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CHAPTER 13

Central Banks and the Federal Reserve System

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Outline

Reading and objectives

- Mishkin, *The Economics of Money, Banking, and Financial Markets*, 13th ed.
- This deck: **Chapter 13** — Central Banks and the Federal Reserve System.
- This opens **Part IV** on monetary policy. Before we can study *how* a central bank moves interest rates and the money supply, we need to know *who* actually decides — the institution, its anatomy, and the politics of its independence.

Learning objectives

13.1 Recognize the historical context behind the founding of the Fed.

13.2 Describe the key features and functions of the Federal Reserve System.

13.3–13.4 Assess the Fed's independence; use the theory of bureaucratic behavior.

13.5 Summarize the arguments for and against central-bank independence.

13.6–13.7 Compare the ECB and other major central banks with the Fed.

PART 1

Origins and Structure of the Fed

Why a central bank at all — and why so late?

The United States was the last major economy to get a central bank. That delay is the key to understanding the Fed's odd structure.

- Deep American **resistance** to a central bank: fear of centralized power and distrust of moneyed interests killed two earlier attempts.
- The cost of having no **lender of last resort**: recurring nationwide bank panics throughout the 1800s and early 1900s.
- The **Panic of 1907** was so severe that public opinion finally turned — a central bank was needed.
- The **Federal Reserve Act of 1913** was the compromise: a deliberately *decentralized* system with an elaborate set of checks and balances.

Mishkin Ch. 13, Section 13.1.

Designed to diffuse power

The drafters wanted no single group — and no single region — to control the new institution. So power was diffused along three lines:

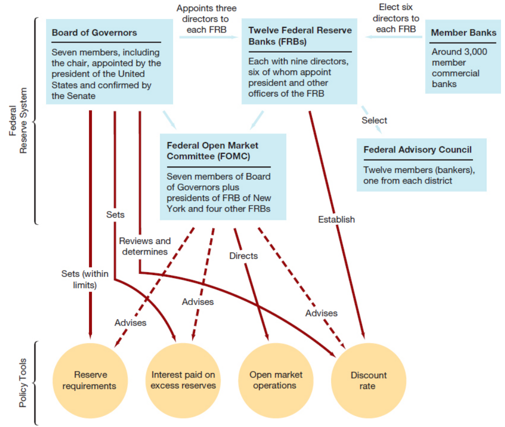
1. **Regional** — between the different districts of the country,
2. **Public vs. private** — between the government and the private sector,
3. **Constituency** — among bankers, business people, and the general public.

The result: a system, not a bank

That diffusion produced the entities we still have today: the **12 Federal Reserve banks**, the **Board of Governors**, the **FOMC**, the **Federal Advisory Council**, and around **2,900 member commercial banks**.

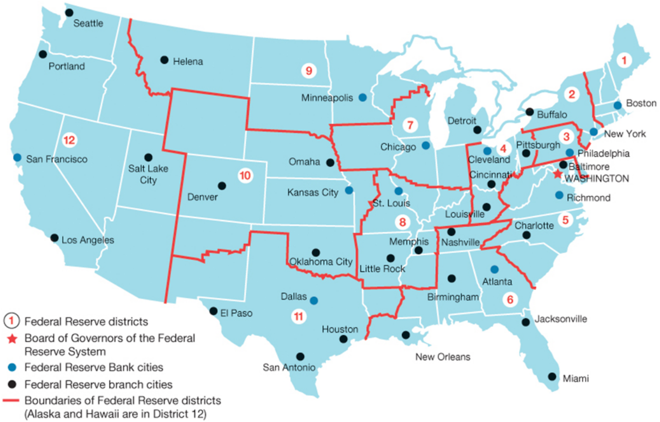
Mishkin Ch. 13, Section 13.2.

Figure 1 — Structure and responsibility for policy tools



Mishkin Ch. 13, Figure 1. The Board of Governors, the 12 Reserve banks, and the FOMC each control a different lever — this map of who does what is the backbone of the chapter.

