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The American Financial System and the Federal Reserve Bank: An Institutional Approach

Insights for the Regulation of the Brazilian Banking System

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Introduction

Brazil is facing a serious banking crisis since the implementation of its 1994 stabilization plan — the "Plano Real" . Two major private commercial banks have gone bankrupt and few others are reported to face severe liquidity shortages.

By and large, the current low inflation rate, compared to what had prevailed in Brazil in the last two decades, and the unprecedented high real interest rates are said to account for the breakdowns. However, the Central Bank has found evidence that those banks were in trouble even before the inflation rate came down. One of them was caught with forged balance sheets. