The Federal Reserve System and Central Banking in the US

Christ University, Bangalore, India
March 10, 2014

FEDERAL RESERVE BANK OF RICHMOND
Richmond ▪ Baltimore ▪ Charlotte

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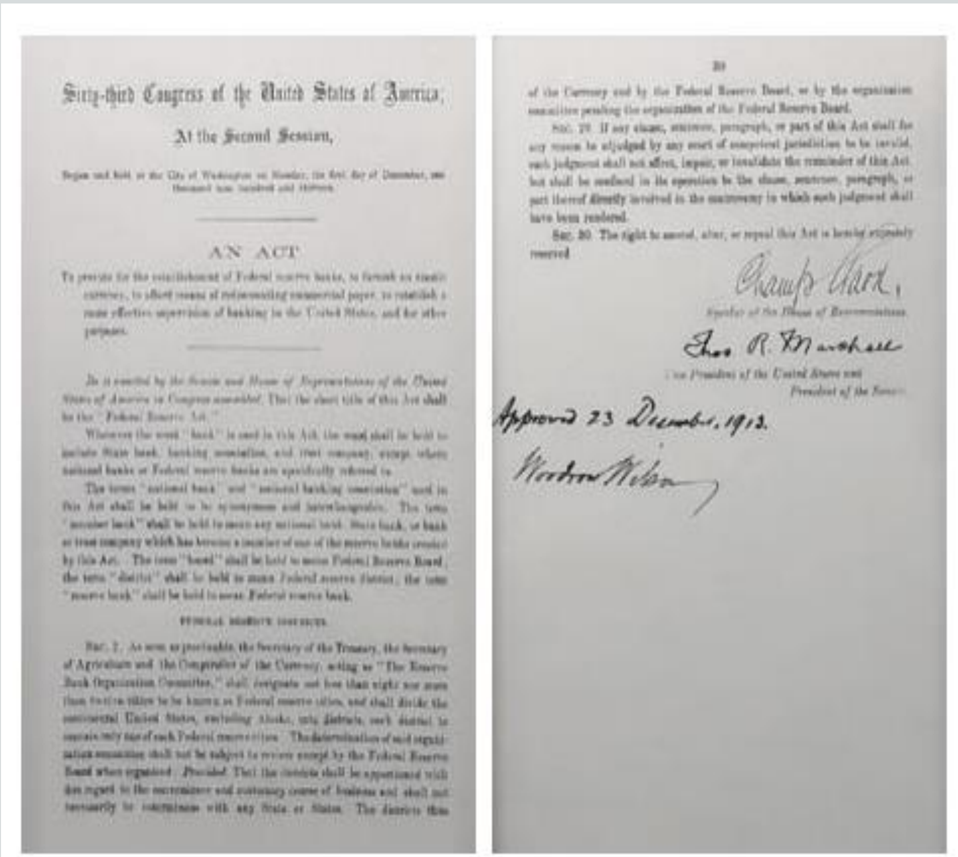
Overview

- A Little History of the Federal Reserve System
- Structure of the Fed
- Key Responsibilities of the Fed
  - Payments
  - Supervision and Regulation of Financial Institutions
  - Monetary Policy
- More on Monetary Policy

First Bank of the United States
1791-1811

Second Bank of the United States
1817-1837

Federal Reserve Act of 1913



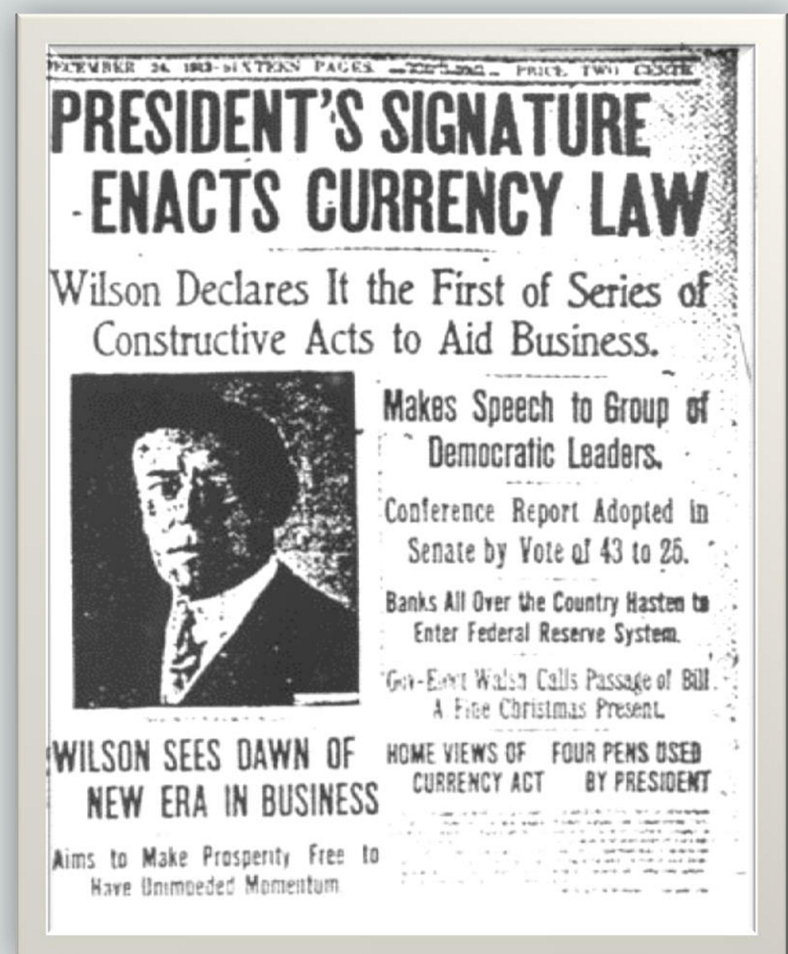
Sixty-third Congress of the United States of America;

At the Second Session,

AN ACT

Approved 23 December, 1913.

Woodrow Wilson



PRESIDENT'S SIGNATURE ENACTS CURRENCY LAW

Wilson Declares It the First of Series of Constructive Acts to Aid Business.