Figure 2 — The 12 Federal Reserve districts



Mishkin Ch. 13, Figure 2 (Federal Reserve Bulletin). The district map is a direct fossil of the 1913 goal of diffusing power along regional lines.

PART 2

Inside the System: Banks, Board, and FOMC

The Federal Reserve banks

The 12 Reserve banks are the *quasi-public*, regional layer of the system.

- Each is a **quasi-public institution** — owned by the private member commercial banks in its district, yet performing public functions.
- Governed by **nine directors**: member banks elect six (classes A and B), the Board of Governors appoints three (class C).
  - Class A: professional bankers. Class B: leaders from industry, labor, agriculture, consumers. Class C: public representatives, barred from banking ties.
- The nine directors appoint the bank's **president**, subject to Board of Governors approval — a built-in public check on a privately influenced body.

Mishkin Ch. 13, Section 13.2.

What the Reserve banks actually do

Day-to-day functions — the plumbing of the payments and banking system:

- Clear checks; issue new currency and withdraw damaged currency.
- Administer and make **discount loans** to banks in their district.
- Evaluate proposed mergers and bank-expansion applications; examine bank holding companies and state member banks.
- Collect local business data; run large staffs of professional economists.

Role in monetary policy:

- Directors "establish" the **discount rate** and decide which banks get discount loans.
- **Five of the 12 presidents** vote on the FOMC at any time.

Mishkin Ch. 13, Section 13.2.

The special role of the New York Fed

Among the 12, the Federal Reserve Bank of New York is first among equals — for four reasons:

1. Its district holds many of the **largest U.S. commercial banks**, whose soundness is paramount to the system.
2. It is **active in the bond and foreign-exchange markets** — and houses the trading desk that executes open market operations.
3. It is the only Reserve bank that is a member of the **Bank for International Settlements (BIS)**.
4. Its president is the **only permanent voting member** of the FOMC among the bank presidents, and serves as the committee's vice-chair.

So the NY Fed president, the Board chair, and the Board vice-chair are the three most important officials in the system.

Mishkin Ch. 13, Section 13.2.

Member banks

- **All national banks** must be members of the Federal Reserve System.
- State-chartered commercial banks **may** join but are not required to.
- The **Depository Institutions Deregulation and Monetary Control Act of 1980** was the great equalizer: it subjected *all* depository institutions to the same reserve requirements as members and gave *all* of them access to the Fed's facilities (e.g. the discount window).

Why this matters

After 1980 the old member/non-member distinction lost most of its bite — monetary control no longer depended on whether a bank had chosen to join.

Mishkin Ch. 13, Section 13.2.

The Board of Governors

The Board is the *public*, Washington-based heart of the system.

- **Seven governors**, appointed by the president and confirmed by the Senate.
- **14-year, non-renewable** terms — staggered, with one expiring every two years, to insulate governors from the electoral cycle.
- Required to come from **different districts** (regional balance again).
- The **Chair** is chosen from among the governors and serves a renewable **4-year** term.

Notice the design: long non-renewable terms remove the incentive to please whoever appointed you — the structural basis of Fed independence.

Mishkin Ch. 13, Section 13.2.

Duties of the Board of Governors

The Board concentrates real policy power:

- Votes on the conduct of **open market operations** (as the FOMC majority).
- Sets **reserve requirements**.
- Controls the **discount rate** through a "review and determination" process.
- Sets **margin requirements** on securities purchases.
- Approves bank mergers and new activities; specifies permissible activities of **bank holding companies**; supervises foreign banks operating in the U.S.
- Sets the salaries and reviews the budgets of each Reserve bank.

Mishkin Ch. 13, Section 13.2.

Why the Chair really runs the show

On paper the Chair is one of seven votes. In practice the Chair dominates:

- Acts as the **spokesperson** for the Fed and negotiates with Congress and the President.
- **Sets the agenda** for FOMC meetings.
- **Speaks and votes first** on policy — anchoring the discussion.
- Supervises the Board's professional economists and advisers.

