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United States House of Representatives
Committee on Financial Services
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M E M O R A N D U M

To: Members of the Committee on Financial Services

From: FSC Majority Staff

Date: November 8, 2013

Subject: November 13, 2013, Monetary Policy and Trade Subcommittee Hearing Entitled "What Is Central to Central Banking?: A Study of International Models"

The Subcommittee on Monetary Policy and Trade will hold a hearing titled "What Is Central to Central Banking?: A Study of International Models" at 2:00 p.m Wednesday, November 13, 2013, in Room 2128 of the Rayburn House Office Building. This hearing will examine the central banks of other advanced economies, focusing on their governance, policy tools, and their successes and failures in implementing monetary policy. This will be a one-panel hearing with the following witnesses:

- Dr. Desmond Lachman, American Enterprise Institute
- Dr. Athanasios Orphanides, Massachusetts Institute of Technology
- Dr. John Makin, American Enterprise Institute
- Dr. Adam Posen, Peterson Institute for International Economics

Background

In 2009, the Bank of International Settlements (BIS) surveyed 41 central banks and reported on both the broad commonalities in the structures and roles of these institutions as well as the differences among them.[1]

The BIS reported that all of the central banks it surveyed have full or partial responsibility for monetary policy. Over half are given policy objectives, usually specified in domestic law or international treaty, but some policy objectives come by published statements that do not have the force of law. Many have either a "single mandate" of price stability or a primary goal of price stability with secondary macroeconomic objectives. Most of the central banks with a single mandate of price stability have a formal inflation target as the policy objective. Other objectives include monetary stability, stability of domestic purchasing power, or currency stability. The United States and Canada are the only two

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[1] Bank for International Settlements, *Issues in the Governance of Central Banks: A Report from the Central Bank Governance Group*, May 2009, available at at http://www.bis.org/publ/othp04.pdf.

countries identified as having a price stability mandate equally weighted with other macroeconomic objectives. Overall, 56% of the central banks surveyed by the BIS had a sole inflation target, 11% had a single target related to price stability or monetary aggregates, and 11% had a sole exchange rate target. Nearly all central banks have full responsibility for formulating and implementing monetary policy.

Central banks are also commonly charged with other responsibilities by their national governments. Some central banks have partial responsibility for implementing their countries' exchange rate policy, and a few have full responsibility. Most central banks carry out exchange rate intervention and manage any foreign exchange reserves. Most have full "lender of last resort" authorities that are exercised in conjunction with a charge to perform macroprudential regulation.

The political framework and legal status of central banks varies. Most central banks are public entities, although some have privately-held non-voting shares. The powers and responsibilities of the central banks are usually set by statute. Some national governments expressly forbid central banks from financing government operations. A few countries permit central bank officials to be dismissed on policy grounds. Most monetary policymaking is determined by a committee, but in rare instances, it is promulgated by the head of the central bank. Relatively few committees have formal votes on policy decisions.

The asset portfolios of central banks vary considerably, with some holding mostly foreign assets, some holding mostly domestic government debt, and some holding mostly claims on financial institutions. Similarly, the types of liabilities held also vary, with some holding currency, bank reserves, government balances, central bank debt, and foreign liabilities to varying degrees. The balance sheets of some central banks have changed considerably due to actions taken during the recent financial crisis.

Only 15% of central banks surveyed were not subject to oversight by the national legislature, although only 43% were subject to regular review. It is rare for these legislative reviews to include a formal judgment on the central bank's performance or budget results. No national legislature could dismiss central bank officials based on performance. Nearly 90% of the central banks surveyed were required to deliver written reports to their countries' legislatures. Most countries did not have formal procedures that could be triggered by the government or legislature when targets were missed or to overrule policy decisions. Although most central banks publicly disclosed information on objectives, strategy, policy changes, and forecasts, few central banks disclosed their minutes or voting records from monetary policy setting meetings. These structural arrangements affect the independence of the central bank from the national governments that charter them.

The Federal Reserve System (Fed)

The Federal Reserve System consists of a presidentially appointed Board of Governors and twelve regional Federal Reserve Banks. It is lead by a Chairman, who chairs both the Board of Governors and the Federal Open Market Committee, the monetary policymaking body within the Fed. The Federal Reserve was created by the Federal Reserve Act in 1913, in response to a series of financial crises. The regional Federal Reserve Banks are owned by the nationally chartered commercial banks in the region, and their boards consist of representatives from banks, non-bank businesses, and other groups.

The Federal Reserve Act directs the Fed to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[2] The first two objectives, low unemployment and low inflation, are often referred to as the Fed's "dual mandate." It has traditionally achieved these objectives by conducting open market operations to achieve a target Fed Funds Rate, but has recently employed non-traditional measures such as large-scale asset purchases, more commonly referred to as "quantitative easing" (QE), and its Maturity Extension Program, more commonly referred to as "operation twist."

