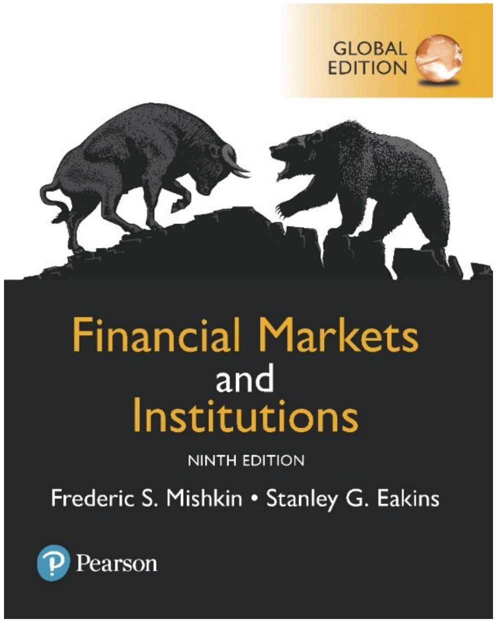
AcF 304 Financial Markets

Topic 4 - Central Banks & Conduct of Monetary Policy

Part 1 – Central Bank Structure & Goals

Financial Markets and Institutions



Central Banking and the Conduct of Monetary Policy

Topic 4 - Part 1 Chapter 9 - **Central Banks**

On this topic the core text book goes into detail into areas that we are not focusing on e.g., Bank of Canada, Bank of Japan, People's Bank of China, and deep detail of ECB monetary decision making.

Be guided by the lecture slides on Part 1 of this week's topic. Core text book is supplementary reading only.

Part 1 Preview (1 of 3)

- Among the most important players in financial markets throughout the world are central banks, the government authorities in charge of monetary policy.

- Central banks’ actions affect interest rates, the amount of credit, and the money supply, all of which have direct impacts not only on financial markets but also on aggregate output and inflation

Part 1 Preview (2 of 3)

- To understand the role that central banks play in financial markets and the overall economy, we need to understand important issues about the central banks:
  - How do central banks work?
  - Who controls the central banks?
  - What determines the actions of the central banks?
  - What motivates the behaviour of the central banks?
  - Who holds the reins of power in the central banks?

Part 1 Preview (3 of 3)

- In this topic we look at the institutional structure of major central banks and focus specifically on the US Federal Reserve, the European Central Bank

  - Origins of the Central Bank System
  - Variations in the Functions and Structures of Central Banks
  - Structure of Central Banks of Larger Economies
  - Central Bank and Independence and the trend toward greater independence

***Note: Core Text Book FM & I Chapter 9 Bank of Japan, Bank of Canada, Bank of England, Bank of China is non-assessed material*.**

Origins of the Central Bank (1 of 2)

- The Sveriges Riksbank* or the Bank of Sweden, was established in 1668, with its main function being lending money to the government of Sweden.
- Rising global trade increased the volume of international payments in the seventeenth century, hence the need to create more central banks throughout Europe.
- The founding of the Bank of England (BoE) in 1694 marks the de facto origin of central banking.
- Gradually, the central banking functions evolved in order to safeguard monetary stability, which required central banks to answer to their parliaments.
- *Sveriges Riksbank - Oldest central bank in the world
- Oldest bank in the world - Banca Monte dei Paschi di Siena (founded in its present form in 1624, but traces its history to 1472)

Origins of the Central Bank (2 of 2)

- To avoid the risk of power concentration, the structure of the US Federal Reserve bank, which was established in 1913, was designed to distribute power over 12 regional **Federal Reserve banks** and remained privately owned by its member banks.
- Most emerging market economies established their central banks after WWII. The structure of these banks became very similar to those of European central banks.
- Over the last two centuries, the functions of central banks throughout the world expanded to regulating the value of the national currency, financing the government, and acting as a ‘lender of last resort’ to banks suffering from liquidity and/or credit crises.

Who Should Own Central Banks

- The arguments for public ownership are:
  - Central banks act in the ultimate public interest.
  - Private ownership bias central banks toward self-serving profit-making interests, hence increasing risk-taking and balance sheet troubles.
  - The global financial crisis highlighted concerns that the profit-making target of private shareholders could hamper them from saving the financial sector during financial crises.

- Advocates of private ownership argue that it:
  - guarantees central bank independence.
  - private owners would be required to recapitalise the central bank in the case of losses which lifts this burden off the fiscal budget.

Who Should Own Central Banks

Can Donald Trump force the Federal Reserve to cut rates?

The central bank has been the target of extraordinary tweets threatening its independence

The Fed's recent dovish turn has made it easier for Donald Trump to push for interventions

Variations in the Functions and Structures of Central Banks

- The roles of central banks have grown in importance as their activities evolve over time.
- There are differences in the structure and policy tools that each central bank adopts depending on the level of sophistication of the banking and financial sectors.
- Central banks have taken on increasing responsibilities which required more independence from fiscal authorities and political institutions.

The European Central Bank, the Euro System, and the European System of Central Banks (1 of 4)

- The **European Central Bank (ECB)** came into existence on June 1, 1998, to handle the transitional issues of the nations that comprise the Eurozone.
- The Eurozone is an economic and monetary union consisting of the member states of the European Union (EU) that have adopted the euro as their currency.
- The creation of the Eurozone and of the new supranational institution, the ECB, was a milestone of European integration.
- All of the member states of the European Union have to comply with a set of economic and legal conditions.

