CHAPTER 3

OTHER BANKING SYSTEMS IN THE WORLD

❁ *Objectives:*

After studying this chapter you should understand:

3.1 The United States of America banking system

3.1.1 Formal structure of the Federal Reserve System

The statutory organisation of the Federal Reserve System is a case study in those currently popular concepts: decentralisation and the blending of public and private authority. A deliberate attempt was made in the enabling congressional legislation, the 1913 Federal Reserve Act, to diffuse power over a broad base – geographically, between the private and public sectors, and even within the government – so that no person, group, or sector, either inside or outside the government, could exert enough leverage to dominate the direction of monetary policy.

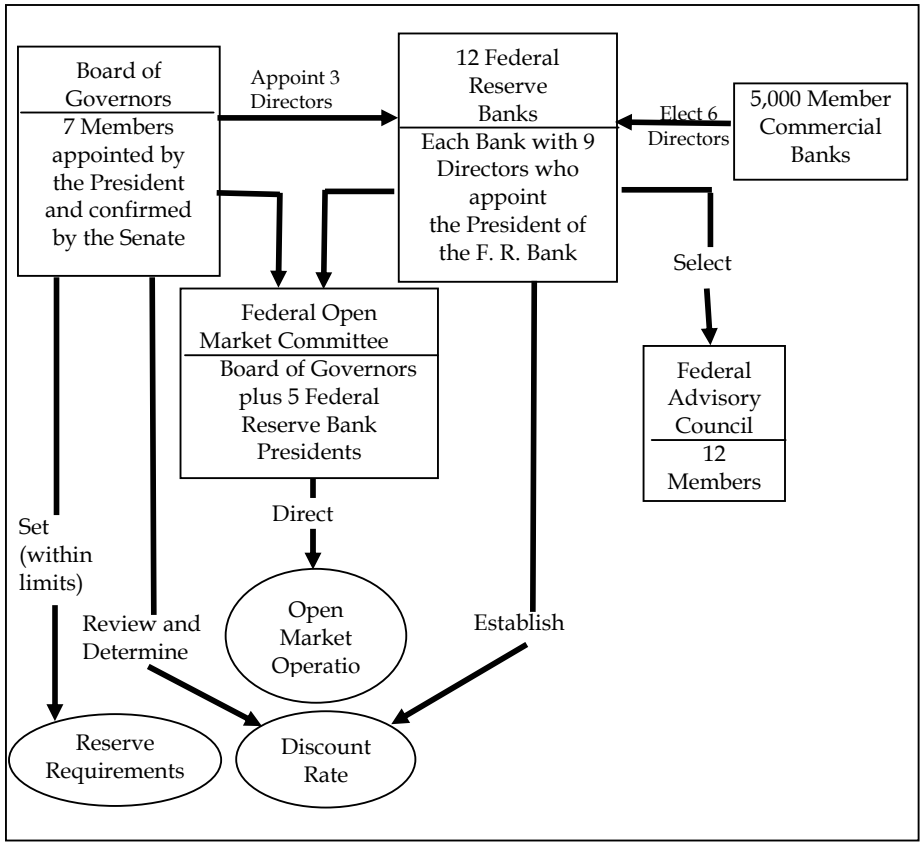


Figure 1: The Formal Structure and Policy Organisation of the Federal Reserve System

As the above figure shows, the Board of Governors of the Federal Reserve System consists of seven members, appointed by the President with the advice and consent of the Senate. To prevent presidential board packing, each member is appointed for a term of fourteen years, with one board member's term expiring at the end of January of each even-numbered year. Furthermore, no two board members may come from the same Federal Reserve district. The Chairman of the Board of Governors, chosen from among the seven by the President, serves a four-year term. However, the Chairman's term does not coincide with the presidential term, so an incoming President is usually saddled with an already appointed Chairman at the beginning of the new administration. The Board is independent of the congressional appropriations process and partly exempt from audit by the government's watchdog the General Accounting Office, because its operating funds come from the earnings of the twelve regional Federal Reserve Banks.

The regional Federal Reserve Banks, one in each Federal Reserve District, are geographically dispersed throughout the country:

New York	Chicago
Boston	Kansas City
St. Louis	Richmond
San Francisco	Dallas
Philadelphia	Minneapolis
Atlanta	Cleveland

Technically, the member banks in its district privately own each Federal Reserve Bank, every bank is charged with supervising and regulating. Each member bank is required to buy stock in its district Federal Reserve Bank equal to 6 percent of its own capital and surplus. Of this 6 percent, 3 percent must be paid in and 3 percent is subject to call by the Board of Governors. However, law to a 6 percent annual dividend on paid-in capital stock limits the profits accruing to ownership. The member bank stockholders elect six of the nine directors of their district Federal Reserve Bank and the remaining three are appointed from Washington by the Board of Governors. These nine directors, in turn, choose the president of their Federal Reserve Bank, subject to the approval of the Board of Governors.

The directors of each Federal Reserve Bank also select a person, always a commercial banker, to serve on the Federal Advisory Council, a statutory body consisting of a member from each of the twelve Federal Reserve Districts. The Federal Advisory Council consults quarterly with the Board of Governors in Washington and makes recommendations regarding the monetary policy.

Legal authority is similarly diffused with respect to the execution of monetary policy, as Figure 1 indicates. The Board of Governors has the power to set reserve requirements on bank time and demand deposits, for example, but it cannot set them outside the bounds of the specific limits imposed by the Congress.

A body known as the Federal Open Market Committee (FOMC), composed of the seven-member Board of Governors plus five of the Reserve Bank presidents directs open market operations. Although open market operations are directed by the FOMC, a person who appears to be simultaneously an employee of the FOMC and of the Federal Reserve Bank of New York executes them at the trading desk of the Federal Reserve Bank of New York.

Legal authority over discount rates is even more confusing. Discount rates are “established” every two weeks by the directors of each regional Federal Reserve Bank, but they are subject to “review and determination “ by the Board of Governors. The difference between “establishing” discount rates and “ determining” them is a fine line indeed, and it is not surprising that confusion arises as to precisely where the final authority and responsibility lie.

3.1.2 The realities of power

Actually, the facts of life are rather different, as the more realistic Figure 2 illustrates.

