Bringing the Exhibit to Life in the Classroom

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June 13, 2012
Federal Reserve Bank of Dallas Economic Summit
Themes

- Need for a Central Bank
- Centralized or decentralized
- Functions
- Success & Failures
- 100 years later – we are still debating if the Fed should exist
Why a Central Bank?

- Tried twice before
  - First Bank of the United States (1791-1811)
  - Second Bank of the United States (1816-1836)
- Deal with *national* debt
- Promote a *national* currency
- Act as commercial banks
  - Stimulate economic growth
  - Creating competition to state banks
Trust

- Reliance on the integrity, strength, ability, surety, etc., of a person or thing; confidence.
- A central bank has to gain the trust of the economic users
  - Hard to gain trust – easy to lose trust
  - Provide stability
- Clearly defined role for the central bank
  - Needed but hard to achieve
What is the role?

- First Bank
  - Pay off war debts
  - Issue currency notes
  - Main office in Philadelphia with 8 branches in major cities
  - Coastal branches
  - And...
Unique function for First Bank

- Commercial bank
  - Not what we think of today as a role for central bank
  - At the time of the Revolution, there were few banks in the U.S.
  - England had prevented rivals
  - Hamilton’s goal was to create a capital system for economic growth
  - Compare with Jeffersonian view of agrarian society
  - Does production or capital lead?
What about #2?

- Second bank
  - War debts from War of 1812
  - Uniform currency
  - Clearinghouse for other bank’s notes
    - Ability to discipline a bank that over-issued notes
    - Regulation enters the job description even if the second bank did not have true regulatory power
  - Headquartered in Philadelphia with 29 branches
  - Started off with problems but under Nicholas Biddle became one of the most powerful organizations in the country
Role of Power

- President Andrew Jackson was suspicious of the central bank
  - What if there was corruption?
  - How does the country control it?
  - Who controls it?
  - Wall Street vs. Main Street
- Who has the power?
- Competition to local banks
Panic

- 70+ years before the willingness to have a central bank
- Panics of 1873, 1893, and 1907
- Is it a willingness or a need to trust a central bank?
  - Need – I will overlook shortcomings
  - Willingness – You need to prove it to me
- Banker or populist controlled?
  - First two were banker controlled
The Federal Reserve is decentralized
- New York and Philadelphia cannot concentrate power
- No commercial bank function
  - Not competing with local banks
- Profits given to Treasury
- Authority over payment systems
- Fungibility
- Monetary policy
Board of Governors

- No president can appoint more than four
- Remove political pressure
- Allow the Fed to have a long-term focus
Twelve Districts
Why Dallas?

- Could have been Dallas or New Orleans
  - Houston?
  - Galveston?
- New Orleans is “old South”
- Dallas is “new Southwest”
- Need to appease Texas
- Texas first, city second
Where the people are (will be)
What should the districts be today?

- Add or re-divide?
  - San Francisco
  - Los Angeles
  - Seattle
  - Phoenix

- Removed?
  - Cleveland
  - Richmond
Is it easy to move an institution?

- Once it is created, it can be hard to change the logistics
  - Important for the first division to be forward-looking
- What institutions and/or institution locations should be changed in your community?
  - Why are they not moved?
- Check clearing sites
  - Cleveland
- Bureau of Consumer Financial Protection
  - Where are the offices?
Transactions Motive

- Currency and other forms of payments as a medium of exchange
  - Both parties must recognize and accept
  - Trust
- To Counterfeit Is Death
- $100 not accepted in many countries
- Take extra $50 bills
Trust in Currency

- Who holds the power regarding the creation of currency?
  - State banks or Federal government
  - Notice the focus on trust in a currency
- Illinois dollar worth less than Tennessee dollar, which is worth less than Philadelphia dollar (Free banking time)
- 30,000 different currencies were in circulation
Cash

- Importance of no counterfeits
  - 0.18% of currency in Dallas is found counterfeit
  - Mostly $5 and $20 bills
  - 2800 containers of cash in the Dallas Fed vault
- Why we redesign the currency
  - Franklin’s leaves
Why still use cash?

