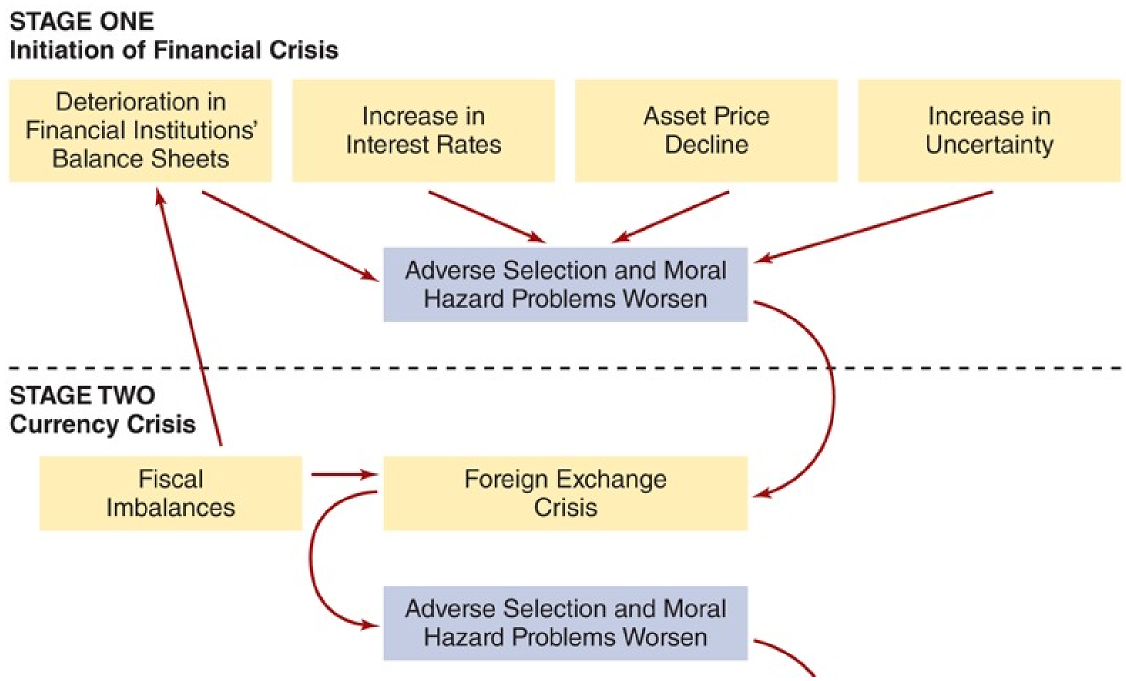
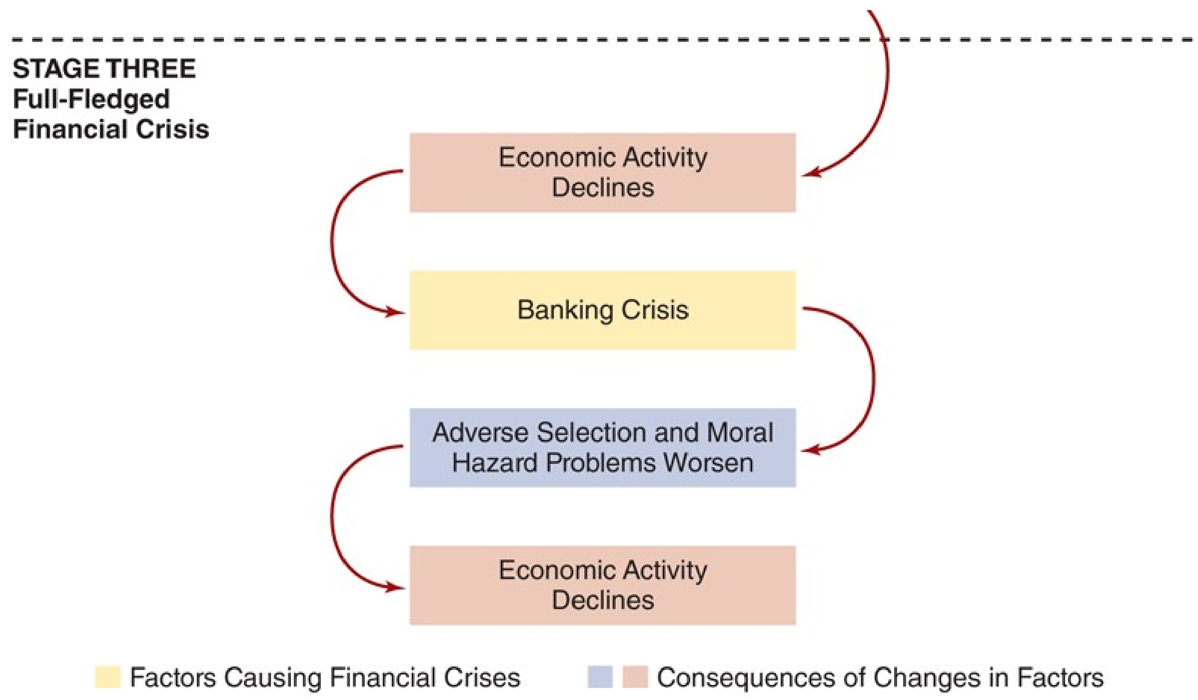
CONTINUE FROM PREVIOUS LECTURE