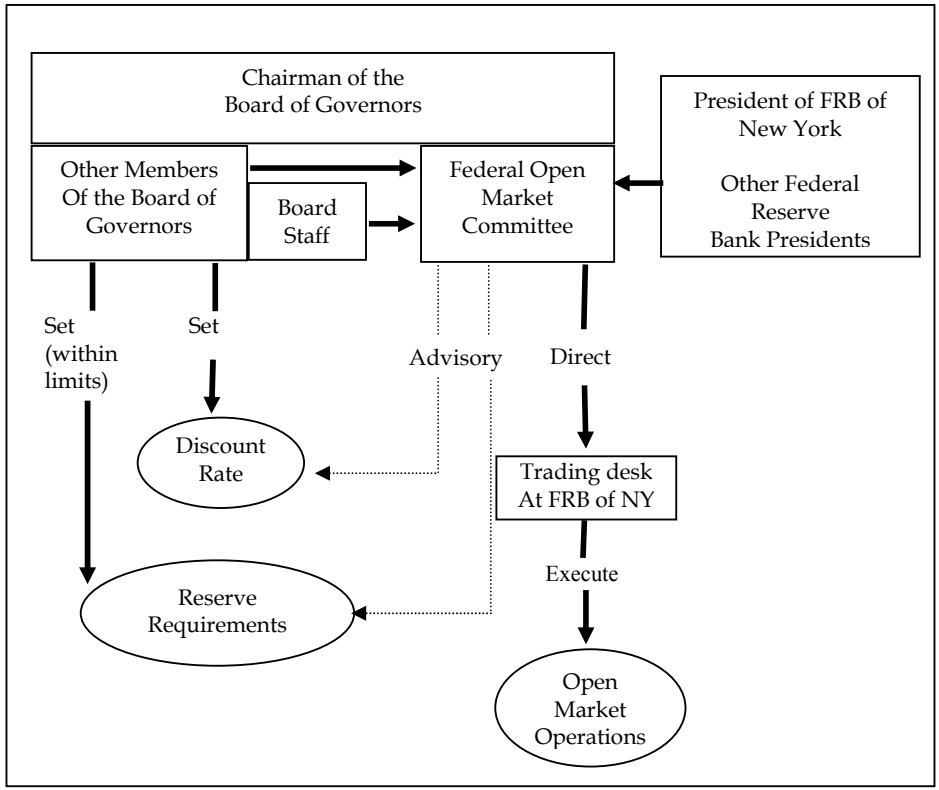


Figure 2. The realities of power within the Federal Reserve System

By all odds, the dominant figure in the formation and execution of monetary policy is the Chairman of the Board of Governors of the Federal Reserve System. The Chairman is the most prominent member of the Board itself and the most influential member of the FOMC and is generally recognised by both Congress and the public at large as the voice of the Federal Reserve System. Although the Federal Reserve act appears to put all seven members of the Board of Governors on more or less equal footing, over the past fifty years strong personalities, outstanding abilities, and determined devotion to purpose have made the chairmen rather more equal than others. As adviser to the President, negotiator with Congress, and final authority on appointments throughout the system, with influence over all aspects of monetary policy as Chairman of both the Board of Governors and the FOMC, the Chairman for all practical purposes is the embodiment of the central bank in the United States.

The other six members of the Board of Governors also exercise a substantial amount of authority, more so is indicated in the formal paper structure of the system, because with the passage of time primary responsibility for monetary policy has become more centralised and concentrated in Washington. When the Federal Reserve Act was passed in 1913, it was though that the Federal Reserve System would be mainly a passive service agency, supplying currency when needed, clearing checks, and providing a discount facility for the convenience of the private commercial member banks. At that time there was no conceptual monetary policy as an active counter cyclical force.

Since then, the central bank has shifted from passive accommodation to active regulation, from the performance of regional service functions to the implementation of national economic policy. This shift has been accompanied, naturally enough, by the rise in the power of the centralised Board of Governors in Washington and a corresponding decline in the role of the regional Federal Reserve Banks and their "owners", the commercial banks.

It would not be unrealistic to describe the central bank today as headquartered in Washington, with twelve field offices throughout the nation. These field offices may be known by the rather imposing name of Federal Reserve Banks, and they do indeed retain considerable authority in expressing their views on the wisdom of various policies. But even so, they essentially amount to little more than branches of the Washington headquarters.

Aside from the Board of Governors, its Chairman, and its staff, the only other body playing a major role in the Federal Reserve policy-making is the FOMC, which meets about every five or six weeks in Washington. Of the twelve members on the FOMC, a majority of seven is the Board of Governors themselves. The other five are Reserve Bank presidents. The President of the Federal Reserve Bank of New York is a permanent member of the FOMC, and the other eleven Federal Reserve Bank presidents rotate the remaining four seats among themselves.

3.1.3 The instruments of Central Banking

The Federal Reserve exercises control over the bank lending and the money supply by altering the reserves of commercial banks and of other deposit-type institutions and by influencing the deposit creation multiplier. The Fed accomplishes these objectives by changing reserve requirements relative to deposits and by changing the actual amount of reserves that financial institutions hold. The Fed varies the actual amount of reserves through the discount rate and open market operations.

3.1.3.1 Reserve requirements

Within limits established by the Congress, the Federal Reserve can specify the reserve requirements that banks and other deposit-type institutions must hold against deposits. Congressional limits for bank reserves were first established in the Federal Reserve Act of 1913 and have been reset a number of times since, most recently in the Banking Act of 1980 and the Garn-St. German Depository Institutions Act of 1982. This most recent legislation provides that all depository institutions – savings banks, savings and loans, and credit unions, as well as all commercial banks, whether members of the Federal Reserve System or not – are subject to the Fed's reserve requirements. As of 1993 each depository institution had to hold reserves (in the form of vault cash or deposits in a regional Federal Reserve Bank) as follows:

1. Against demand deposits and similar checking-type accounts, reserves equal to 3 percent of its first $46.8 million of demand deposits.

2. Against business-owned time and savings deposits.

3. Reserve requirements against personal time and savings deposits, which used to exist, have been eliminated.

Lowering the required reserve ratio for demand deposits – e.g. from 12 to 10 percent – does two things. First, it instantly and automatically increases banks' excess reserves, sine fewer reserves are now required against any given volume of demand deposits. More excess reserves, of course, enable banks to make more loans, buy more securities, and expand demand deposits.

In addition, lowering the required reserve ratio also increases the demand deposit expansion multiplier for the entire banking system. The multiplier is the reciprocal of the required reserve ratio; the smaller the ratio, the larger it's reciprocal. Thus a decrease in the required reserve ratio from 12 (or about 1/8) to 10 percent (1/10) would raise the deposit expansion multiplier from about eight to ten.

Raising the required reserve ratio – for example, from 10 to 12 percent – would have the opposite effects. It would create reserve deficiencies, or at least reduce excesses, and lower the potential for multiple expansion. Putting banks into a deficit reserve position would force them to call in loans and sell securities, bringing about a reduction in demand deposits, while smaller excesses would at least restrain lending and deposit creation.

How crucial are reserve requirements for monetary policy? What would happen if the Federal Reserve eliminated reserve requirements entirely in order to increase bank profits?

Actually, even without formal reserve requirement the Fed would still be in business. Financial institutions would still need both cash to meet customer withdrawals and balances in the Fed to clear checks. As long as they have a demand for claims against the central bank, and as long as the central bank controls the supply of such claims, monetary policy can still work. While the Fed would lose one tool of monetary policy if it could no longer change reserve requirements, it could still influence the behaviour of financial institutions.

3.1.3.2 Discounting and the discount rate

The Federal Reserve can also alter the excess reserves of banks and other depository institutions by changing the actual amount of reserves that financial institutions hold. One way this is accomplished is through the discount mechanism, by which the Fed lends reserves, temporarily, to the banks. The Fed charges an interest rate, called the discount rate, on such loans. In other words, banks faced with reserve deficits can temporarily borrow reserves from their regional Federal Reserve Bank at a price (the discount rate).

When a manufacturer borrows from a bank, he receives a brand-new deposit at the bank. A bank is in the same position relative to the Federal Reserve: when it borrows from its district Reserve Bank, it receives a brand-new deposit at the Fed, which increases its legal reserves. The ability to borrow these reserves – to discount from the Fed – means that when a bank is faced with reserve deficiency, the bank does not have to call in loans or sell securities an thus the money supply can remain unchanged.

The Federal Reserve tries to influence the willingness of banks to borrow reserves by changing the interest rate it charges on such loans (the discount rate). A lower discount rate will make the borrowing of reserves more attractive to banks, and a higher discount rate will make it less attractive.

The effectiveness of the discount mechanism as a means of injecting or withdrawing reserves is limited by the fact that the initiative of borrowing from the Fed rests not with the Fed but with the banks. Banks will want to borrow reserves only when they need them. If they already have ample reserves, there is no need for them to borrow more, no matter how low the discount rate.

It has been recognised for a long time that discount policy has two dimensions: the first is price, the discount rate, the rate of interest the Federal Reserve charges financial institutions when they borrow from the Fed. The second dimension has to do with the quantity of the Federal Reserve lending, including Fed surveillance over the amount that each institution borrows and the reasons why it borrows. Let us examine quantity first and price second.

