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:
  - LO4: Explain the structure of the Federal Reserve System and the mechanisms in which it controls the money supply.

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Reading

- Read Mishkin, Chapter 12.

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.
  - Deflation is prevented for social concerns.

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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:
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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.
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Structure of the Federal Reserve

- 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 14 years.
  - One chairman with a 4 year renewable term.
- Federal Open Market Committee
  - Board of governors
  - President of the New York Fed
  - Four presidents of the other regional feds (rotate).
- Federal Reserve Districts
  - Twelve Federal Reserve Districts, each with a federal reserve bank.
  - New York Fed implements monetary policy.

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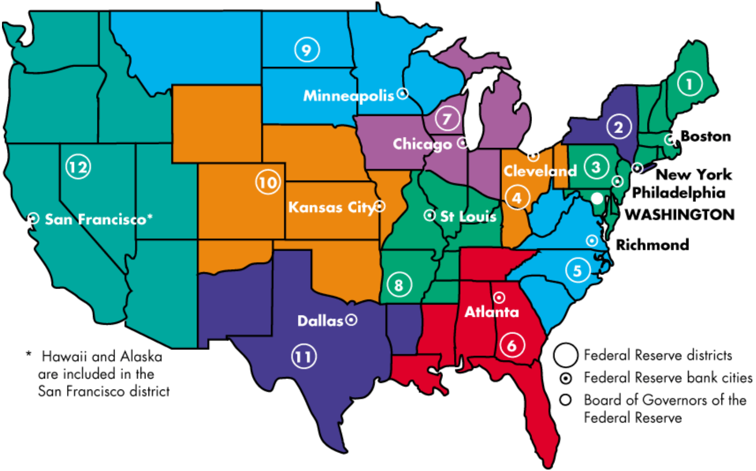
Federal Reserve Districts



Federal Reserve Districts

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.
- Collect data and report on local and national economic conditions.
- Hold reserve deposits for banks in their district.

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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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Coming up...

- Another debate.
- Money Supply Process (Chapter 13)