Fed and Monetary Policy

Virtually all countries have central banks. What is a central bank and what are its roles? Most central banks have several roles in the economy. Traditionally, a central bank's primary role has been monetary policy. Thus, most of our time in this section will involve the goals, conduct and impact of monetary policy. However, first we will discuss other roles as well as the structure of the Fed.

Lender of Last Resort

The original role of most central banks is to be a lender of last resort. For example, the US Federal Reserve (Fed) was created in 1913 in response to the Panic of 1907. During the panic, many banks were on the verge of collapsing, but were rescued by a bailout led by J.P. Morgan (the man, not the bank). The economy suffered, but the bank rescue prevented a more serious collapse of the economy. To avoid a recurrence of the situation, Congress created the Federal Reserve in 1913, giving it the role of lender of last resort. The US had experienced financial panics and severe depressions during the previous century (1817-1907) and wanted to reduce the likelihood of a repeat of such severe economic hardships. Given the financial panics are such rare events, the more common roles of central banks are to conduct monetary policy and to help regulate the financial system.

Regulator

In some countries, the central bank is the sole regulator of the banking or financial system while in others, it's one of several regulators. In the US, the Fed has been one of many regulators, each with uncertain authority over the system. For example, some financial institutions could choose their regulator based on the structure of their organization. The recent changes in financial regulation has streamlined the regulatory process somewhat, giving a little more authority to the Fed (similar to the practice of most other advanced economies). Most experts generally agree that regulatory policy failed prior to the recent financial crisis. Financial institutions were allowed to become overleveraged without recognizing the risks involved in their lending practices. Reinhart and Rogoff (2010) have found that a common precursor to most financial crises is the introduction of a new financial instrument whose riskiness is not properly understood until its too late. In this case, the new financial instruments were credit default swaps and collateralized debt obligations (CDOs), first introduced in 2000. Abuse of these new instruments contributed to extreme excesses in the financial system leading eventually to the crisis.

Structure of the Fed

The leadership of the Federal Reserve is the Board of Governors, seven members who are appointed by the President and confirmed by the Senate to serve one 14-year term. Many times, a member of the Board will resign before the end of his/her term. The replacement can serve the remaining years of that term and then serve one full term. The terms are staggered such that one term expires every two years. This is to ensure continuity and also minimize the effect of politics. The intent is that the decisions will be based on economic reasoning instead of politics. In some other countries, leaders of the central bank must follow the desires of the ruling party and thus make decisions to affect an election instead of looking out for the long-term interest of the economy. One member of the Board of Governors is chosen to be chair. The chair is appointed by the President and confirmed by the Senate to serve a 4-year term. The chair can be reappointed as many times as desired as long as they are a member of the Board of Governors. For example, Alan Greenspan was appointed by President Reagan to finish Paul Volcker's term as a member of the Board of Governors in 1987. At the
same time, he was also appointed to replace Volcker as chair of the Fed. In 1992, President Bush appointed Greenspan to a full term as a member of the Board, with the term expiring in 2006. Along the way, he was reappointed as chair by President Bush, twice by President Clinton and once more by President Bush. When his term as a member of the Board expired in Jan 2006, President Bush had to choose a replacement for Greenspan both for the Board as well as chair. He chose Ben Bernanke, whose term on the Board ends in 2020. President Obama reappointed Bernanke as chair in 2010, so his current term as chair ends in 2014.

The Federal Reserve is broken up into 12 districts, each responsible for regulating member banks in their district. Each district has a president, chosen by the district directors and subject to the approval of the Board of Governors. Member banks within each district keep deposits at their local Fed bank; these deposits are part of the reserves of the member banks. Federal Reserve district banks also help to manage the payments system (for example, check clearing) as well as distribute the currency.

Eight times a year (about every 6 weeks), the Board of Governors and presidents of the district banks meet as members of the Federal Open Market Committee (FOMC) to discuss the state of the economy and decide whether any changes need to be made to monetary policy. While all district presidents are involved in the discussions, only 5 get to vote. The president of the NY Fed is always a voting member since the NY Fed implements the decision made. The other 11 district presidents take turns serving as voting members, serving one year at a time. The European Central Bank has a similar structure, with a 6-member executive board (comparable to the Board of Governors), national banks for each of its 16 members (comparable to district banks) and a governing council (similar to the FOMC). For further information about the organization of the European Central Bank (ECB), click here.

Next: Goals of Monetary Policy