Historically, the primary function of a central bank has been to stand ready to supply funds –promptly and in abundance – whenever the economy is in danger of coming apart because of cash storage. While that is no longer its sole function, it is still one of its most important. The central bank is the ultimate source of liquidity in the economy, because with its power over bank reserves it can increase (or decrease) the ability of the banking system to create money. Since no one else can do the job, it is the central bank that must be responsible for supplying funds promptly on those rare but crucial occasions when liquidity shortages threaten economic stability: “financial panic”, the history books call them. Because of this responsibility, the central bank has traditionally been called the “lender of last resort”.

The discount facilities instituted by the passage of the Federal Reserve Act in 1913 were supposed to provide a vehicle through which the Federal Reserve could quickly inject funds precisely where needed in order to stop a panic from spreading. Banks threatened with cash drains could borrow what they needed from the Fed – the lender of the last resort. Thus they could get more reserves without any other bank losing them and thereby prevent an infection from becoming a plague.

In the ordinary course of events, however, bank use of the discount facility is rather routine, not at all panic-oriented, with banks borrowing here and there to make short-run adjustments in their reserves. The Fed has always stresses that ordinary borrowing of this sort should not be used too often to get banks out of reserve difficulties. Banks should run their affairs so they do not have to rely on the Fed to bail them out every few weeks. Or, as the Federal Reserve usually puts it, discounting is considered a privilege, not a right, and privileges should not be abused. Federal Reserve surveillance enforces the "privilege, not a right" concept by checking up on banks that borrow too much or too frequently. A bank is supposed to borrow only because of need, and not go out and make a profit on the deal.

One Fed method of preventing "abuse" of the discounting facility is to tighten surveillance procedures: it checks up on why banks are borrowing and what they are doing with the money. Another way is simply to raise the price of borrowing – which brings us to the discount rate itself.

3.1.3.3 Open Market Operations

The most important way the Federal Reserve alters the actual amount of reserves the banks hold is not by discounting, but buying and selling government securities – technically known as open market operations. Undertaken at the Fed's own initiative, open market operations are the mainstay of the Federal Reserve policy.

When the Federal Reserve buys $1,000 of government securities, much as you might buy a stock or a bond on one of the stock exchanges, it pays with a check drawn on itself. If the Fed buys the securities directly from a commercial bank, that bank sends the Fed's check to its regional Federal Reserve Bank and has its deposit at the Fed – its reserves – increased by $1,000. The bank excess reserves rise by the full amount of the transaction,

and with more excess reserves it can make more loans and increase its demand deposits.

But what the central bank gives, the central bank can take away. When the Federal Reserve sells government securities out of its portfolio, it gets paid for them, and everything is reversed. The Fed takes payment by deducting that sum from the buying bank's deposit at the Federal Reserve, thus diminishing its reserves.

Of course, when the Federal Reserve buys (or sells) government securities, it has no assurance that a bank will be the other party of the transaction. But it doesn't matter whether the securities someone else is selling by a bank or the Fed buys. In either case, when the Fed buys, bank reserves go up, and when the Fed sells, bank reserves go down.

Commercial banks are unable to do anything to offset these measures. If the Fed wants to reduce bank reserves by open market sales, there is nothing banks can do about it. By lowering its selling price, the Fed can always unearth a buyer. Since it is not in business to make a profit, the Fed is free to alter its selling price as it wishes.

And while any single commercial bank can replenish its own reserves by selling securities to other banks – or to individuals who keep their accounts in other banks – the reserves of the other banks will then decline. Another loses reserves replenished by one bank. Total bank reserves must fall by the value of the securities sold by the Federal Reserve.

There are three types of Interest Rates, as follows:

- The *prime rate,* the *discount rate,* and the *federal funds rate* are referred to in newspapers so often that they deserve special mention, particularly since they are frequently confused with each other.

  The *prime rate* is the interest rate that commercial banks charge on loans to their most creditworthy business customers, most creditworthy meaning financially strongest and therefor most likely to repay on time. Banks charge higher rates then the prime for loans to corporations without such strong credit ratings. The prime rate is an *administered* rate in that banks set it and it stays there until they decide to raise or lower it; thus the prime rate typically stays the same for weeks or even months at a time.

- The *discount rate* is the interest rate that the Federal Reserve, the government's central bank, charges on loans to commercial banks. The Federal Reserve makes short-terms loans to banks when the banks need funds for relatively brief periods of time. Thus the prime rate involves a payment commercial banks receive, while the discount rate is a cost, something they pay out. Like the prime rate, the discount rate is also an administered rate, set in this case by the Federal Reserve and often staying unchanged for months.

- *Finally, the* federal funds rate – *often called just the "funds rate" – is the interest rate that banks charge each other on very short-terms loans among themselves. Usually the loans are "overnight" – made on one day and paid back the next. Unlike the prime rate and the discount rate, the federal funds rate is not an administered rate; rather, it is a* market-determined *rate, fluctuating continuously depending on the relationship between the demand for loans (by banks who need to borrow) and the supply (from banks who want to lend).*

3.1.4 Financial institutions

Financial institutions – such as banks, insurance companies, and pension funds – are called by a special name: financial intermediaries. They dominate the financial scene at home and abroad. It is virtually impossible to spend or save or lend or invest money nowadays without getting involved with some kind of financial intermediary in one way or another.

Financial Institutions in Profile

Although financial institutions have a lot in common, there are also substantial differences among them. Ranked in terms of asset size, commercial banks are easily the largest. In addition to sheer size, the composition of liabilities and assets also differs significantly from one type of financial institution to another.

Commercial banks are the most prominent of all financial institutions. There are about 12,000 of them, ranking from Citibank, with hundreds of billions of dollars in assets, to thousands of small banks scattered throughout the country, many of which have less that a hundred million dollars.

Commercial banks are also the most widely diversified in terms of both liabilities and assets. Their major source of funds used to be demand

deposits (checking accounts), but in the past few decades savings and time deposits – including certificates of deposits – have become even more important than demand deposits. With these funds, commercial banks buy a wide variety of assets, ranging from short-term government securities to long-term business loans and home mortgages.

Life insurance companies rank third in asset size. They insure people against the financial consequences of death, receiving their funds in the form of periodic payments (called premiums) that are based on mortality statistics. They can predict with a high degree of actuarial probability how much money they will have to pay out in benefits over the next years. They invest accordingly, aiming for the highest yield consistent with safety over the long run. Thus a high percentage of their assets are in the form of long-term corporate bonds and long-term mortgages, although the mortgages are typically on commercial rather than residential properties.

Pension and retirement funds are similar to life insurance companies in that they are mainly concerned with the long rather than the short run. Their inflow of money comes from working people building a nest egg for their retirement years. They are able to predict amounts they will have to pay out in pensions (called annuities) for the next years. Since they face few short-term uncertainties, they invest mainly in long-term corporate bonds and high-grade stocks.

Mutual funds are frequently stock market related institutions but there are also mutual funds specialising in bonds of all kinds and in mortgages as well. Pooling the funds of many people of moderate means, the fund's management invests the money in a wide variety of stocks or bonds, thereby obtaining diversification those individuals acting alone might not be able to achieve. Buying shares in a mutual fund is more risky than buying a savings deposit or a money market instrument such as a Treasury bill, butt it is less risky than buying stocks or bonds on your own.

Money market mutual funds are like the old-fashioned kind of mutual fund. However, the fund's management does not invest the money in the stock market or in corporate or municipal bonds. Instead, it purchases highly liquid short-term money market instruments, such as large-size bank negotiable CDs, Treasury bills, and high-grade commercial paper.