Personality matters

Mishkin notes that chairs differ in style — Greenspan (1987–2006) versus Bernanke, Yellen, and Powell — and that those styles shape how decisions actually get made.

Mishkin Ch. 13, Section 13.2; "Why the Chair Really Runs the Show."

The FOMC: where monetary policy is decided

- Meets **eight times a year**.
- **12 voting members**: the 7 governors, the NY Fed president, and 4 of the other 11 presidents on rotation.
- The Board **Chair** also chairs the FOMC.
- Issues **directives** to the trading desk at the NY Fed — the bridge from decision to action.

Inside an FOMC meeting: a report from the open-market manager; the staff national economic forecast; alternative policy scenarios; a briefing on relevant Congressional actions; and a public announcement of the decision.

Mishkin Ch. 13, Section 13.2.

The research staff and the colored "books"

The Fed is the world's largest employer of economists. Their core job: track incoming data and tell policymakers where the economy is headed and how policy would bite.

Green, blue, teal, and beige

- **Green book —** staff national economic forecast (to 2010).
- **Blue book —** monetary-aggregate projections + policy scenarios A/B/C (to 2010).
- **Teal book —** the green and blue books, combined since 2010.
- **Beige book —** district-level evidence from surveys and business contacts, produced by the Reserve banks.

Mishkin Ch. 13, Section 13.2; "Inside the Fed."

PART 3

Independence: Structure and the Debate

How independent is the Fed?

Independence comes in two flavors — and the Fed has both:

- **Instrument independence:** the ability to set its own policy tools (the funds rate). *Yes.*
- **Goal independence:** the ability to set its own objectives. *Largely yes* (a dual mandate, loosely specified).

Structural supports for independence:

- **Independent revenue** — the Fed funds itself from its securities portfolio; it does not depend on Congressional appropriations.
- Long, non-renewable governor terms.

Limits on independence: the Fed's structure is *written by Congress and can be changed at any time*; the President appoints governors and the Chair, and influences Congress.

Mishkin Ch. 13, Section 13.3.

Should the Fed be independent? The case *for*

Core argument

Subjecting monetary policy to short-run political pressure imparts an **inflationary bias**.

- **Political business cycle:** elected officials would be tempted to juice the economy before elections, then pay the inflation bill later.
- **Deficit financing:** a dependent Fed could be pressed to *accommodate* Treasury borrowing by printing money.
- **Principal–agent problem:** monetary policy is too important and too technical to leave to politicians, whose incentives are even more distorted than a bureaucrat's.

Mishkin Ch. 13, Section 13.5.

Should the Fed be independent? The case *against*

Core argument

It is **undemocratic** to have policy that affects everyone controlled by an unelected elite accountable to no one.

- **Unaccountable:** no direct electoral check on the people setting policy.
- **Coordination:** hard to align fiscal and monetary policy when the two are run by separate, independent authorities.
- **Track record:** critics argue the Fed has not always used its independence successfully (e.g. the Great Depression, the 1970s inflation).

The empirical verdict: across countries, greater central-bank independence is associated with *lower* inflation, with no clear cost in output — which is why the trend has been *toward* independence.

Mishkin Ch. 13, Section 13.5.

Independence under political pressure

Independence is a norm, not a guarantee — and presidents have tested it.

- Presidents from **Lyndon Johnson** to **Richard Nixon** pressured the Fed behind the scenes.
- The **Rubin doctrine** (Clinton-era Treasury Secretary Robert Rubin): the President simply does *not* comment on Fed policy — adopted by George W. Bush and Obama.
- That norm was **abandoned** under Donald Trump, whose public attacks on the Fed beginning in 2018 were unprecedented in their intensity.

The episode shows that the Fed's independence rests partly on *convention* — and conventions can be discarded.

Mishkin Ch. 13, Section 13.3.