The Federal Reserve also has macroprudential regulatory responsibilities, and its Chairman sits on the Financial Stability Oversight Council, an inter-agency body created by the Dodd-Frank Act to monitor and contain systemic risk. Additionally, the Fed oversees payment and settlement systems. The Federal Reserve Bank of New York also acts as a fiscal agent for the U.S. government and distributes currency.

During the financial crisis, the Federal Reserve set up a number of facilities to purchase commercial paper and other assets, make loans, and provide dollar funding through liquidity swaps with foreign central banks. The Federal Reserve has significantly expanded the size of its balance sheet, initially lending as a last resort to financial institutions, and also by purchasing trillions of dollars worth of U.S. Treasury and agency mortgage-backed securities.

The European Central Bank (ECB)

The Eurosystem comprises the European Central Bank and the national central banks of the 17 countries that have adopted the euro. Monetary policy decisions are made by the ECB's Governing Council, consisting of the six members of the Executive Board and the governors of each member central bank. The Executive Board, including the ECB

[2] 12 USC 225a. As added by act of November 16, 1977 (91 Stat. 1387) and amended by acts of October 27, 1978 (92 Stat. 1897); August 23, 1988 (102 Stat. 1375); and December 27, 2000 (114 Stat. 3028).

President, is chosen by a majority of the European Council, to serve non-renewable eight-year terms.

The ECB describes the main objective of the Eurosystem as maintaining price stability and "safeguarding the value of the euro"; the ECB accomplishes this objective by "organizing, evaluating, and cross-checking the information relevant for assessing risks to price stability" based on "economic analysis and monetary analysis."[3] The ECB's most recent policy statement "clarified that, in the pursuit of price stability, [the ECB] aims to maintain inflation rates below, but close to, 2% over the medium term."[4] The ECB measures inflation by the euro area's index of consumer prices.

The ECB sets interest rates for refinancing operations, its deposit facility, and its marginal lending facility. Refinance operations are primarily the purchase or sale of repurchase agreements on the open market. The deposit facility allows banks to earn interest on reserves deposited with the ECB. The marginal lending facility allows banks to access liquidity directly from the ECB, similar to the Fed's discount window. The rates for the deposit facility and marginal lending facility thus act as a floor and ceiling on the interest rate for main refinancing operations.

The European Union is reforming its financial system, and those reforms are expected to take effect in the latter part of 2014. When these reforms are fully implemented, the ECB will be responsible for the single supervisory mechanism, in cooperation with national financial regulators. The ECB will supervise "significant credit institutions" and will coordinate supervision of other institutions with national regulators. Previously the ECB had no regulatory responsibilities. The ECB will continue to operate and oversee payment and settlement systems, central counterparties, and trade repositories. It will also continue to issue the common currency.

During and after the financial crisis and euro crisis, the ECB employed several unconventional policy tools, including long-term liquidity-providing refinance operations, dollar funding provided through liquidity swaps with the Federal Reserve, and outright purchases of euro-denominated covered bonds and euro-area government bonds on the secondary market. The ECB's balance sheet has increased significantly during the crisis, initially due to the provision of credit through its lender of last resort function, and later because of bond purchases.

[3] European Central Bank, "The Mission of the European Central Bank," available at http://www.ecb.europa.eu/ecb/orga/escb/html/mission_eurosys.en.html.
[4] European Central Bank, "Strategy," available at http://www.ecb.europa.eu/mopo/strategy/html/index.en.html .

The Bank of Japan (BoJ)

The Bank of Japan is led by a Governor, who is appointed by the Japanese Prime Minister, and eight additional board members. The BoJ derives its authority from the Bank of Japan Act, which directs the BoJ "to issue banknotes and to carry out currency and monetary control" and "to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing the maintenance and stability of the financial system."[5]

The statute also directs the BoJ to set monetary policy in a manner that "achieves price stability, thereby contributing to the sound development of the national economy." Japan's recently-elected Prime Minister Shinzo Abe has made combating perceived deflation and aggressive quantitative easing a core pillar of his economic reform agenda. In January 2013, the BoJ announced a price stability target of 2% growth in the consumer price index. The BoJ targets interest rates through money market operations, whereby the central bank supplies funds to money markets through loans to financial institutions, repurchase agreements, and purchases of government debt. It conversely absorbs funds by repurchase agreements, selling government bonds, or issuing and selling its own bonds.

The BoJ has both macroprudential and microprudential regulatory responsibilities for Japanese banks and other financial institutions. Additionally, it oversees payment and settlement systems. The BoJ conducts foreign exchange operations at the direction of the government and, therefore, holds foreign exchange reserves. It also acts as a fiscal agent for the national government, manages debt issuance, and also issues and distributes currency.

