The Federal Reserve (1913)

• Original Roles
  -- Provider of Discount Window --
  "Lender of Last Resort"
  -- Regulate Member Banks
    (e.g. Reserve Ratios)
• Manages Monetary Policy
Structure of the Federal Reserve
Board of Governors (BOG)

- 7 members
- appointed by the President, with the consent of the Senate
- serve 14 year, non-renewable terms
- sets policy instruments other than open market operations
- decides what banks can do
• Important Chairs of the BOG (Federal Reserve)

• Paul Volcker -- 1979-87
• Alan Greenspan -- 1987-2006
• Ben Bernanke – 2006-
The Federal Open Market Committee (FOMC)

- 12 voting members -- 7 Board of Governors + 5 District Bank Presidents (19 members)
- meet 8 times per year (or more)
- design monetary policy, by specifying Federal Funds rate target (since 1988)
Federal Reserve District Banks

• each bank exists within 12 districts within the US
• holds deposits of Federal Government
• collects economic data and does economic research
• issues and discards currency
• performs check clearing services
District Banks -- Administer Monetary Policy

- conduct Discount Loans with banks within district
- enforce reserve requirements for banks within district
- hold reserves of banks within district
- New York bank most important, open market operations done there
Federal Reserve Branch Banks and Member Banks

• **Branch (District) Banks** -- serve as decentralized regulators, primarily for larger Fed districts in geographic size

• **Private Banks** -- membership distinction trivialized by DIDMCA
How Independent is The Federal Reserve?

• Structure implies considerable independence.

• Federal Reserve is financially independent of the Federal Government’s budget.
• Federal Reserve is still subject to Congressional legislation.
  -- House Concurrent Resolution 133 -- Fed must announce its policy objectives for money growth.
  -- Humphrey-Hawkins Bill -- Fed must testify to Congress how its objectives are consistent with the President.
• The President and the Federal Reserve
  -- President appoints members of the BOG
  -- BOG typically serve less than 14 year terms
  -- part of the legislative process, can introduce legislation
• Federal Reserve has **vigorous** lobby in Congress.
  -- banks: stability of banking system
  -- financial markets: low inflation, stability
  -- international presence
Explaining Federal Reserve Behavior

• **Theory of Bureaucratic Behavior** -- The objective of a bureaucracy is to maximize its own welfare.

• Applied to the Federal Reserve -- The Fed seeks to maximize its power and autonomy.
Evidence: The Fed and The Theory of Bureaucratic Behavior

• Fed avoids conflict with Congress.
• Fed does not admit policy mistakes (e.g. “Base Drift)
• Fed supports legislation that increases its authority (DIDMCA, FDICIA)
• Fed has not seen any of its powers removed.
Should the Federal Reserve Remain Independent?
Arguments to Remove Independence

• Current Federal Reserve is not democratic, not accountable.
• Fed has made policy mistakes.
• Potential for uncoordinated fiscal and monetary policies
• Example -- expansionary fiscal policy with contractionary monetary policy ⇒ Interest rates↑
Arguments to Maintain Independence

- If part of the Federal Government, the Federal Reserve could be used to purchase all of the Federal deficit and debt ("monetizing the debt), highly inflationary.
- Federal Reserve is more knowledgeable and focused on the economy than Congress.
The Biggest Argument For Continued Independence

• Current Federal Reserve can make the tough policy decisions.

• The track record of the US Federal Reserve
Ben Bernanke at the Federal Reserve: What Can We Expect?

Henning Bohn
Professor of Economics
UC Santa Barbara
Ben Bernanke at the Federal Reserve
What Can we expect?

1. Who is Ben Bernanke?
   *Personality matters. Fed Policy is run by committee.*

2. Bernanke’s approach to monetary policy.
   - Foundations: New Keynesian macro theory.
   - His signature proposal: Inflation targeting.
   - His views on asset prices, world savings, a/o key issues.