Makes Speech to Group of Democratic Leaders.

Conference Report Adopted in Senate by Vote of 43 to 25.

Banks All Over the Country Hasten to Enter Federal Reserve System.

Gov.-Elect Walsh Calls Passage of Bill A Fine Christmas Present.

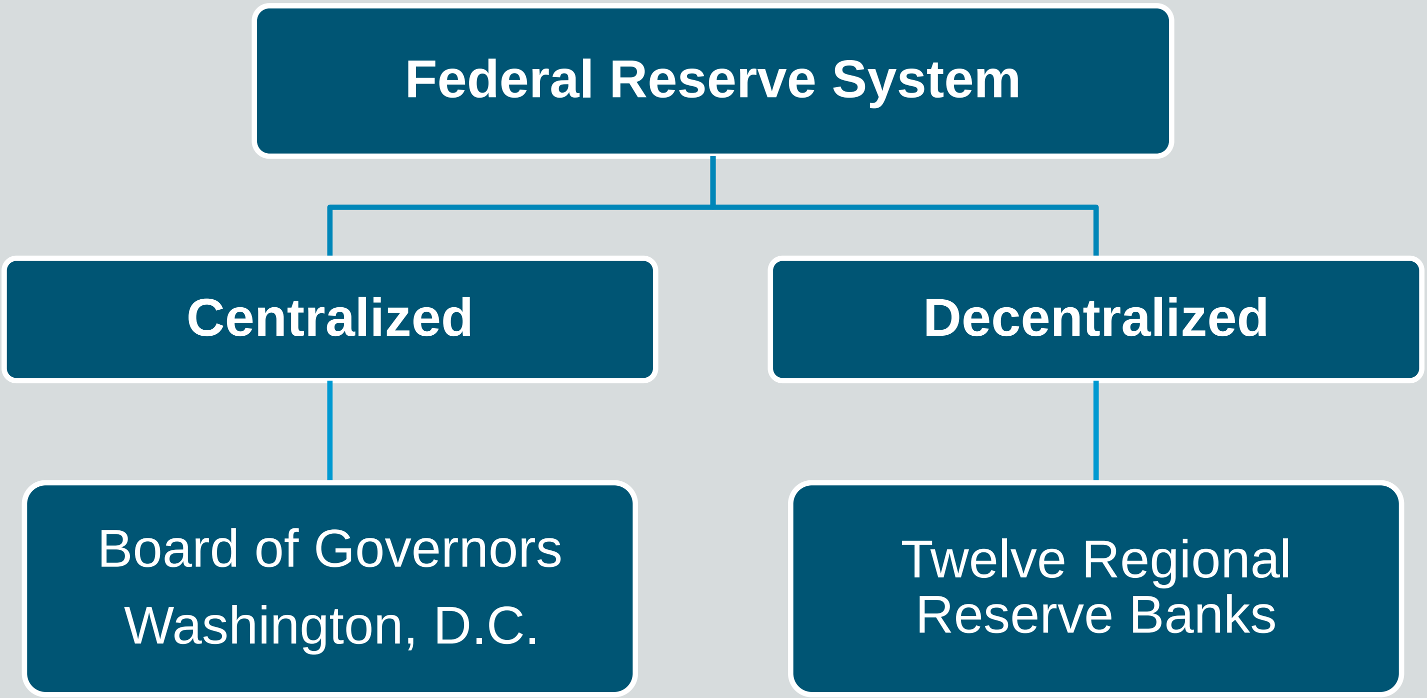
WILSON SEES DAWN OF NEW ERA IN BUSINESS

Aims to Make Prosperity Free to Have Unimpeded Momentum

HOME VIEWS OF CURRENCY ACT

FOUR PENS USED BY PRESIDENT

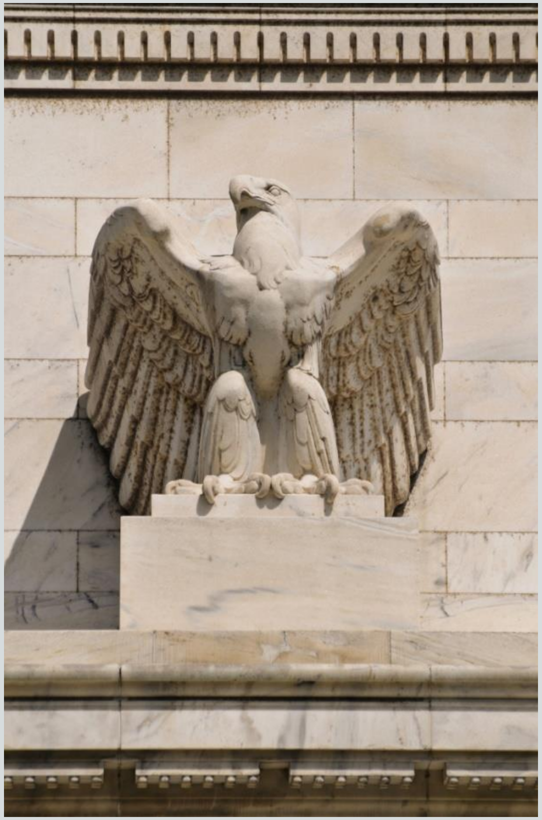
The Compromise Borne Out: The Fed




Minneapolis
Chicago
Cleveland
Boston
New York
Philadelphia
Kansas City
St. Louis
San Francisco
Richmond
Atlanta
Dallas

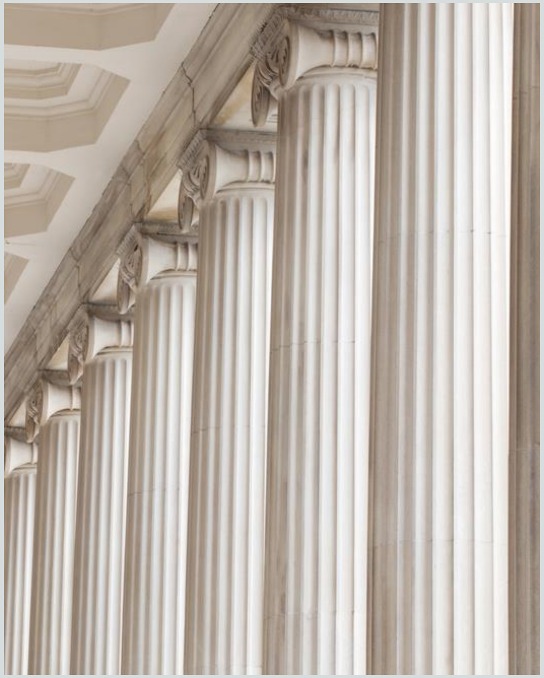
Our Primary Functions

- Monetary Policy
- Banking Supervision and Regulation
- Payments



Monetary Policy

We manage the nation's money supply to keep inflation low and help the economy grow.



