearing services.
- Issue new currency.
- Withdraw damaged currency.
- Provide discount loans to banks in their district.
- Evaluate proposals for bank mergers and expansion of services.
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# Central Bank Independence



- Federal Reserve is largely independent from whims of politicians.
- Board of governors have long terms (14 years).
- Fed does not use tax dollars - they actually earn around $40 billion / year.
- Legislation that structures Fed was written by Congress, they can change it.
- Case for independence:
  - Policy that results in successfully meeting long-term goals, may have negative short-run consequences.
  - Possible pressure to finance Federal Government budget deficits.

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