Savings and loan associations (S&Ls) have traditionally acquired almost all their funds through savings deposits – usually called shares instead of deposits – and used them to make home mortgage loans. This was their original purpose – to encourage family thrift and home ownership. The Banking Act of 1980 granted them the power to issue checking accounts (NOW – negotiable order of withdrawal) and also to make consumer loans.

Sales and consumer finance companies specialise in leading money for people to buy cars and take vacations and for business firms to finance their inventories. Many of them are owned by a manufacturing firm and lend money mainly to help retailers and customers buy that firm's products. They get their funds by selling their own short-term promissory notes (called commercial paper) to business firms with funds to invest for a short while, as well as by selling their own long-term bonds.

Property and casualty insurance companies insure homeowners against burglary and fire, car owners against theft and collision, doctors against malpractice suits, and business firms against negligence lawsuits, among other things. The premiums they receive they buy high-grade municipal and corporate bonds, high-grade stock and short-term money market instruments such as Treasury bills (for liquidity).

Credit unions (about 13,000) are organised as co-operatives for people with some sort of common interest, such as employees of a particular company or members of a labour union. Credit union members buy shares, which are the same as deposits, and thereby become eligible to borrow from the credit union.

Mutual savings banks are practically identical with savings and loan associations except that there are only about 500 of them. They are legally structured as "mutual" or "co-operatives", with the depositors or shareholders owning the institution. Savings banks have traditionally obtained most of their funds in the form of savings deposits and used the money mainly to make home mortgages. The Banking Act of 1980 also gave them the power to issue demand deposits (NOW accounts) and to make consumer and some business loans.

3.1.5 The regulation and structure of depository institutions

3.1.5.1 The dual banking system

The American commercial banking system is known as a dual banking system because its main feature is side-by-side federal and state chartering (and supervision) of commercial banks. It has no counterpart in any other country. Indeed, it arose quite by accident in the United States, the unexpected result of legislation in the 1860s that was intended to shift the authority to charter banks from the various state governments to the federal government.

Thus today the USA has a dual banking system: federally chartered banks, under the aegis of the Comptroller of the currency, and state-chartered banks, under the supervision of each of the various states.

A unique feature of the system is that the regulated can choose their regulator: state banks can shift to national charters and vice versa, state member banks can shift to non-member status and vice versa.

The justification for the dual banking system – side-by-side federal and state bank regulation – is that it is supposed to foster change and innovation by providing alternative routes through which banks can seek charters and do business. It is claimed that a dual banking system is more responsive to the evolving banking need of the economy than a single system would be. The validity of these arguments is difficult to assess, but whatever their merits no one has been marching in the streets demanding change in the status quo. The dual banking system seems to be working tolerably well, regardless of its logic.

3.1.5.2 Multiple federal authorities

The dual banking system has aroused considerably less controversy than the existence of multiple and sometimes opposing supervisory authorities at the federal level. In 1960s the Federal Reserve and the Comptroller clashed frequently over the interpretation of certain laws. Relations between the FDIC and the Comptroller were also strained, although the Comptroller is one of the three members of the FDIC's Board of Directors.

Different interpretations of the same statuses and intermittent dissension that has punctuated relations among the federal supervisory agencies have led many to recommend that all federal chartering, examination, and supervisory responsibilities be combined in a single agency. The proposal has always foundered, however, on lack of consensus as to which agency – The Federal Reserve, the FDIC, or the Comptroller of the Currency – is most appropriate. Notice that consolidation at the federal level would not affect the dual banking system, since state chartering and supervision would continue to exist.

The present system is defended by some on the grounds that divided federal authority, like the dual banking system, provides an element of flexibility, fostering innovation and change that would be lacking if all federal banking powers were concentrated in one agency. On the other hand, if there is to be federal supervision of banking at all, it would appear axiomatic and operated at minimum cost – which implies that one supervisory body is preferable to disagree fairly often among themselves.

It has to be admitted, however, as an argument in favour of the status quo, the federal regulatory agencies, in general, have not compiled a particularly outstanding record for imaginative leadership, for stimulating innovation, or even for protecting (not to mention furthering) the public interest. While a forward-looking, able, and conscientious federal banking authority would undoubtedly be an improvement over present arrangements, lack of these qualities in a consolidated agency might only make matters worse.

3.1.5.3 Deposit insurance and the FDIC

During the 1920s bank failures averaged about 600 a year, and during the years 1930-1933 over 2,000 a year! At the end of 1933 there were fewer than 15,000 commercial banks remaining out of 30,000 that had been in existence in 1920. It is not surprising, therefore, that the Congress established the Federal Deposit Insurance Corporation (FDIC) in response to this historic debacle.

The Banking Act of 1993 to insure deposits at commercial and mutual savings banks created the FIDC. Companion legislation created the Federal Savings and Loan Insurance Corporation to do the same for savings and loan associations, and in 1970 the National Credit Union Administration initiated deposit insurance for federally chartered credit unions. FDIC

deposit insurance became effective on January 1, 1934, with coverage limited to $2,500 per depositor per bank. This was raised to $5,000 in mid-1934, $10,000 in 1950, $15,000 in 1966, $20,000 in 1969, $40,000 in 1974, and $100,000 in 1980.

According to FDIC survey data, the present coverage provides full insurance for about 99 percent of the depositors in the insured banks. With respect of the dollar volume, however, the 1 percent of the depositors not fully covered holds uninsured balances that constitute a fourth of the dollar value of total deposits. In other words, although almost all depositors are fully insured (that is, they have less than $100,000 in their accounts in any single bank), a fourth of the deposits in term of dollar value are not insured.

Although nominal insurance coverage is $100,000 per depositor per bank, in fact actual coverage may be greater (never less), depending on the procedure used by the FDIC in taking over a failed bank. The FDIC may allow the bank to go into receivership, the so-called payoff method. In such cases the FDIC sends its agents to the bank verifies the deposit records, and then pays out funds directly to each depositor up to a limit of $100,000.

Alternatively, the FDIC may succeed in merging the failed bank with a healthy one, the so-called assumption method. The deposits of the failed bank are assumed by another bank into which the distressed one is merged and are made available in full to the depositors. The FDIC usually assists in this procedure, either by making payments to the bank taking over and/or by relieving it of some of the weaker assets of the failed bank. The assumption method has been the one most often used in the recent years; in such cases the FDIC has in effect completely insured all depositors to the full amount of their deposits, regardless of the technical insurance coverage limit. In addition, in a few cases the FDIC has extended loans to a bank in difficulty and allowed it to continue in business.

The explanation for the success of the FIDC does not involve calculations of actuarial probability, but rather rests on the premise that the very existence of federal deposit insurance eliminated the possibility large-scale bank failure. By insuring deposits under the auspices of the federal government, backed by the implied support of the United States Treasury to whatever extent necessary, the FDIC has successfully eliminated the old-fashioned “run on the bank” by frightened depositors that formerly heralded another

bank failure. If people hear their bank is "in trouble" now, they hardly pay attention. They're insured, so who cares?

Where does the FDIC get the money it uses to pay off depositors of failed banks? It gets it from premiums it assesses on the banks it insures. Until recently these were flat premiums, unadjusted for risk, but since 1993 this has been changed: banks now pay annual premiums to the FDIC equal to 23 cents for every hundred dollars of insured deposits, with premiums rising to as much as 31 cents per $100 of insured deposits for banks considered more risky with respect to possible failure. The FDIC measures a bank's risk of failure by the amount of capital the bank has and by an assessment of the quality of its loans and investments.

In 1989, the FDIC was given additional powers when the government agency that insured deposits at savings and loan associations – the Federal Savings and Loan Insurance Corporation (FSLIC) – was abolished after it ran out of money. As a result, the FDIC now has two departments:

1. The Savings Association Insurance Fund (SAIF), which took over responsibility from the defunct FSLIC for the insurance of deposits at savings and loans, and

2. The Bank Insurance Fund (BIF), which insures deposits at commercial banks and most savings banks, which is what the FDIC has always done.