Banking Supervision and Regulation

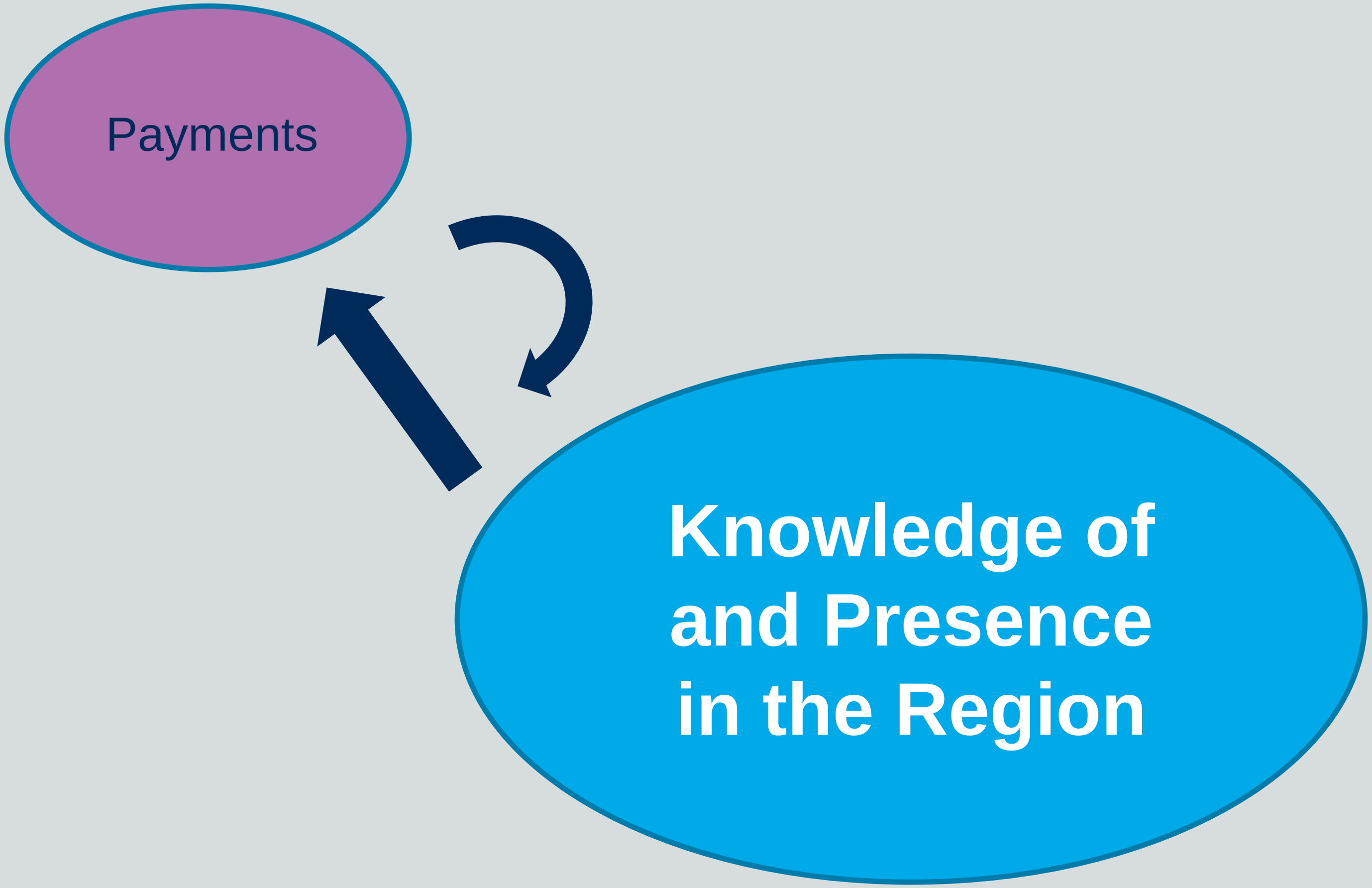
We supervise financial institutions to help protect our nation’s financial system.