Explaining central-bank behavior

How should we *predict* what the Fed does? Two competing lenses:

- **Public-interest view:** the bureaucracy simply serves the public good.
- **Theory of bureaucratic behavior:** a bureaucracy acts to *maximize its own welfare* — its power and prestige.

Predictions of the bureaucratic-behavior theory

The Fed will (1) **fight to preserve its autonomy**, and (2) **avoid conflict with more powerful groups** (Congress, the President). This explains a lot of Fed behavior — the fierce defense of independence, the careful management of Congressional relations — though it does not rule out genuine altruism.

Mishkin Ch. 13, Section 13.4.

The Fed's evolving communication strategy

A striking trend: the Fed has moved from secrecy toward radical **transparency**.

- **Post-meeting press conferences** by the Chair (following the Jan/Apr/Jun/Nov meetings) clarify the policy message.
- A **specific numerical inflation target** (2%) was announced, anchoring expectations.
- Greater transparency is itself a tool: clear communication shapes expectations, and expectations move long rates.

Why the shift? An independent, unelected body buys legitimacy through accountability — and transparency is how it pays.

Mishkin Ch. 13, Section 13.4; "Inside the Fed."

PART 4

Central Banks Abroad

The European Central Bank

The ECB is patterned after the Fed — a federal design — but with key differences.

- **National central banks** (the Bundesbank, Banque de France, . . .) play the role the Reserve banks do in the U.S.
- **Executive Board:** president, vice-president, and four others, on **8-year non-renewable** terms.
- **Governing Council:** the Executive Board plus the national central-bank heads; it sets policy, meets in Frankfurt, and operates by **consensus**, moving to a rotation system as the euro area grows.

Mishkin Ch. 13, Section 13.6.

ECB vs. Fed: the key differences

- **Budgets:** the national central banks control their own budgets *and* the ECB's — the reverse of the U.S., where the Board controls the Reserve banks' budgets.
- **Operations are not centralized:** monetary operations are run through the national central banks rather than a single desk.
- **No supervisory role:** the ECB does not supervise and regulate financial institutions (a function the Fed retains).

How independent is the ECB?

The **most independent central bank in the world**: long terms, its own budget, and a charter set by the **Maastricht Treaty** that legislation cannot alter — only a treaty revision can. But it is *less goal-independent*: price stability is mandated as the overriding objective.

Mishkin Ch. 13, Section 13.6.

Other major central banks

- **Bank of Canada:** essentially controls monetary policy, though the government has formal override authority it has never used.
- **Bank of England:** gained **instrument** independence in 1997 — it sets the rate to hit an inflation target the *government* chooses (so limited *goal* independence).
- **Bank of Japan:** gained much greater independence in the **1998** reform of the Bank of Japan Law.

The common thread

Across all of them, the unmistakable trend is **toward greater independence** — driven by the same evidence that links independence to lower inflation.

Mishkin Ch. 13, Section 13.7.

PART 5

Wrap-up

Key terms from Chapter 13

- Federal Reserve Act of 1913
- lender of last resort; Panic of 1907
- Federal Reserve banks (quasi-public)
- Board of Governors; the Chair
- Federal Open Market Committee (FOMC)
- Federal Advisory Council
- member banks; DIDMCA of 1980
- discount rate; reserve requirements
- open market operations; trading desk
- instrument vs. goal independence
- political business cycle
- theory of bureaucratic behavior
- green/blue/teal/beige books
- ECB; Governing Council; Maastricht Treaty

The one idea to take away

Structure is a deliberate answer to a political problem

Every odd feature of the Fed — 12 regional banks, a quasi-public/private hybrid, 14-year non-renewable terms, self-funding — is an engineered solution to one question: *how do you give an institution enough independence to resist the inflationary temptations of politics, while keeping it accountable enough to be legitimate in a democracy?*

- The case for independence rests on avoiding the political business cycle and inflationary bias; the case against rests on democratic accountability. The cross-country evidence — and the global trend — favors independence.
- Next: **Chapter 14** — the money supply process: how this institution's tools actually move the quantity of money.