But in 1991 the Bank Insurance Fund part of the FDIC also ran out of money. The FDIC had a working balance of over $18 billion in 1987, but the flood of subsequent bank failures wiped that out in less than four years.

What happens now? If banks continue to fail at the peace of the late eighties and early nineties, current insurance premiums that banks pay to the FDIC will be insufficient to pay off all the insured depositors and the FDIC will have no other choice but to borrow the remainder from the federal government. This brings us to the heart of the matter: it is the government's commitment to stand behind the FDIC that is important, not whether the FDIC has actually got enough money on hand to cover all contingencies. So long as that commitment is honoured, depositors need not worry about the safety of their money.

3.1.5.4 Bank size distribution and the McFadden Act

The objectives of bank supervision, regulation, and insurance are to protect the safety of depositors' funds and promote a viable and smoothly functioning banking system – one that will encourage saving channels funds from savers to borrowers, enable borrowers to get funds on reasonable terms, and foster economic stability and growth. All of this means that the objectives of bank supervision, regulation, and insurance are to make sure that banks are both safe and competitive. The FDIC and bank examinations are design to ensure safety, while other aspects of supervision are intended to promote competition. In down-to-earth terms, competitive conditions mean that customers can shop around, that they have alternatives. For example, are the opportunities open to depositors sufficiently varied to give them an array of choices with respect to deposit terms and yields, so they can pick those that best suit their particular need? Similarly, do borrowers who are refused a loan at one bank have alternatives open to them – other banks to which they can turn? Do banks actively seek customers, either depositors or borrowers, by offering more service or better terms than rival banks are offering?

With so many commercial banks in the United States, there would appear to be, on the face of it, a high degree of robust competition in banking. However, as Table 2 indicates, a large percentage of banks are very small institutions, with less that $50 million of assets per bank.

Size Distribution of Insured Commercial Banks (end of 1990)

Asset size	**No. of banks**	**% of total banks**	**% of total assets**
Less that $25 million	3,330	27	2
$25 – 50 million	3,145	25	3
$50 – 100 million	2,782	23	6
$100 – 500 million	2,461	20	14
$500 – 1 billion	253	2	5
over $1 billion	374	3	70
TOTALS	**12,345**	**100**	**100**

Indeed, almost 6,500 of the banks in the country – 52 percent of them – are that small (see lines 1 and 2 in the table). These 6,500 banks have only 5 percent of the aggregate assets in the banking system. Most of them are in small, one-bank towns. At the other end of the scale, about 600 large banks

(the last two line of Table 2), only 5 percent of the total have 75 percent of all bank assets.

If the large number of very small were the product of natural evolution, it would indicate that the optimum (low-cost) size bank is probably a very small size institution. Their large numbers would attest to their competitive viability. In fact, the reason for so many very small banks in this country does not have much to do with their successful adaptation to changing economic needs or their innovative capabilities. It is that most of them are *sheltered* from competition by state anti-branching statutes, to which the federal banking authorities defer. Many very small banks would be unable to remain in business if a large bank opened up a branch next door. The fact that in many states the large bank is legally prohibited from doing so is what permits many small banks to survive.

The McFadden Act of 1927 (a) prohibits banks from branching across state lines and (b) permits national banks to branch within a state only to the state extent as state-chartered banks. The result is that the McFadden Act and state anti-branching statute not economic circumstances are the principal determinants of the number of banks in the United States.

However, there are many straws in the wind indicating that the prohibition against interstate branching is on its last legs: mergers between banks located in different states, acquisitions by parent holding companies, enacting of legislation permitting reciprocal interstate banking, establishing by both national and state banks of bank-related subsidiaries and affiliates. Everything considered, a number of steps toward nation-wide branch banking appear to have been taken. Most observers believe that it will be commonplace by the turn of the century.

3.1.5.5 Savings banks and savings and loan associations

Savings banks were the first thrift institutions in the country. The Provident Institution for Saving in Boston and the Savings Fund Society in Philadelphia was not organised until fifteen years later. Nowadays, though, for all practical purposes savings banks and savings and loans are hard to tell apart except by their names.

The 400 or so savings banks, mostly on the eastern seaboard, are almost all state chartered; federal chartering of savings banks was not begun until

1978. Because most are state chartered, they are state regulate and state supervised.

Savings and loan associations may be federally or state chartered. Of the roughly 2,000 S&L in existence, slightly more than half is chartered by the states in which they operate and the rest by the federal government. Prior to 1989, virtually all of them were members of a system that was to S&Ls what that Federal Reserve System is to commercial banks: the Federal Home Loan Bank System, like the Federal Reserve System, consisted of twelve regional banks plus a supervisory board in Washington. The Federal Home Loan Bank Board (FHLBB) regulated S&Ls by chartering them, conducting examinations, and reviewing applications for branches and mergers.

Under the Depository Institutions Deregulation and Monetary Control Act of 1980, otherwise known as the Banking Act of 1980, both S&Ls and savings banks must hold reserves against their checking accounts and business time deposit liabilities, as specified by the Federal Reserve; as a *quid pro quo*, they have full access to temporary borrowing from the Federal Reserve when needed.

Most savings banks are insured by the Bank Insurance Fund of the FDIC, up to the standard $100,000 per depositor, just likes commercial banks. S&Ls, on the other hand, used to be insured by the Federal Savings and Loan Insurance Corporation (FSLIC), also up to $100,000 per depositor. While the FDIC is an independent agency, the FSLIC was a subsidiary of the Federal Home Loan Banking System, and the Federal Home Loan Bank Board determined its policies. Because of the large number of savings and loan failures, the FSLIC ran out of money in the late eighties and was abolished in 1989. Today, the Saving Association Insurance Fund (SAIF), a branch of the FDIC, insures deposits in savings and loans.

3.1.5.6 Mortgage-related financial institutions

It should be noted that there are a number of government – sponsored efforts to support the activities of mortgage – related financial institutions. Perhaps the most popular is the Federal National Mortgage Association, also known as Fannie Mae, established by Congress in 1938. It later became part of the Department of Housing and Urban Development (HUD) and in 1968 became a privately owned corporation with certain ties to the government.

Fannie Mae buys mortgages from S&Ls and other institutions that no longer wish to hold them as investments and finances these so-called secondary-market operations primarily by issuing bonds to the public.

Fannie Mae's performance in the mortgage market is complemented by the work of Ginnie Mae, more properly called the Government National Mortgage Association. A relative newcomer to the mortgage market scene, Ginnie Mae has a name in connection with the "pass-through" program. Instead of buying mortgages and financing these acquisitions by issuing her own securities, Ginnie Mae guarantees the timely payment of interest and principal on packages of pools of mortgages that are insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA). Private mortgage originators such as savings and loan associations or mortgage bankers put these pools of mortgage together. GNMA pass-through securities are attractive to such investors as pension funds and insurance companies because of their government guarantee and liquidity. The pass-through program has made mortgages look very mush like bonds to some investors, thereby broadening the source of mortgage funds.

In 1970, Congress established the Federal Home Loan Mortgage Corporation (FHLMC). Dubbed Freddie Mac by the investment community, this latest creation does just about what Ginnie Mae does, except that instead of FHA-VA mortgage-backed securities, Freddie Mac creates participation certificates in conventional mortgages and sells them to ultimate investors. As with Ginnie Mae, the objective is to attract non-traditional funds into the mortgage market by packaging individual mortgage loans into a bond like instrument.