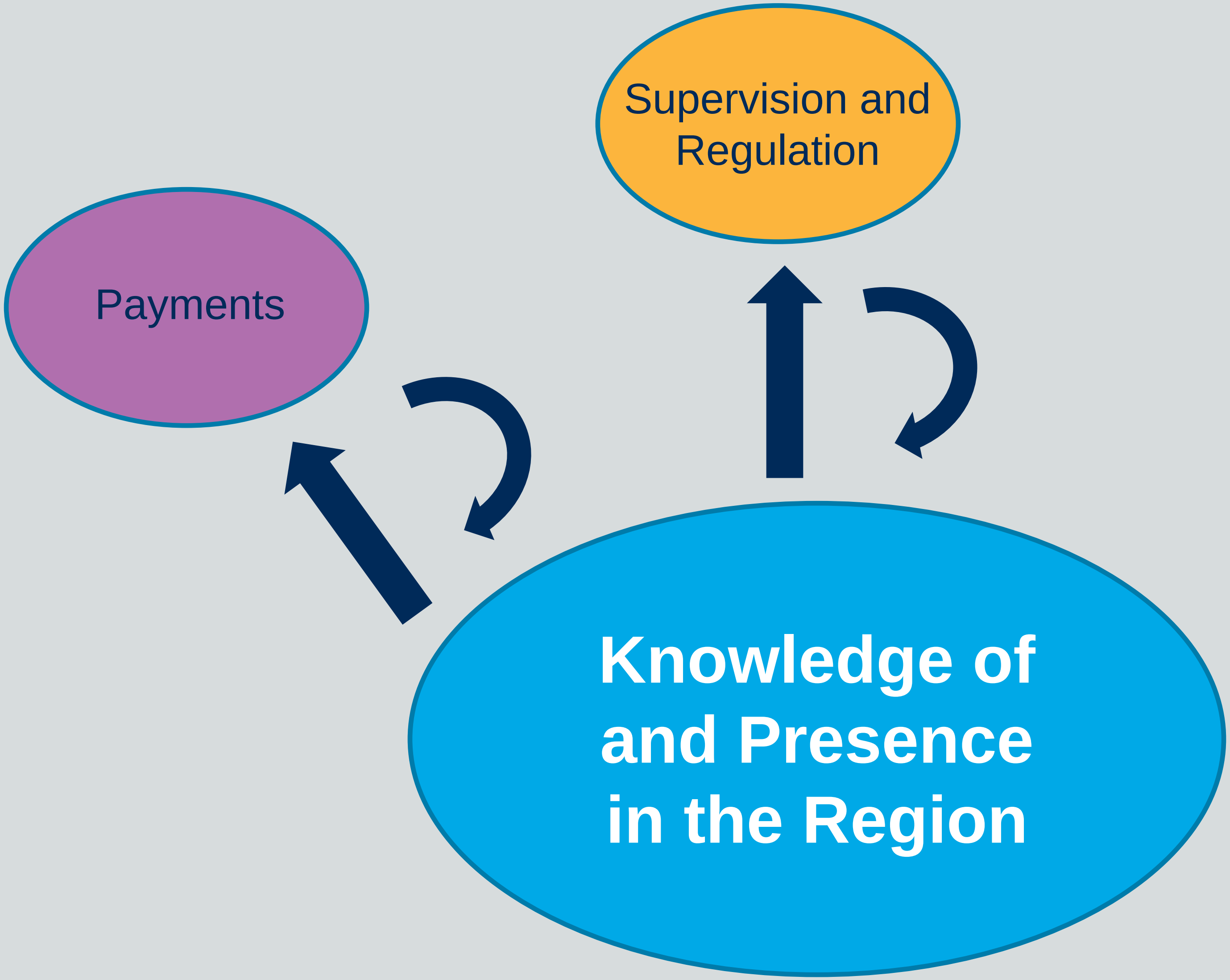
Payments

We safeguard the integrity of our nation’s payments systems.

What Else Do We Do?

Knowledge of and Presence in the Region


Payments
Knowledge of and Presence in the Region


Supervision and Regulation
Payments
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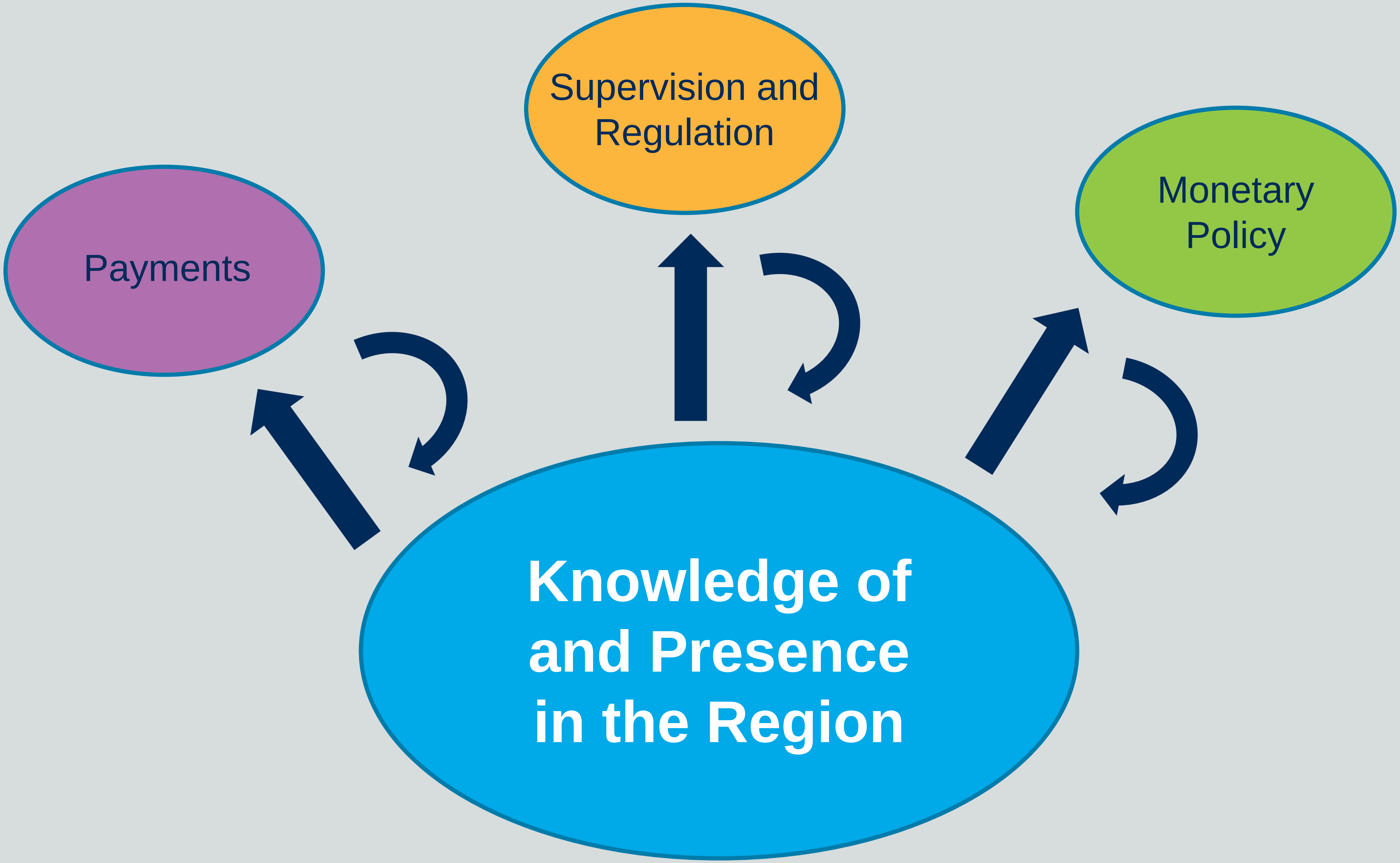
Supervision and Regulation
Payments
Monetary Policy
Knowledge of and Presence in the Region

