Structure of Central Banks

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Agenda

- We are now going to study all aspects of the conduct of monetary policy

- First, we look at the structure of the Bank of Canada and some other central banks

- Then we will look at policy tools, the process of money creation, transmission of policy to the economy
Bank of Canada: Origins

- Depth of the Great Depression was blamed on the operation of the monetary system – in Canada at the time, just a system of private banks

- In response, in 1934, Bank of Canada was established (began operation in 1935)

- Initially a private institution, nationalized in 1938.

Bank of Canada: Structure

- Board of Directors, 15 members – governor, senior deputy governor, deputy minister of finance, and 12 outside directors
  - Governor and senior deputy appointed by the Board, terms of 7 years
  - Minister of finance appoints outside directors, terms of 3 years – cannot be bankers
  - Responsible for overall operations of the Bank

- Governing Council (established 1994) – governor, senior deputy governor and 4 deputy governors.
  - Collective responsibility for conduct of monetary policy
Bank of Canada: Functions

“...to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada”
Bank Note Issue

- Before Bank of Canada: federal government and banks issued currency
- The Bank replaced outstanding issue of federal government notes and gradually removed bank-issued notes
- 1945 – monopoly over note issue
- Original provision – a gold standard
- Phased out in 1967 – thereby granting the Bank unlimited authority to issue currency
- Ongoing research to make money issue more cost-effective, more durable, more counterfeit-proof
Fiscal Agent of Government

- Debt management services for government –
  advising on borrowing, managing new debt issue,
  servicing outstanding debt
  - Administering bondholder accounts
  - Making payments on behalf of government for interest and
    debt redemption

- Manages foreign exchange reserves held by Department of Finance
  - Assists in investing foreign reserves and borrowing when
    necessary to maintain adequate level of reserves
  - Engages in international financial transactions in order to
    influence the exchange rates
Central Banking Services

- Lender of last resort to deposit-taking institutions in liquidity crisis
  - Extends advances to banks
  - Can create base money to do so
  - Closely coordinated with federal regulatory agencies
  - Considers effects on other financial institutions, money supply and policy

- Oversees the central clearing and settlement system for payments made between banks
  - Main concern: network effects, where problems of one participant may spread to others

- Holds deposit accounts of federal government, banks, IMF and other central banks
Monetary Policy

- Monetary policy tools:
  - Open market operations – purchase and sale of government securities that affect both the interest rate and the supply of reserves in the banking system
  - Shifting of government balances between itself and banks to implement changes in money supply

- Main policy goal: to keep inflation low
  - And thus to maintain stability of economic growth

- Joint responsibility: Bank of Canada determines policy, but ultimate responsibility rests with the government which answers to the Parliament
Independence of the Bank of Canada

- *Instrument independence* – ability to choose monetary policy instruments
- *Goal independence* – ability to set the goals of monetary policy/actions

Bank of Canada has the first but not the second

Initially: privately owned, so largely independent from public influence, and from private influence by regulation.

Later nationalized – to further isolate from influence of the private system. Government at the time believed that Bank’s actions should be in accord with government views.

Ultimately, system of joint responsibility was adopted in 1967 – bank has considerable autonomy in setting the course of policy, but federal government must take full responsibility for it.
The charter of the Bank may be viewed as opaque and not always internally consistent. Since the early 1990’s, the Bank has established as it’s number-one goal the maintenance of the price level. Has announced an explicit inflation target (1-3%). Has increased its transparency by issuing policy reports, governor’s appearances in front of the Parliament, etc. Idea: to avoid surprising markets.
Foreign Central Banks

Most other central banks in developing countries have a more decentralized structure than the Bank of Canada, and have more independence than the Bank

- Federal Reserve System (1913)
- ECB (1999)
- Bank of England (1694)
- Bank of Japan (1882)
Federal Reserve System

Board of Governors of the Federal Reserve (Washington, DC) – main location of the Fed, a policy branch

- 7 governors, including chairman. Often governors are heads of regional Feds.
- All seven are appointed by the President and confirmed by Senate for non-renewable term of 14 years.
- Rick Mishkin was one of the governors
- 12 regional Federal Reserve Banks
- Federal Open Markets Committee (FOMC) – 7 governors + NY Fed president + 4 other Fed presidents (rotating)
  - Conducts monetary policy. Meets 8 times a year.
- Federal Advisory Council – twelve bankers, one from each Fed region
- 2800 member commercial banks
European Central Bank

- Established in 1999 with the start of the European Monetary Union (EMU) – agreed on in Maastricht Treaty, 1991
- Pattern – that of the Federal Reserve System, with national central banks serving like the regional Feds
- Executive Board – president, vice-president, + 4 other members
- Governing Council – the Board + national central bank presidents. Operates by consensus rather than by vote.
- Members appointed by a committee consisting of head of states of the EMU
- Budget of the ECB is controlled by the national central banks
- Monetary operations are conducted by all national central banks – less centralized than in the U.S.
- ECB is not involved in bank supervision and regulation
Bank of England

- Least independent

- Since 1946, government has statutory authority over Bank of England – decision to raise or lower interest rates lay with the minister of finance (Chancellor of the Exchequer)

- 1997: Gordon Brown announced that Bank of England will set interest rates (Monetary Policy Committee)

- Government still has authority to override Bank’s decisions and set rates in extreme conditions – likely to use such power sparingly

- Inflation target set by the chancellor of the exchequer
Bank of Japan

- Monetary policy determined by the Policy Board – similar to FOMC, Bank of England’s committee, etc.
- Not formally independent of the government until 1998
- Now the Board has all the power – government officials can attend policy meetings, but have no voting rights
Central Bank Independence: Good or Bad?

Good:
- Politicians may pursue short-term goals to get re-elected that may be inconsistent with long-term policy goals. Central bank, if removed from the political process, can pursue the long-term goals more consistently.
- Sever the link between government debt and its financing: if Central Bank is controlled by government, it is easier to get the bank to buy government bonds, leading to increased money supply and possibly inflation.
- Politicians don’t know economics?

Bad:
- Lack of accountability of the central bank (no provisions in law for “punishment” for bad policy.)