All these government and government-sponsored agencies are very active, especially during periods of tight money, in helping to finance mortgage activity. They have, in fact, let to concern in the capital market over the "federalisation of the mortgage market".

3.1.5.7 Credit unions

The first credit union in the country was established in Manchester, New Hampshire in 1909. Credit unions now number 14,000, making the most numerous of the thrift institutions. They have not been subject to the same problems as S&Ls and mutual savings banks, because the bulk of their lending has historically taken the form of relatively short-term consumer's

loans. They may encounter similar problems if they don't watch out, though, because credit unions now engage in mortgage lending as one of their activities.

Credit unions may be federally or state chartered, but the majority has federal charters. State-chartered institutions are regulated and supervised by the states in which they operate and the federally chartered ones by the National Credit Union Administration in Washington. The National Credit Union Share Insurance Fund, run by the National Credit Union Administration, provides deposit insurance (up to $100,000 per depositor) for both state and federally chartered credit unions.

The Current Federal Regulatory Structure In Brief

Federal Reserves (Fed). Established as an independent agency in 1913, supervises and examines state-chartered banks that are members of the FR System and regulates all bank holding companies, regardless of charter.

Comptroller of the currency. Established in 1863 as an office within the US Treasury Department. Charters, regulates, examines, and supervises nationally chartered banks.

Office of thrift Supervision (OTS). Established in 1989 and, like the Comptroller of the Currency, a department within the US Treasury. Charters, regulates, examines, and supervises savings and loan associations. (Until 1989 these functions were performed by the Federal Home Loan Bank Board.)

Federal Deposit Insurance Corporation (FDIC). Established as an independent agency by the Banking Act of 1933. Has historically insured deposits at virtually all commercial banks and most savings banks. Examines and supervises state-chartered banks that are not members of the Federal Reserve System. Given additional Insurance powers in 1989, it now administers:

(a) the *Bank Insurance Fund (BIF)*, which insures deposits at commercial and most savings banks, and
(b) the *Savings Association Insurance Fund (SAIF)*, which insures deposits at savings and loan associations.

(In 1689, the SAIF replaced the FSLIC, the Federal Savings and Loan Insurance Corporation.)

Resolution Trust Corporation (RTC). Managers the closing and/or merging of insolvent savings and loan associations.

Federal Housing Finance Board (FHFB). Oversees the twelve regional Federal Home Loan Banks, a role that until 1989 was performed by the Federal Home Loan Banks Board.

National Credit Unit Administration (NCUA). Established in 1970 as an independent agency to charter, regulate, examine and supervise federal credit unions.

National Credit Union Share Insurance Fund (NCUSIF). Created in 1970 under management of NCUA. Insures deposits at federal credit unions and insured state-chartered credit unions.

US Department of Justice. May review proposed mergers, acquisitions, and related changes in the structure of the financial industry and sue to block those believed to be anti-competitive.

Securities and Exchange Commission (SEC). Established under 1933 and 1934 legislation to regulate securities brokers and dealers and securities markets. Mutual funds, including money market funds, are now also under its jurisdiction. Specifies and enforces public disclosure requirements and regulates "insider" trading. Involved with banks particularly with respect to bank holding companies and public disclosure regarding such matters as problem loans.

3.2 The European System of Central Banks

3.2.1 Organisation of the European System of Central Banks (ESCB)

The ESCB is composed of the European Central Bank (ECB) and the EU national central banks (NCBs). The NCBs of the Member States which do not participate in the Euro area, however, are members of the ESCB with a special status: while they are allowed to conduct their respective national monetary policies, they do not take part in the decision-making regarding the single monetary policy for the Euro area and the implementation of such decisions.

In accordance with the Treaty establishing the European Community and the Statute of the European System of Central Banks and of the European

Central Bank (ESCB Statute), the primary objective of the ESCB is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community and act in accordance with the principles of an open market economy.

The basic tasks to be carried out by the ESCB are:

- to define and implement the monetary policy of the Community;
- to conduct foreign exchange operations;
- to hold and manage the official foreign reserves of the Member States; and
- to promote the smooth operation of payment systems.

In addition, the ESCB contributes to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system, while it also has an advisory role vis-à-vis the Community and national authorities on matters which fall within its field of competence, particularly where Community or national legislation is concerned. Finally, in order to undertake the tasks of the ESCB, the ECB, assisted by the NCBs, shall collect the necessary statistical information either from the competent national authorities or directly from economic agents.

The decision-making bodies of the ECB govern the ESCB: ***the Governing Council, the Executive Board and the General Council.***

The Governing Council comprises all the members of the Executive Board and the governors of the Member States without derogation, i.e. those NCBs, which fully participate in the Monetary Union.

The main responsibilities of the Governing Council are:

- to adopt the guidelines and make the decisions necessary to ensure the performance of the tasks entrusted to the ESCB; and
- to formulate the monetary policy of the Community, including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB, and to establish the necessary guidelines for their implementation.

The Executive Board comprises the President, the Vice-President and four other members; all chosen from among persons of recognised standing and professional experience in monetary or banking matters. They are appointed by common accord of the governments of the Member States at the level of the Heads of State or Government, on a recommendation from the European Council after it has consulted the European Parliament and the Governing Council of the ECB (i.e. the Council of the European Monetary Institute for the first appointments).

The main responsibilities of the Executive Board are:

- to implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council of the ECB and, in doing so, to give the necessary instructions to the NCBs; and
- to execute those powers which have been delegated to it by the Governing Council of the ECB.

The General Council comprises the President and the Vice-President and the governors of all the NCBs, i.e. of both those Member States with as well as those without a derogation. The General Council performs the tasks, which the ECB took over from the European Monetary Institute (EMI) and which, owing to the derogation of one or more Member States, still have to be performed in the third stage.

The General Council also contributes to:

- the ESCB's advisory functions (see above);
- the collection of statistical information;
- the preparation of the ECB's quarterly and annual reports and weekly consolidated financial statements;
- the establishment of the necessary rules for standardising the accounting and reporting of operations undertaken by the NCBs;
- the taking of measures relating to the establishment of the key for the ECB's capital subscription other than those already laid down in the Treaty;
- the laying-down of the conditions of employment of the ECB's staff; and
- the necessary preparations for irrevocably fixing the exchange rates of the currencies of the Member States with a derogation against the Euro.

The ESCB is an independent system. When performing ESCB-related tasks, neither the ECB, nor an NCB, nor any member of their decision-making bodies may seek or take instructions from any external body. The Community institutions and bodies and the governments of the Member States may not seek to influence the members of the decision-making bodies of the ECB or of the NCBs in the performance of their tasks.

The ESCB Statute makes provision for the following measures to ensure security of tenure for NCB governors and members of the Executive Board:

- a minimum renewable term of office for governors of five years;
- a minimum non-renewable term of office for members of the Executive Board of eight years (it should be noted that a system of staggered appointments is foreseen for the first Executive Board for members other than the President in order to ensure continuity);
- removal from office is only possible in the event of incapacity or serious misconduct; and
- the European Court of Justice is competent to settle any disputes.

The ECB's capital is 5,000 million. The NCBs are the sole subscribers to and holders of the capital of the ECB. The subscription of capital is based on a key established on the basis of the EU Member States' respective shares in the GDP and population of the Community. The NCBs of the eleven Member States participating in the Euro area in proportion and up to their shares will pay up the capital of the ECB.

In addition, the NCBs will provide the ECB with foreign reserve assets other than the Member States' currencies, Euro, IMF reserve positions and SDRs, up to an amount equivalent to 50,000 million. The contributions of each NCB are fixed in proportion to its share in the ECB's subscribed capital, while in return each NCB is credited by the ECB with a claim equivalent to its contribution. The ECB has the full right to hold and manage the foreign reserves that are transferred to it and to use them for the purpose set out in the ESCB Statute. The Statute contains specific rules with regard to the calculation of those amounts, which will ultimately determine the profit distributed to the ECB's shareholders.

3.2.2 Objectives and tasks of the European System of Central Banks

The primary objective of the European System of Central Banks (ESCB), as defined in Article 2 of the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute) is to maintain price stability. Without prejudice to the primary objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community. In pursuing its objectives, the ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

The basic tasks to be carried out by the ESCB are defined in Article 3 of the ESCB Statute. These tasks include:

- to define and implement the monetary policy of the Community;
- to conduct foreign exchange operations;
- to hold and manage the official foreign reserves of the participating Member States;
- to promote the smooth operation of payment systems; and
- to contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

Monetary functions and operations of the ESCB:

The ESCB Statute (Articles 17 to 24) specifies the monetary functions and operations of the ESCB. On the basis of these provisions, the European Monetary Institute (EMI) prepared an operational framework for the ESCB's monetary policy. The Governing Council of the European Central Bank (ECB) will take the final decision on the operational framework. The Governing Council of the ECB may decide not to use all the available options or may change certain features of the instruments and procedures presented below. Further detailed information on these issues can be found in the EMI publications entitled "The single monetary policy in Stage Three - Specification of the operational framework" (January 1997) and "The single monetary policy in Stage Three - General documentation on ESCB monetary policy instruments and procedures" (September 1997).
Monetary policy instruments

The operational framework consists of a set of instruments; the ESCB will conduct open market operations, it will offer standing facilities and it may require credit institutions to hold minimum reserves on accounts with the ESCB.

Open market operations

Open market operations will play an important role in the monetary policy of the ESCB for the purpose of steering interest rates, managing the liquidity situation in the market and signalling the stance of monetary policy. Five types of instruments will be available to the ESCB for the conduct of open market operations. The most important instrument will be reverse transactions (applicable on the basis of repurchase agreements or collateralised loans). The ESCB may also use outright transactions, the issuance of debt certificates, foreign exchange swaps and the collection of fixed-term deposits. Open market operations will be initiated by the ECB, which will also decide on the instrument to be used and the terms and conditions for the execution of such operations. It will be possible to execute open market operations on the basis of standard tenders, quick tenders or bilateral procedures. With regard to their aim, regularity and procedures, the ESCB open market operations can be divided into the following four categories:

- The main refinancing operations are regular liquidity-providing reverse transactions with a weekly frequency and maturity of two weeks. They will be executed by the national central banks on the basis of standard tenders and according to a pre-specified calendar. The main refinancing operations will play a pivotal role in pursuing the purposes of ESCB open market operations and provide the bulk of refinancing to the financial sector.

- The longer-term refinancing operations are liquidity providing reverse transactions with a monthly frequency and a maturity of three months. They will be executed by the national central banks on the basis of standard tenders and according to a pre-specified calendar. These operations aim to provide counterparts with additional longer-term refinancing. As a rule, the ESCB will not intend to send signals to the market by means of these operations and will therefore normally act as a rate taker.

- Fine-tuning operations can be executed on an ad hoc basis with the aim both of managing the liquidity situation in the market and of steering interest rates, in particular in order to smooth the effects on interest rates caused by unexpected liquidity fluctuations. Fine-tuning operations will primarily be executed as reverse transactions, but may also take the form of outright transactions, foreign exchange swaps and the collection of fixed-term deposits. The instruments and procedures applied in the conduct of fine-tuning operations will be adapted to the types of transactions and the specific objectives pursued in performing the operations. Fine-tuning operations will normally be executed by the national central banks through quick tenders or bilateral procedures. The Governing Council of the ECB will decide whether, under exceptional circumstances, fine-tuning bilateral operations may be executed by the ECB itself.

- In addition, the ESCB may carry out structural operations through the issuance of debt certificates, reverse transactions and outright transactions. These operations will be executed whenever the ECB wishes to adjust the structural position of the ESCB vis-à-vis the financial sector (on a regular or non-regular basis). Structural operations in the form of reverse transactions and the issuance of debt instruments will be carried out by the national central banks through standard tenders. Structural operations in the form of outright transactions will be executed through bilateral procedures.

Standing facilities

Standing facilities aim to provide and absorb overnight liquidity, signal the general stance of monetary policy and bound overnight market interest rates. Two standing facilities, which will be administered in a decentralised manner by the national central banks, will be available to eligible counterparts on their own initiative:

- Counterparts will be able to use the marginal lending facility to obtain overnight liquidity from the national central banks against eligible assets. The interest rate on the marginal lending facility will normally provide a ceiling for the overnight market interest rate.
- Counterparts will be able to use the deposit facility to make overnight deposits with the national central banks. The interest rate on the deposit facility will normally provide a floor for the overnight market interest rate.

Minimum reserves

Preparatory work has been carried out with a view of enabling the ESCB to impose minimum reserves as from the start of Stage Three. It will be up to the Governing Council of the ECB to decide whether minimum reserves will actually be applied. Any minimum reserves system would be intended to pursue the aims of stabilising money market interest rates, creating (or enlarging) a structural liquidity shortage and possibly contributing to the control of monetary expansion. The reserve requirement of each institution would be determined in relation to elements of its balance sheet. In order to pursue the aim of stabilising interest rates, the ESCB's minimum reserves system would enable institutions to make use of averaging provisions. This implies that compliance with the reserve requirement would be determined on the basis of the institutions' average daily reserve holdings over a one-month maintenance period.

Counterparts

The ESCB monetary policy framework is formulated with a view of ensuring the participation of a broad range of counterparts. If minimum reserves are applied, only institutions subject to minimum reserves may access the standing facilities and participate in open market operations based on standard tenders. If no minimum reserves are applied, the range of counterparts will broadly correspond to credit institutions in the Euro area. The ESCB may select a limited number of counterparts to participate in fine-tuning operations. For outright transactions, no restrictions will be placed a priori on the range of counterparts. Active players in the foreign exchange market will be used for foreign exchange swaps conducted for monetary policy purposes.

Underlying assets

Pursuant to Article 18.1 of the ESCB Statute, all ESCB credit operations have to be based on adequate collateral. The ESCB will allow a wide range of assets to underlie its operations. A distinction is made, essentially for purposes internal to the ESCB, between two categories of eligible assets: "tier one" and "tier two" respectively. Tier one consists of marketable debt instruments, which fulfil uniform Monetary Union-wide eligibility criteria specified by the ECB. Tier two consists of additional assets, marketable and non-marketable, which are of particular importance for national financial

markets and banking systems and for which eligibility criteria are established by the national central banks, subject to ECB approval. No distinction will be made between the two tiers with regard to the quality of the assets and their eligibility for the various types of ESCB monetary policy operations (except for the fact that tier two assets are normally not used in outright transactions). The eligibility criteria for underlying assets to ESCB monetary policy operations are the same as those applied by the ESCB for underlying assets to intra-day credit. Furthermore, ESCB counterparts may use eligible assets on a cross-border basis, i.e. they may borrow from the central bank of the Member State in which they are established by making use of assets located in another Member State.

Key for the ECB's capital

1 December 1999

Following the notification issued by the Commission of the European Communities of revised GDP statistical data, it was decided to adjust the shares of the national central banks in the key for the capital of the European Central Bank (ECB) to the following percentage rates:

Nationale Bank van Belgie/Banque Nationale de Belgique	2.8658%
Danmarks Nationalbank	1.6709%
Deutsche Bundesbank	*24.4935%*
Bank of Greece	2.0564%
Banco de España	*8.8935%*
Banque de France	16.8337%
Central Bank of Ireland	0.8496%
Banca d'Italia	14.8950%
Banque centrale du Luxembourg	0.1492%
De Nederlandsche Bank	4.2780%
Oesterreichische Nationalbank	2.3594%
Banco de Portugal	1.9232%
Suomen Pankki	1.3970%
Sveriges Riksbank	2.6537%
Bank of England	14.6811%

3.2.3 The European Central Bank (ECB)

The European Central Bank was established in June 1st, 1998. Thus, this is one of the world's youngest central banks. The legal basis for the European

Central Bank and the European System of Central Banks is the Treaty establishing the European-Community.