EMERGING MARKET FINANCIAL CRISIS: SEQUENCE OF EVENTS (A)



EMERGING MARKET FINANCIAL CRISIS: SEQUENCE OF EVENTS (B)



STAGE ONE: INITIATION

Financial crises in emerging market countries develop along two basic paths:

- **Credit Boom and Bust:**

Liberalization/Innovation → weak credit culture and capital inflows → credit boom → risky lending → high loan losses → bank balance sheets deteriorate → lending cut (more severe here since the rest of the economy is not as developed) → economy contracts

- **Severe Fiscal Imbalances:**

Large fiscal deficit → banks forced to buy gov't bonds → confidence falls → gov't bonds price decline → bank balance sheets deteriorate → lending cut → economy contracts

- **Other factors:** Asset price decline, a rise in uncertainty, a rise in external interest rates

STAGE TWO: CURRENCY CRISIS

A speculative attack in the FX markets

- Bets on the depreciation of the currency of the emerging market
- Oversupply of local currency (Mass sell-offs of currency) → value of the currency falls → rundown of int' reserves → currency crisis

Large fiscal imbalance

- Investors suspect inability to repay the loans
- Mass sell-offs of debt → Mass sell-offs of currency → A speculative attack on the currency

STAGE THREE:
FULL FINANCIAL CRISIS

Currency crisis → currency devaluation

Devaluation → foreign-currency denominated debt burdens increase → HH/Firms' balance sheets deteriorate → Banks' balance sheets deteriorate

→Banking Crisis

→Economy contracts further

CH 9
CENTRAL BANKS

FINANCIAL MARKETS & INSTITUTIONS
MISHKIN AND EAKINS

KRIST DACHARUX
17 NOV 2018
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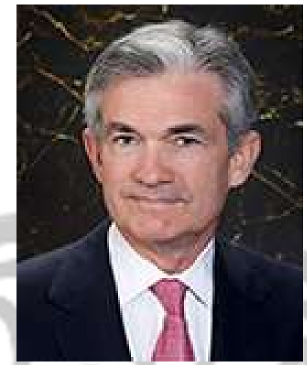
THE FEDERAL RESERVE SYSTEM



Current Chairman:
Jerome Powell
2018-2022

Source: Federal Reserve

12 FEDERAL RESERVE BANKS

Source: Federal Reserve *Bulletin.*

STRUCTURE OF THE FEDERAL RESERVE SYSTEM

Designed to diffuse power along the following dimensions:

- Regions of the U.S.
- Government and private sector interests
- Needs of bankers, businesses, and the public

The system includes:

- Twelve Federal Reserve Banks
- Board of Governors (BOG) of the Federal Reserve System
- Federal Open Market Committee (FOMC)
- Federal Advisory Council
- Member Banks (around 2,000)

BOARD OF GOVERNORS

7 governors appointed by the President, and confirmed by the Senate

14-year term

All Board members are members of the FOMC

Sets reserve requirements and effectively set the discount rate.

FEDERAL RESERVE BANK FUNCTIONS: GENERAL

Clear checks

Issue new currency and remove damaged currency

Administer and make discount loans to banks in their districts

Evaluate bank mergers and expansions

Liaison between local community and the Federal Reserve System

Perform bank examinations

Collect and examine data on local business conditions

Conduct research related to monetary policy

THE FED

Dual Mandates:

1. **Maximum Employment (Unemployment rate)**
2. **Stable Prices (Inflation)**

Three policy tools:

1. **Open market operations (Fed Fund Rate: FFR)**
2. **Discount rate**
3. **Reserve requirements**

FEDERAL RESERVE BANK FUNCTIONS: MONETARY POLICY

"Establish" the discount rate at which member banks may borrow from the Federal Reserve Bank (subject to BOG review)

Determine which bank receive loans

Elect one member to the Federal Advisory Council

Five of the 12 bank presidents vote in the Federal Open Market Committee

THE FRBNY

Oversees some of the largest financial institutions headquartered in Manhattan and the surrounding area

Houses all open market operations

New York Fed chairman as the only permanent member of the FOMC

New York Fed the only member of the Bank for International Settlements (BIS), providing close contact with other foreign central bankers

FEDERAL OPEN MARKET COMMITTEE (FOMC)

Make decisions regarding open market operations, to influence the monetary base.

Open market operations are the most important tool that the Fed has for controlling the money supply (along with reserve requirements and the discount rate)

All actions are directed the Federal Reserve Bank of New York, where securities are bough / sold as required.

INSIDE THE FED: FOMC MEETING

Meet eight times each year (about every 6 weeks)

Important agenda items include

- Reports on open market operations (foreign and domestic)
- National economic forecasts are presented
- Discussion of monetary policy and directives, including views of each member
- Formal policy directive made
- Post-meeting announcements, as needed

STRUCTURE AND INDEPENDENCE OF THE EUROPEAN CENTRAL BANK

Founded in 1999 by a treaty between the European Central Bank (ECB) and the European System of Central Banks (ESCB).

Housed in Frankfurt, Germany.

Executive board consists of the president, vice president, and four members, all serving eight-year terms.

The policy group consists of the executive board and governors from the 17 member countries central banks.

THE EUROPEAN CENTRAL BANK

Difference between the Fed and the ECB:

Only the 17 members attend the monthly meetings of the ECB, with no staff.

No voting! All decisions are made by consensus.

The ECB holds a press conference following the monthly meeting, while the Fed typically doesn't.

Monetary operations are conducted at the national level, not directly by the ECB.

The ECB is not involved in bank regulation or supervision.

BANK OF JAPAN

Founded in 1882

The Policy Board sets monetary policy, and consists of the governor, two vice governors, and six outside members. All serve five-year terms.

The Bank of Japan Law (1998) gave the Bank considerable instrument and goal independence.

Japan's Ministry of Japan can exert authority through its budgetary approval of the Bank's non-monetary spending.

BANK OF JAPAN

Recently, Ministry of Finance lost its authority to oversee many operations of the Bank of Japan.

In a recent episode, the new Abe government put pressure on the Bank of Japan to adopt a 2% inflation target against the wishes of its current Governor.

Governor resigned! May suggest that the Bank of Japan's independence is limited.

TREND TOWARD INDEPENDENCE

In recent years, we have seen a remarkable trend toward increasing independence. The Fed used to be substantially more independent than other central banks, but this has changed with the formation of the ECB and changes at other central banks. This trend should continue.

CENTRAL BANK INDEPENDENCE

Instrument Independence: **the ability of the central bank to set monetary policy instruments.**

Goal Independence: **the ability of the central bank to set the goals of monetary policy.**

Independence comes with accountability

CASE FOR INDEPENDENCE

Political pressure usually add an inflationary bias to monetary policy.

Political business cycle: Expansionary monetary policy leads to lower unemployment and lower interest rates—a good idea just before elections. Deal with consequences later. (higher inflation and higher interest rates)

Risk of monetization: Government trying to finance its deficits through bonds purchased by central bank, leading to inflationary pressure

Unpopular choice in the best interest of the public: hard choices must be made for the good of the economy

CASE AGAINST INDEPENDENCE

Undemocratic: an elite group controlling an important aspect of the economy, one of the most important tools to direct the economy

Not always successful/correct

COMMUNICATION STRATEGY

In the past, very discrete.

The Fed generally likes to keep its actions hidden—not transparent—to avoid conflicts with Congress and other politicians.

Now, toward more transparency

1994 - reveal the FOMC directives immediately after each FOMC meeting

1999 - announce the “bias” toward which direction monetary policy was likely to go

2002 - report the FOMC meeting votes

2004 – moved up the release date of the minutes of FOMC meetings

2007 - FOMC publishes economic projection quarterly (previously twice a year).

STRUCTURE OF THE FEDERAL RESERVE SYSTEM

Figure 9.1 Structure and Responsibility for Policy Tools in the Federal Reserve System