The European Central Bank, the Euro System, and the European System of Central Banks (2 of 4)

- In January 1, 1999, only 11 EU member states had adopted the euro. All of the **Eurozone** or euro area countries - i.e., the EU countries that have adopted the euro - retain their own National Central Banks (NCBs) and their own banking systems.
- Currently, the euro (€) is the official currency of **19** out of 27 EU member countries which together constitute the Eurozone

Decision-Making Bodies of the ECB (3 of 6)

Governing Council monetary policy fortnightly decision meeting

After meeting ECB holds a press conference to explain monetary policy decisions and rationale.

- So European Bond markets will be quiet in anticipation of the monetary policy announcement.
- Will they raise/lower/keep unchanged short-term interest rates?
- If interest rates go up, bond yields will rise in sychronisation and bond prices will fall.
- It is equally important for bond markets what the ECB **'says'** at the press conference as much as what they **'do'**. *Is it Hawkish or Dovish?*

How Monetary Policy is Conducted within the ECB

- The main objectives of the ECB is :
  - maintain price stability in the economies of the EU
- As price stability is important for attaining economic growth and job creation, the ECB endeavors to maintain its independence from governments.
- German Bundesbank is a powerful voice within the ECB and is perhaps still haunted by the days of the Weimar Republic esp 1923
- Prices ran out of control, for example a loaf of bread, which cost 250 marks in January 1923, had risen to 200,000 million marks in November 1923

How Monetary Policy is Conducted within the ECB

- To achieve its primary objective of price stability, the ECB aims to maintain a medium-term inflation rate closely below 2%.*
- It uses conventional and unconventional monetary tools to attempt to achieve this.

***Euro area annual inflation was at 8.5% (February 1st 2023) !!!**

How Monetary Policy is Conducted within the ECB

- The ECB’s operational framework consists of the following set of conventional monetary policy instruments:
  - **open market operations**
  - standing facilities to provide and absorb overnight liquidity
  - minimum or required reserve requirements for credit institutions.

How Monetary Policy is Conducted within the ECB

- The unconventional monetary policy measures include:

  - emergency liquidity assistance (ELA) - that provides liquidity and loans exceptionally to solvent banking and financial institutions that are facing temporary liquidity problems.

  - **quantitative easing**, where central banks buy sovereign bonds and/or other financial assets from commercial banks and financial institutions to increase money supply and stimulate the economy.

The Federal Reserve System

- The **Federal Reserve System**, also known as the Federal Reserve bank or the ‘Fed’ for short, is one of the largest and most influential central banks in the world.
- The Fed is an independent entity that is privately owned by its member banks.
- The Fed is subject to oversight from Congress that periodically reviews its activities.
- The Fed supervises and regulates the nation’s financial institutions and simultaneously serves as their banker.

The Federal Reserve System

- There are 12 regional Federal Reserve banks that are located in major U.S. cities.
- These regional Federal Reserve banks act as the operating arm of the Fed that carry out most of its activities and implement the Fed's **dual mandate** of long-term price stability and macroeconomic stability through creating jobs.

The Federal Reserve Meeting

- The Federal Open Markets Committee holds eight meetings a year
- It executes monetary policy for the Federal Reserve System
- It reviews economic conditions each time it meets
- It will then decide whether to use expansionary or contractionary monetary policy
- FOMC changes the Fed Funds Rate
- Even if the FOMC holds rates steady, the meeting minutes give you a high-level analysis of the US economy

The Federal Reserve Meeting

- As a result, the stock market reacts immediately to the FOMC meetings, announcements, and minutes
- The minutes are released a few weeks after the meeting but the Fed now holds a press conference immediately after its meeting with every word immediately analysed by the press/markets.

FOMC Press Release

- The US Federal Reserve Website: https://www.federalreserve.gov/newsevents/pressreleases/monetary20240131c.htm

Difference between the ECB and the Fed

- Both the ECB and the Fed are entities that bind a number of regional central banks together, 19 National Central Banks for the ECB and 12 regional Federal Reserve banks for the Fed.
- Both are independent institutions with a decentralized structure
- The ECB supports political independence and makes monetary policy decisions independent of political authorities.
- The Fed is highly independent of the government and reports to Congress.

Difference between the ECB and the Fed

- However, there are some important differences between the structure of the Euro system and that of the Federal Reserve System:
    I. The primary objective of the ECB is to achieve price stability. On the other hand, the Fed's dual mandate and monetary policy objective is to deliver price stability and support economic growth.
    II. The monetary operations of the Euro system are not centralized but conducted by the National Central Banks while monetary operations are centralized in the Federal Reserve System.
    III. The ECB is not involved in supervision and regulation of financial institutions as these tasks are left to the individual countries in the European Monetary Union, while the Federal Reserve is involved in these areas.

Central Banks and Independence

The Case for Independence

There are 3 arguments for central bank independence:

1. Focus on potential inflationary biases that are likely to exert themselves as a result of political pressure to boost output in the short run i.e. before an election and reversed after an election leading to ‘boom’ & ‘bust’.
2. Public generally distrusts politicians in regard to making politically motivated decision and their lack of expertise in conducting monetary policy.
3. Politicians often opt for more central bank independence when there is disagreement between policymakers regarding unpopular macroeconomic decisions (to avoid criticism)

The Case Against Independence

- The main argument against central bank independence is that macroeconomic stability can be best achieved if monetary policy is properly coordinated with fiscal policy. As the government is responsible for the country's macroeconomic performance, it must have some control over monetary policy.

Central Banks and Independence

The Trend Toward Greater Independence

- While the Federal Reserve has historically been more independent than most other central banks, the structure and the level of political independence of the European Central Bank make it even more independent.

The Federal Reserve and Independence

The Trend Toward Greater Independence

Senators warn Trump against more attacks on Fed

Flake and Coons say legislation may be needed to preserve central bank's independence

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Part 2 – US Federal Reserve & Conventional Monetary Tools