Central Banking History

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Commercial Banks

- Standard banks as we know – Accepts deposits, offers checking account services, offers loans etc.
- Primary Functions are:
    - Safe and secure place to store wealth
    - Provide credit and debit cards, loans, check-writing privileges
    - Act as an intermediary between savers and borrowers
    - Operates to make money – earns interest from loans
    - Money Multiplier effect – create credit that did not previously exist when they make loans

Central Banks

- Manages a country’s currency, money supply, and interest rates
- Oversee the commercial banking system
- Possesses a monopoly on increasing the monetary base – prints national currency
- During times of financial crisis becomes a “lender of last resort” to the banking sector
- Most have supervisory and regulatory powers to ensure solvency, prevent bank runs, and prevent reckless or fraudulent behavior

Early Central Banks

- Bank of Amsterdam – forerunner to modern central banks – influenced state banks throughout Europe
- Sveriges Riksbank – Swedish Central Bank – considered world's oldest central bank but lacked monopoly over issuing bank notes until 1904
- Bank of England – model on which most central banks are built
  - Originated in 1694 as a private bank acting as a banker to the gov.
  - Primarily founded to fund war effort against France – Public funds were in short supply and Gov. had such bad credit they couldn't borrow money to finance the war
  - Also acted as public commercial bank – accepted deposits

Bank of North America

- Chartered in 1781 – Based on Hamilton's ideas but legislative proposal drafted by Robert Morris (US Superintendent of Finance)
- Bank became the country's first IPO – Have start-up capital of $10 Million with $2 million owned by Gov.
- Conceived to deal with war debt and help government financials – issue currency notes – modeled after Bank of England
- In addition to facilitating government finances would also operate as a commercial bank – lend to new businesses and develop economy
- Opposed by Thomas Jefferson as unconstitutional and by agrarians

End of First Bank

- Arguments that bank was unconstitutional and supported interests of merchants and industrialists over farmers
- Bank had taken care of most of war debt – many no longer saw a need for bank
- 1811 Congress refused to renew the Bank’s charters
- Overall bank had been successful in war debts and commercial operations

War of 1812

- Federal debt begins to mount due to war
- State-chartered banks (issue own currency) suspended specie payments
- Second Bank of the US – held large quantities of other banks' notes in reserve, and acted as early bank regulator
  - Had capital of $35 million, gov. held $5 million
  - Nicholas Biddle Vs. President Andrew Jackson
  - Jackson won presidency and withdrew federal funds from bank – crippled and charter expired in 1836

First and Second Central Banks

- Both were not central banks in the modern sense
  - Did not conduct monetary policy and did not supervise/regulate other banks
  - Acted as Federal Government’s fiscal agent – receiving revenues, holding deposits and making payments
  - Acted as a commercial bank –
    - Made business loans
    - Accepted Deposits
    - Issued bank notes

Free Banking Era

- 1837-1863 – A mess of state-chartered banks not subject to federal regulations
- By 1860 = 8,000 banks operated, each issued their own currency
  - Wildcat banks
- Financing of the civil war led to the National Banking Act of 1863 which
  - Created a uniform national currency
  - Only national Chartered banks could issue bank notes

Financial Panics and Runs

- Industrial economy expands – the weakness of decentralized banking system becomes apparent
- Bank panics and runs occurred frequently as most banks did not keep enough cash in reserves
  - Panics often occurred when customers lost confidence in their bank after hearing news of failures of other bans
  - Created contagion that triggered a succession of bank failures
  - 1907 – J.P. Morgan personally stopped a severe panic

The Third Central Bank

- Initially operated as a system of reserve banks with decentralized decision making
  - Some Reserve banks sold treasury securities at the same time others bought treasury securities
- 1920s – Reserve banks form Open Market Committee – predecessor to FOMC established in 1933
  - All 7 board members on FOMC and rotates reserve banks – limited to only 5 at a time
  - 12 reserve banks placed in most populous areas serving a specific region

The Federal Reserve

- Not designed to service the public – Acted as the Bankers' Bank
  - Made loans and deposits to financial institutions
  - Issued notes that circulated as currency
  - Acted as Gov's fiscal agent
- McFadden Act of 1927 = permanent
- Issues currency and provides banking and securities services to US treasury

Functions

- Conducts monetary policy to establish max employment, stable prices, and moderate long-term interest rates
- Examines and regulates financial institutions
- Keeps cash reserves and processes payments for depository institutions
- Issues currency and coin and banking and securities to US Treasury
- Creates and enforces regulations

Monetary Policy

- Aimed at maximum sustainable output and employment and stable prices (low, stable inflation)
  - Both goals imply moderate long-term interest rates
- Fulfills dual mandate through the Federal Funds Rate
  - Rate at which financial institutions charge each other for loans in overnight borrowing market
  - Serves as benchmark for many other short-term interest rates

Monetary Policy Cont.

- Does not directly control inflation, output, employment nor can it set long-term interest rates
- All banks hold minimum reserve balances in accounts at the Fed
  - The Federal Funds Rate is interest charged for overnight loans of reserves
- Fed monetary policy alter the supply of the reserves in the banking system
  - More reserves = lower Federal Funds Rate – excess of supply over demand
- Indirectly the Federal Funds Rate affects long-term interest rates, total amount of money and credit, and employment, output, and inflation

Example

- 2007-2008 Financial Crisis
  - Fed Cuts Interest Rates
  - Targeted Assistance to ailing financial institutions
  - Quantitative Easing
  - Forward Guidance regarding interest rates
- Slowly Raising Interest Rates as labor market strengthens
- Believe inflation will stabilize around 2%
- Current Fed Funds Rate = 2.25% unchanged from a month ago – steadily rose post Crisis as economy strengthened

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