Monetary Policy

- What is monetary policy?
  - Objectives of monetary policy
  - How monetary policy differs from fiscal policy
- Who decides monetary policy?
- How are monetary policy and fiscal policy independent in the US?
- What are the major tools of monetary policy?

Objectives of Monetary Policy

"…promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates"

Monetary Policy

Supply of Money and Credit

Monetary Policy

Supply of Money and Credit

Fiscal Policy

Taxing and Spending

Monetary Policy Wasn't Always Independent

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- In 1949, Chairman McCabe announced that the Fed would conduct monetary policy with a primary regard to business conditions.
- The Treasury Accord of 1951 solidified the Fed's independence.

Tools of Monetary Policy

- Open market operations (federal funds rate)

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- Discount rate

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- Interest on reserves
- Other tools (starting in 2007)

Starting in 2007, Everything Changed

- Financial crisis
  - Initial shock: housing downturn in ‘05 and ‘06
  - Losses on housing-related assets
  - Uncertainty about where else losses were hiding
  - Financial market volatility rose considerably in 2007, threatening to grind economic activity to a halt.

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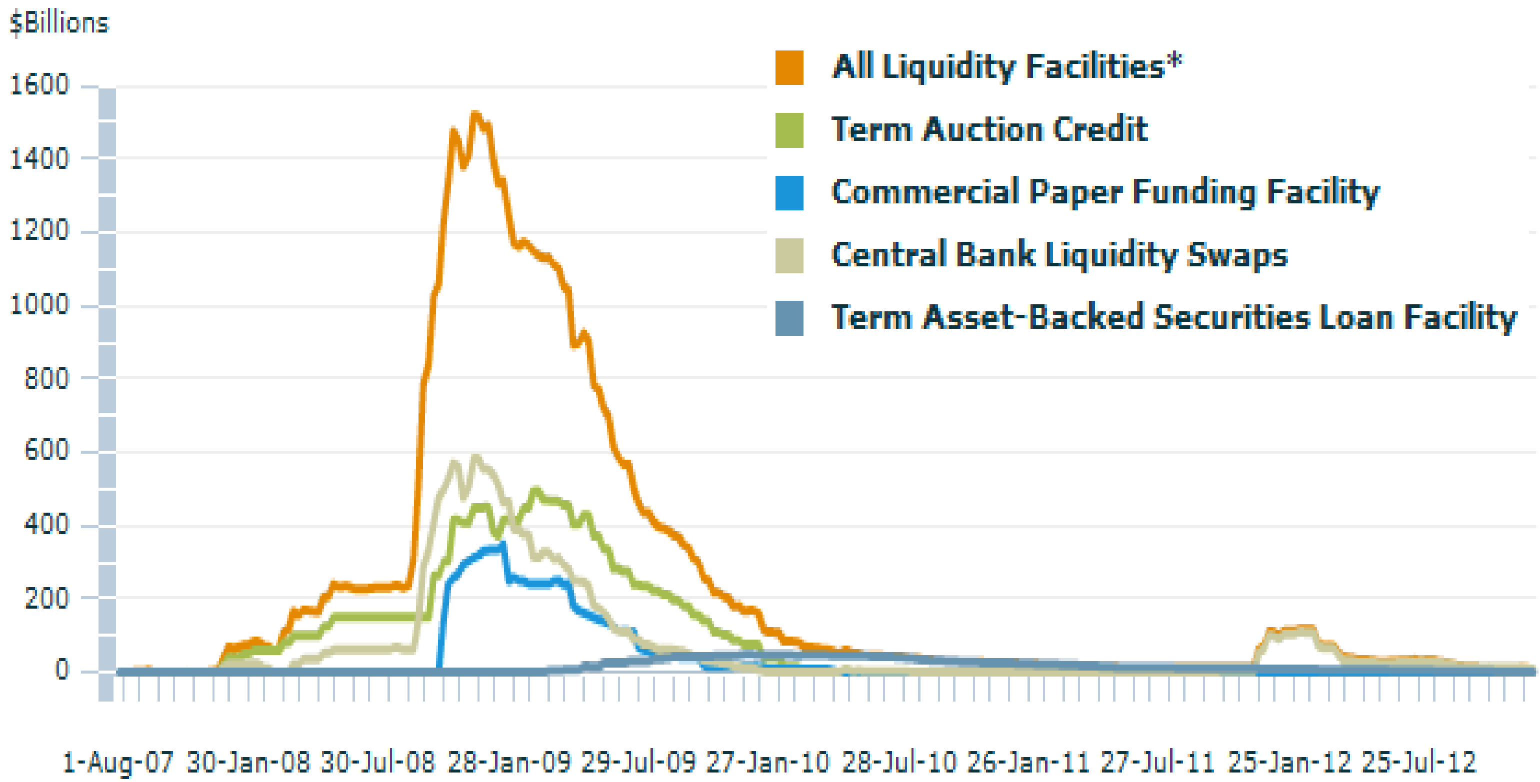
- The Great Recession and slow recovery

First Unusual Event: Financial Crisis

- Fed usually lends only to banks (through discount window)
- During crisis, lent to certain (new) institutions and markets

First Unusual Event: Financial Crisis



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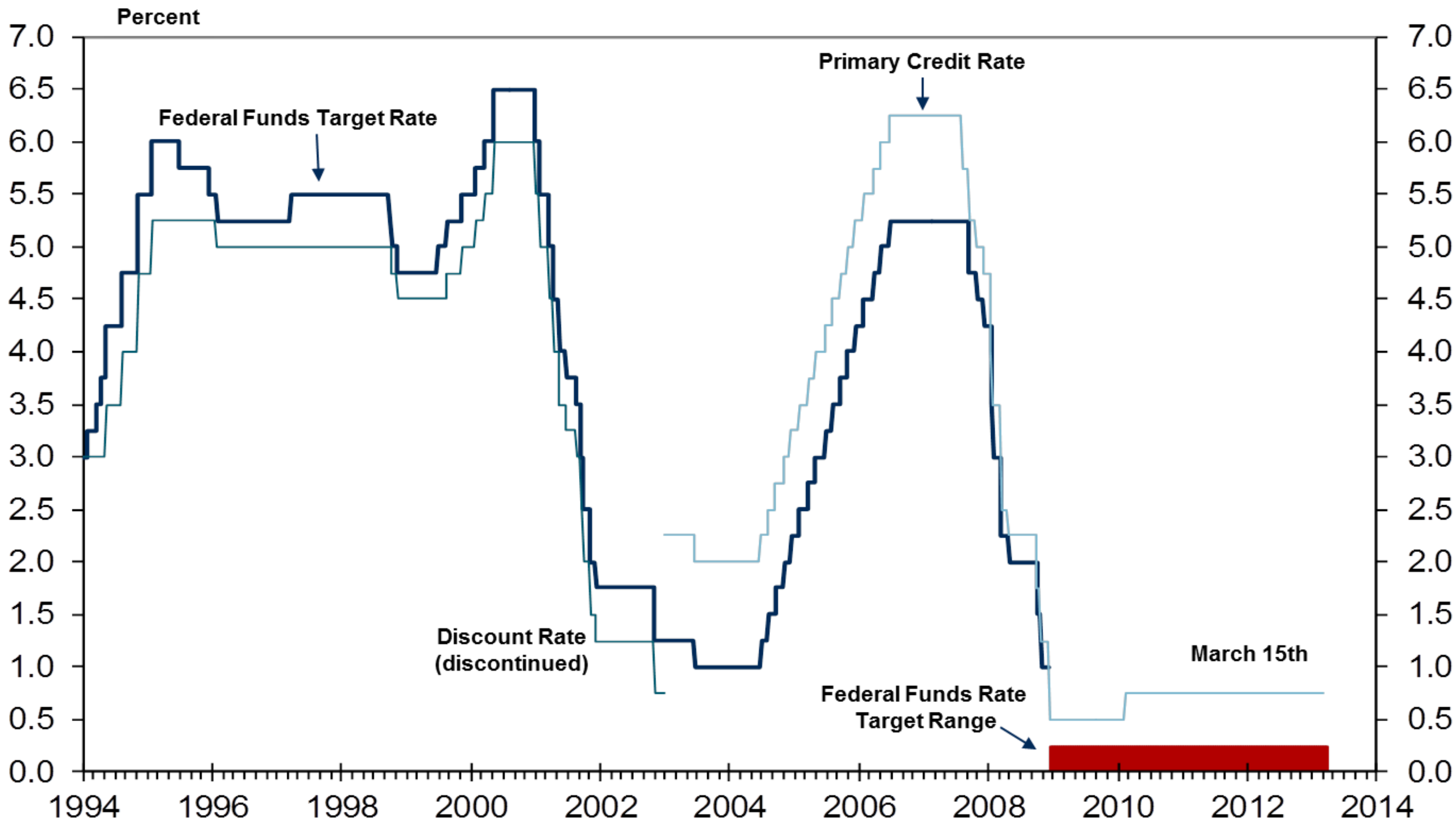
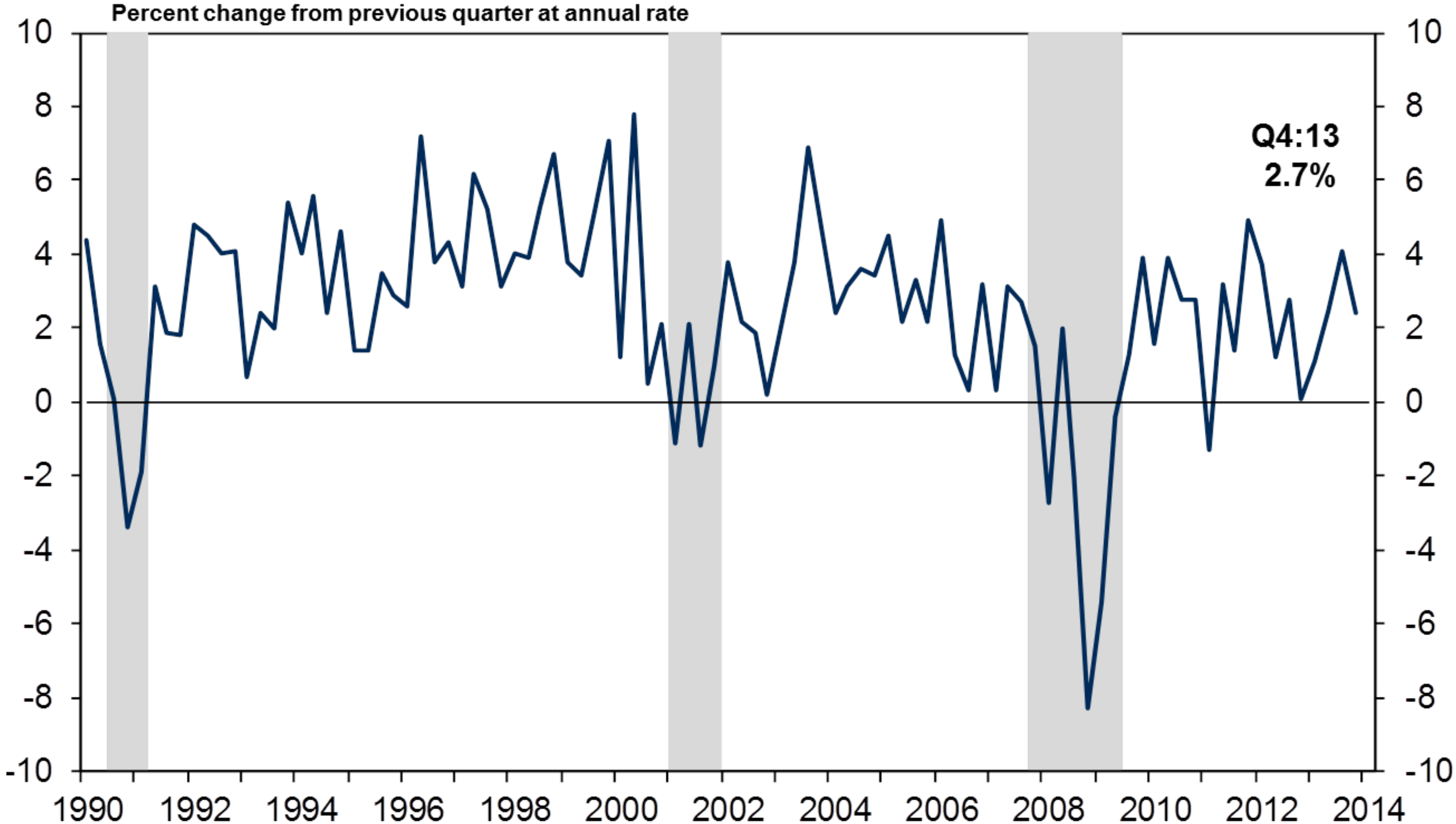
Second Unusual Event: The Zero Bound



Source: *Board of Governors/Haver Analytics*

Economic Weakness Persisted Despite ZLB



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Source: *Bureau of Economic Analysis/Haver Analytics*

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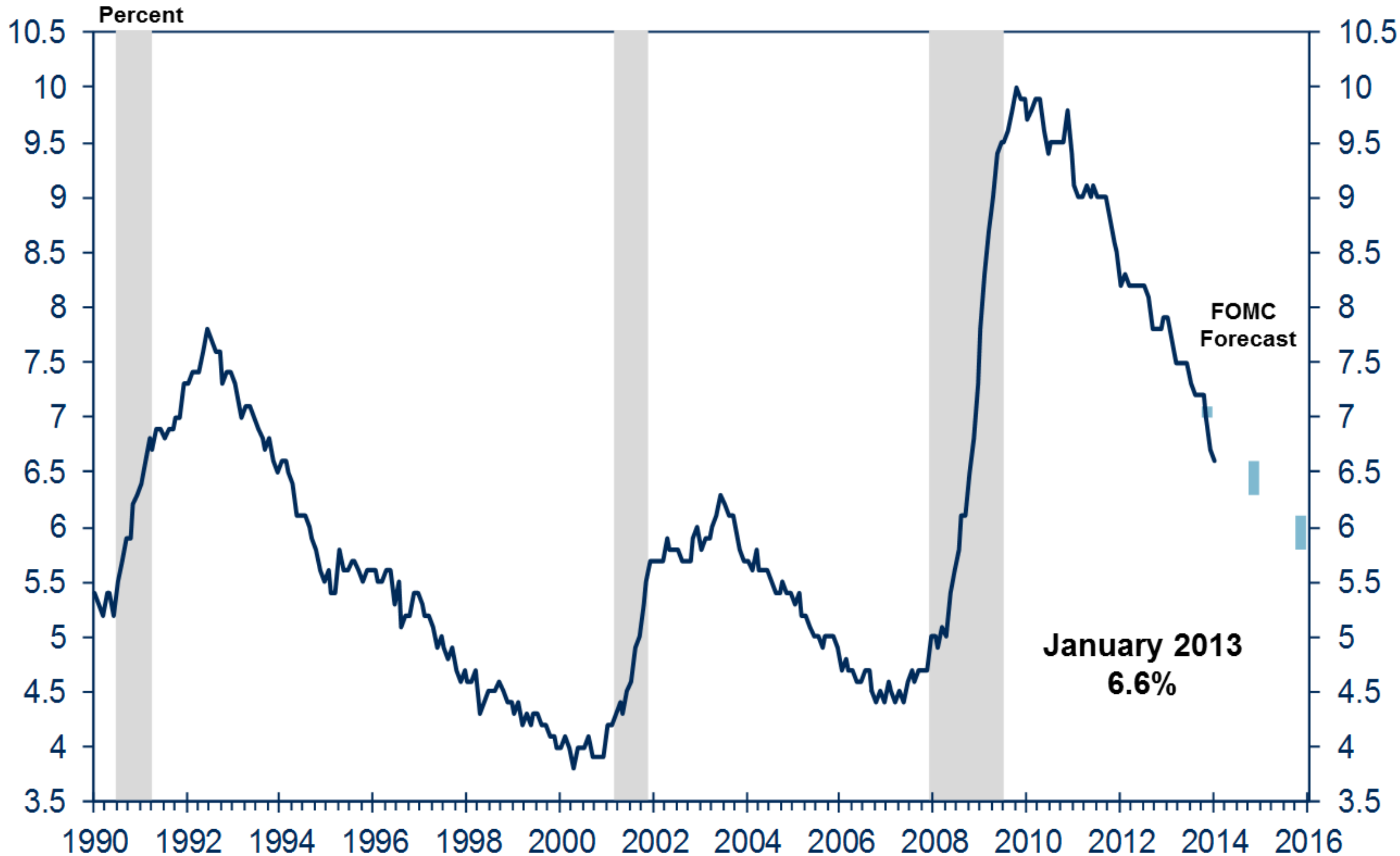

Note: FOMC forecast is the central tendency for the Q4 levels, from the December 2013 meeting.

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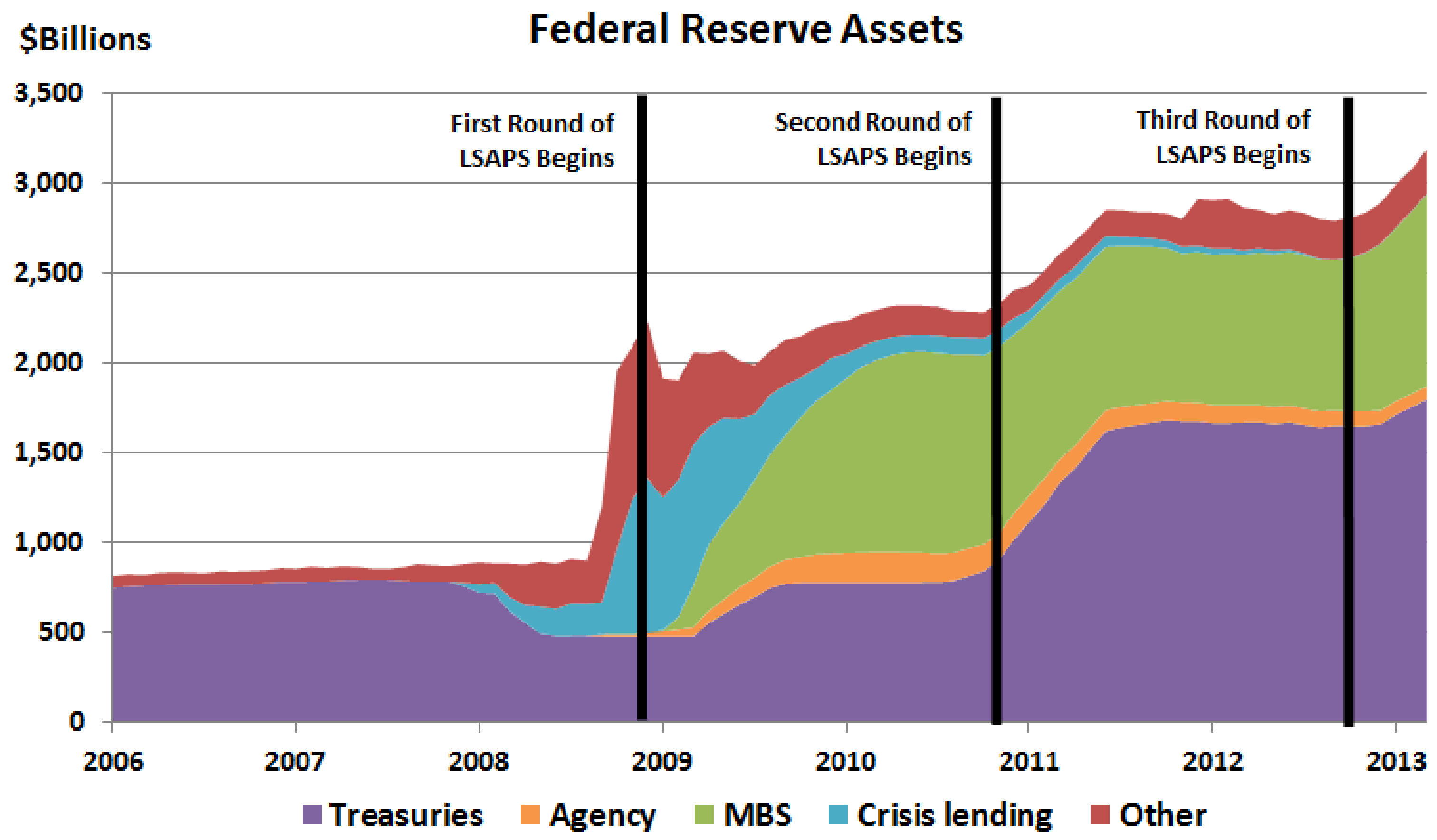
Source: *Bureau of Labor Statistics, Board of Governors, Haver Analytics*

What to Do at ZLB?

- Central bankers identified three unconventional monetary policies:
  - Expanding balance sheet (buying lots more assets)
  - Changing composition of balance sheet (buying different stuff)
  - Making people believe policy will stay easy for a long time
- We did all three.

Unconventional MP #1: Expand Balance Sheet



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Unconventional MP #1: Expand Balance Sheet

- Also called quantitative easing or large scale asset purchases (LSAPs)
- Goal: With short-term rates stuck at zero, reduce long-term interest rates to stimulate spending

Unconventional MP #2: Alter Balance Sheet

- Normal Treasury purchases usually aren't large enough relative to size of the market to directly affect longer term Treasury rates.
- Now Fed is intentionally making purchases large enough to lower lending rates in these markets
  - Mortgage-backed securities
  - Long-term treasuries (Maturity Extension Program, or "Operation Twist")

Unconventional MP #3: Forward Guidance

- Since 1999, FOMC post-meeting statements have hinted about future policy
- Statements ramped up considerably
  - "for an extended period"
  - "at least through mid-2013"
  - "for a considerable time after the economic recovery strengthens"
  - until unemployment falls to 6.5% as long as medium-term inflation stays under 2.5%

Since 2007, Central Banking Now Includes …

- Being the lender of last resort – in a new way
- A large balance sheet, many excess reserves, and IOR
- Monetary policy at the zero bound
- Buying more than just Treasuries
- Strong forward guidance

Since 2007, Central Banking Now Includes …

- Much of this is uncharted territory for any central bank, and it will take several years to identify the full effects.
- Despite new policy, the Fed remains committed to its same monetary policy objectives.

And Now, Tapering …

December 18, 2013 FOMC meeting:

"…In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions, the Committee decided to modestly reduce the pace of its asset purchases. Beginning in January, the Committee will add to its holdings of agency mortgage-backed securities at a pace of $35 billion per month rather than $40 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $40 billion per month rather than $45 billion per month…."

The Bottom Line

- The regional structure of the Federal Reserve System was born out of compromise in 1913 and is still critical to our primary functions.
- The independence of monetary policy—and monetary policymakers—is critical to the ability of policy-makers to control inflation and to think about the long-term well-being of the U.S. economy.
- In recent years, the Fed has engaged some unconventional monetary policy tools that have caused great debate among policymakers and among the broader public.

The views expressed here are those of the speaker, and do not necessarily represent those of the Federal Reserve Bank of Richmond or the Federal Reserve System.

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