In May 1998 the European Council invited the large majority of countries (11) which were able to meet the Maastricht convergence conditions to join the European Monetary Union (EMU). The four non-members were the United Kingdom, Denmark, Sweden, which all opted out, and Greece, which alone failed to meet the convergence conditions.

The European Central Bankor Eurofed ensures a common monetary policy, and governments had to follow precise targets on public debt and the way in which public deficits were financed. Ceding financial power to a new central financial body was seen to be more effective and efficient than continuing weakly co-ordinated policies by existing National Central Banks.

The European System of Central Banks involves the National Central Banks (NCBs) and the European Central Bank. The European Central Bank is dominant in policy-making and has exclusive authorisation and control of currency issue. Most monetary operations are decentralised to the National Central Banks. The ESCB's main instrument of control is open-market operations plus other instruments undertaken at the initiative of the European Central Bank.

The European Central Bank has in its statutes the goal of price stability, whereas the US Federal Reserve Bank also has to consider output and employment as well as inflation. For inflation, no numerical target is set, whereas the European Central Bank had set a tight limit at less than 2 per cent per annum. There are also concerns about the undemocratic nature of the European Central Bank in setting the targets and implementing them. In the United Kingdom, for example, the Chancellor of the Exchequer sets the inflation targets, leaving the implementation to the Bank of England – the latter is also more in publishing its minutes.

The legal basis for the ECB and the European System of Central Banks (ESCB) is the Treaty establishing the European Community. According to this Treaty, the ESCB is composed of the ECB and the national central banks of all 15 EU Member States. The Statute of the European System of Central Banks and of the European Central Bank was attached to the Treaty as a protocol.

The highest decision-making body of the ECB is the Governing Council. It consists of the six members of the Executive Board and the 11 governors of the national central banks of the Euro area. The President of the ECB chairs both the Governing Council and the Executive Board.

The key task of the Governing Council is to formulate the monetary policy of the Euro area. Specifically, it has the power to determine the interest rates at which commercial banks may obtain liquidity from the central bank. Thus the Governing Council indirectly influences interest rates throughout the Euro area economy, including the rates that commercial banks charged their customers for loans and those that savers earn on their deposits.

The Executive Board of the ECB consists of the President, the Vice-President and four other members. All are appointed by common accord of the Heads of State or Government of the 11 countries, which form the Euro area.

The Executive Board is responsible for implementing the monetary policy as formulated by the Governing Council and gives the necessary instructions to the national central banks for this purpose.

The third decision-making body on the ECB is the General Council. It comprises the President and the Vice-President of the ECB and the governors of all 15 national central banks of the EU Member States. The General Council contributes to the advisory and co-ordinating functions of the ECB and to the preparation for the possible enlargement of the Euro area.

The working units of the ECB are grouped in Directorates General, Directorates and Divisions, overall responsibility for which lies with individual members of the Executive Board.

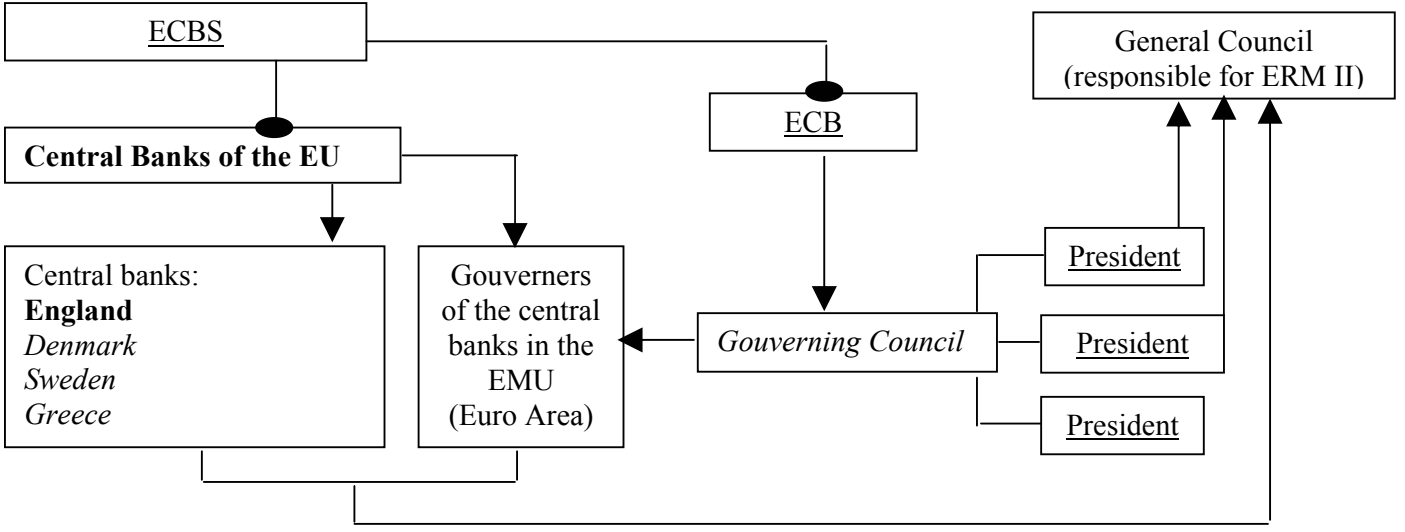
Independence is vital to the operational success of any central bank. Thus, the ECB has its own budget, independent of that of the European Community. This keeps the administration of the ECB separate from the financial interests of the Community.
The capital of the ECB does not come from the European Community but has been subscribed and paid up by the national central banks.

At an international level, arrangements exist for the ECB to be represented at the International Monetary Fund (IMF), one of the key elements of the international monetary system, and at the Organisation for Economic Co-operation and Development (OECD). The ECB participates in meetings of these international organisations with the sole aim of exchanging information. The independence of the ECB is thus fully respected.

Progress test

1. Describe the structure of the Federal Reserve System.
2. What are the instruments of Central Banking?
3. Explain how the discount rate influences the American financial market.
4. Describe the Open market operations.
5. Describe the activity of the FDIC.
6. What are the savings banks?
7. What are mortgage-related financial institutions?
8. What are credit unions?
9. Describe the organisation of the ESCB.
10. What are the main tasks carried out by the ESCB?
11. What are the main responsibilities of the Governing Council?
12. What are the main responsibilities of the General Council?
13. What are the main monetary policy instruments of the ESCB?
14. What is the ECB?
15. Describe the ESCB's structure and its main tasks.

ANNEX No 1


ECBS
General Council
(responsible for ERM II)
ECB
Central Banks of the EU
Central banks:
England
Denmark
Sweden
Greece
Gouverners of the central banks in the EMU (Euro Area)
Gouverning Council
President
President
President

ANNEX No 2

TASKS OF THE ECB:

- IMPLEMENT THE MONETARY POLICY
  - Price stability
  - Sustainable economic growth
- SUPPORT THE GENERAL ECONOMIC POLICIES OF THE EU
- CONDUCT THE FOREX EXCHANGE OPERATIONS
- HOLD AND MANAGE THE OFFICIAL FOREIGN RESERVES OF THE MEMBER STATES
- PROMOTE SMOOTH OPERATION OF THE PAYMENT SYSTEMS (ADOPTING *TARGET)*