- Anonymity
- Speed
- Convenience
- Safer?
- Travel
- Easier to manage a budget
  - For some people, when they see the cash disappear, they recognize that they are spending
- Budget envelopes
Cash Expenditures

- Life-span shortest for $5 and $10 and then $1
  - $100 last 4x longer
- What are we buying with cash?
- Where are we buying with cash?
Checks as Payments

- State banks created checks as a way to deal with regulation.
  - Remember that regulation creates the incentive to develop something to get around the regulation.
Check Clearing

- 45 locations in 2003
- Check 21 in 2003
  - Electronic collection
- One location since 2010
- How many jobs lost?
  - Technology impact
  - Outsourced – is it easier to lose your job to a machine or to another person in a different country?
Changes to Payments

- Float goes to the business
- Mail float is gone
- Pay with smart phone instead of cash
- Need the mom-and-pop shops to convert
- Probably take a decrease in technology cost or a technology subsidy
- Security issue – trust
- Draft from our accounts
- Cheaper for firm
Cash in a Crisis

- The Fed makes sure cash is available during a crisis
  - Y2K
  - 9-11
  - Katrina
- Keynes discussed the precautionary motive for money
Trust Revisited

- Credibility
  - Always focus on long-term goals

- Reputation
  - Clearly present actions

- Delegation
  - Central banker
  - Decentralized
Independence

- One of its most important features
  - Removes/reduces political pressure
- The Fed voraciously wants to maintain its independence
- Responsible to Congress
  - Humphrey-Hawkins testimony
  - Use as reputation builder
- The Fed earns a profit – does not cost the public an explicit outlay
Transparency

- If the public knows more, is Fed policy more effective?
- We act based on their words
  - Less pull on Stephen’s extension cord
- Today, the information makes us more confident in the Fed’s actions
  - Not favoring one group over another
Views of Independence

- Public interest view
  - Serve the public

- Bureaucratic behavior view
  - Maximizes its own welfare

- Generally, Fed policy never compromises its own independence
  - Bailouts – public interest or bureaucratic?
  - Revisit the banker vs. populist
Local Interests

- Beige book
  - Anecdotal evidence
  - Share the story of each district
  - Populist
- Eleven Fed banks rotate for four voting positions
  - Eleven banks have to respect the others so that when one bank does not have a vote, its interests are still heard
- Is the average American aware of this?
  - The bailouts linked the Fed to TBTF
Relationship with Treasury

- Act as the bank for Treasury
- Accord of 1951
  - Separates Fed and Treasury
  - Allows Fed to change interest rate for monetary policy and not for cheap borrowing costs for Treasury
- Fed is proud of this
  - Act in best interest of country not government
Panics

- J.P. Morgan $25 million + Treasury’s $25 million + $30 million from 12 friends
- Public and private solution
- Warren Buffett provided funds to financial institutions in 2008
- Lender of Last Resort
Recent Bailouts

- Who had the funds?
  - Fed pumped $3 trillion
  - Fed made all the major banks borrow from the discount window to avoid a bank run
- Stigma problem
- August 23, 2007 – Citigroup, Bank of America, JP Morgan Chase, and Wachovia each borrowed $500 million
- Four largest banks
What if?

- Moral hazard
- What would have happened if there was no bailout?
- Second Bank of the U.S. became too large according to critics
  - Citigroup and Bank of America?
Bagehot’s Rule

- During a crisis, a central bank should lend to those banks that are sound (have collateral) but at a penalty rate.
- Were the bailouts at a penalty rate?
Fed Marketing (Lack of)

- Bank of America complains about buying Merrill Lynch but Fed does not counter in press that BAC was already looking to buy Merrill
Let’s go to Kansas

- If the Fed loses credibility, to whom should we delegate the role of monetary policy?
- Gold Standard – impotent monetary policy because trying to maintain standard
- Impossible Trinity
Impossible Trinity

Monetary Autonomy

Impossible Trinity

Fixed Exchange Rate

International Free Flow of Capital
Greek Crisis

- Euro
  - Fixed exchange rate
- How much will the Germans pay to keep the euro?
- What happens with Spain and Italy, which are much larger than Greece?
- Is the European Central Bank credible?
- Germans have the credibility
Regional Differences

- Let Greece fail?
- We let states fail
- We let cities fail
- Why are some more special than others?
- Regional importance
Regional Economy

- 11th District’s economy is outward looking
  - Exports
  - Commodities
  - Keeps the jobs here
- Exhibit
  - M.L. Leddy’s niche manufacturing of boots
  - Laguada. Low export service
Demographics

- We cannot ignore the demographic changes within the U.S.
  - Older
    - Social Security and Medicare are just beginning to feel the pressure
  - More varied backgrounds
    - More of a feeling of mistrust for financial institutions?
  - What are our shared experiences?
Fed’s Future

- Does the Fed need to earn our trust all over again?
  - Were we spoiled by the 1980s and 1990s?
- What do we expect?
  - Would it be different if we could “see” the banks punished for the financial crisis?
Thank You!

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