3. Challenges: Dealing with the Unexpected.
   - Setting Interest Rates - the Fed Funds target.
   - The Slowdown in Real Estate: How will the Fed respond?
   - Potential problems: The Dollar. Bank lending.
Who is Ben Bernanke?
A personal perspective.
Ben Bernanke’s Monetary Policy

• How will he run the Federal Reserve?
  Easy to answer: Read his writings!
  – On New Keynesian macroeconomic theory.
  – On inflation targeting.
  – On many other issues - usually find a publication.

• Do the academic writings matter?
  – Yes, for credibility. And in New Keynesian theory
    Credibility is crucial.
Perspectives on Monetary Policy (1):

New Keynesian Macro Theory

1. Inflation is economically harmful.
   - *Fed’s top priority: keep inflation low and stable.*

2. Money affects real output and employment.
   - There is a short run trade-off between stable employment and stable prices; a.k.a. the “Phillips curve”.
   - *Fed must be sensitive to business cycles.*

3. Households/firms respond to expected inflation.
   - If low inflation is expected, the Fed can more easily respond to cycles & keep interest rates more stable.
   - *Fed must maintain credibility (that inflation will stay low).*
Perspectives on Monetary Policy (2):

**Inflation Targeting**

- Bernanke’s proposal on how the Fed *should* operate.
  - Detailed in a Princeton Univ. book:
    "*Inflation Targeting: Lessons from the International Experience.*"
  - Message: A specific target helps stabilize inflation at low “cost”.
- Will the Fed adopt an official inflation target?
  - All Fed governors have an informal target. Growing support.
    Newest Fed Gov. Mishkin is a coauthor of *Inflation Targeting*.
- What exactly is the target? Several measures of inflation:
  - **CPI** (consumer price index) or **PCE** (personal consumption expend. deflator)?
  - **Headline** (all items) or **Core** (excluding food & energy)?
  - Answer: Core PCE. Ben’s comfort zone: 1-2% growth.
Recent Inflation Data

Core CPI: +2.6% (Dec.06). Up 0.1%.
Core PCE: +2.2% (Dec.06). Constant.
Key Non-monetary Issues

Clues how Bernanke would respond to economic problems

• Asset prices:
  – Ignore bubbles and crashes, but do respond to the effects on inflation and employment.
  – Recognize the Fed’s crisis-management responsibility.

• The U.S. current account deficit:
  – Driven primarily by a “glut” of world savings.

• Fiscal policy:
  – Preference for the Fed to stay silent.
What Could Go Wrong?

- The real challenge: Dealing with the Unexpected!
  *How would the Bernanke Fed respond?*

- The “Slowdown” in Real Estate
  - No direct response [unless it triggers a banking crisis or mass unemployment]
  - Problem: Core-PCE includes rental cost! Rising > 3%.

- **Potential for bank lending problems** [if beyond sub-prime]
  - Recognize the ‘Credit Channel’ - respond to employment effects.
  - Worst case: Fed *will* serve as ‘Lender of Last Resort.’

- **Potential for a U.S. dollar/current account crisis**
  - Benign view of imbalances - inclined to let the markets work.
  - Key Issues: Rising import prices vs. employment effects.
Conclude: What Can We Expect?

5.25% Fed Funds rate target - “Paused, with Upward Bias”

Federal Reserve Projections
(Percentage changes - 4th quarter to 4th quarter.)

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<thead>
<tr>
<th>Key Data</th>
<th>Actual 2006</th>
<th>Expect 2007</th>
<th>Expect 2008</th>
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<tr>
<td>Inflation Core PCE</td>
<td>2.3</td>
<td>2.0-2.25</td>
<td>1.75-2.0</td>
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<td>Real GDP</td>
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<td>2.5-3.0</td>
<td>2.75-3.0</td>
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<td>Unempl. Rate</td>
<td>4.5</td>
<td>4.5-4.75</td>
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