During the financial crisis, the BoJ set up a number of facilities to purchase private debt securities, make loans, provide dollar funding through liquidity swaps with the Federal Reserve, and offer long-term refinancing operations. In January 2013, the BoJ pledged to double the size of the aggregate monetary base in two years through quantitative easing, more than doubling its balance sheet through the purchase of government bonds, exchange traded funds, and real estate investment trusts.

The Bank of England (BoE)

The Bank of England sets monetary policy through a majority vote by its Monetary Policy Committee. The Committee consists of the BoE's Governor, two Deputy Governors, the Chief Economist, the Executive Director for Markets, and four external members appointed by the Chancellor of the Exchequer (Finance Minister). Non-monetary policymaking is overseen by the Court of Directors, nine individuals appointed by the

[5] Bank of Japan, "Outline of the Bank," available at http://www.boj.or.jp/en/about/outline/index.htm.

sovereign. The BoE also has twelve regional agencies responsible for assessing economic conditions.

The BoE identifies its core purposes as monetary stability and financial stability. The BoE defines "monetary stability" as stable prices and confidence in the currency, and it defines "financial stability" as an efficient flow of funds and confidence in financial intermediaries. The BoE also states that its "monetary policy objective is to deliver price stability—low inflation—and, subject to that, to support the Government's economic objectives including those for growth and employment."[6] The BoE has an inflation target, set by the Chancellor of the Exchequer, of 2% growth in the Consumer Price Index. To achieve its policy objectives, the BoE sets the official repo rate and conducts repurchase agreements with the money market to establish market equilibrium at that rate.[7]

The United Kingdom has recently restructured its financial regulatory system. The BoE has assumed responsibility for supervising banks, building societies, credit unions, insurers, and major investment firms. While most regulation was previously carried out by the Financial Services Authority, the agency has been dissolved and replaced by the Prudential Regulation Authority and the Financial Conduct Authority, which along with the Bank of England carry out supervisory functions. In addition, the BoE oversees and regulates key payment, clearing, and settlement infrastructure.

During the financial crisis, the BoE purchased government bonds, private debt, engaged in long-term refinancing operations, provided dollar funding through liquidity swaps with the Federal Reserve, and made long-term loans to depositories through its "Funding for Lending" Program. The BoE's balance sheet expanded significantly during the crisis, initially because of lending, and later because of bond purchases.

The Swiss National Bank (SNB)

The Swiss National Bank is led by a Bank Council. The SNB is a privately owned joint-stock company. Some shares are held by the cantons, the member states of the Swiss federal state, but none of the stock is held by the federal government. Additionally, the SNB has a regional network responsible for informing the SNB on economic developments.

The SNB's primary goal "is to ensure price stability, while taking due account of economic developments."[8] Per its policy statements, the "SNB equates price stability with a

[6] Bank of England, "Monetary Policy Framework," available at http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx.
[7] Bank of England, "The Transmission Mechanism of Monetary Policy," available at http://www.bankofengland.co.uk/publications/Documents/other/monetary/montrans.pdf .
[8] Swiss National Bank, "Goals and responsibilities of the Swiss National Bank," available at http://www.snb.ch/en/iabout/snb/id/snb_tasks.

rise in consumer prices of less than 2% per annum. Deflation—i.e. a protected decline in price levels—is also regarded as a breach of the objective of price stability. A medium-term inflation forecast serves as the main indicator for monetary policy decisions."

The SNB sets a target range for the three-month Swiss franc London Inter-bank Offered Rate (LIBOR), and it maintains that range primarily through repurchase agreements, but it can also conduct open market operations by issuing short-term debt. If banks need liquidity, the SNB can engage in special-rate repo transactions. Since September 6, 2011, the SNB has also maintained an exchange rate ceiling against the euro and intervenes in foreign exchange markets to maintain that ceiling, a process commonly referred to as "sterilization." The SNB believes that by intervening in this manner, it can support Swiss exports to Eurozone countries.

The SNB also has authorities to act as a lender of last resort and to issue bank notes. It works with the Swiss Financial Market Supervisory Authority to ensure financial stability, and also operates and oversees systemically important payment and settlement systems. The SNB also acts as a fiscal agent and compiles statistical data.[9]

During and after the financial crisis, the SNB conducted long-term refinancing operations, provided dollar funding through liquidity swaps with the Federal Reserve, and purchased private debt. During the financial crisis, the SNB's balance sheet increased significantly, initially because of lending, and later because of its efforts to stabilize the Swiss franc.

[9] Swiss Financial Market Supervisory Authority and the Swiss National Bank, *Memorandum of Understanding in the Field of Financial Stability*, Feb. 2010, http://www.snb.ch/en/mmr/reference/mofu/source.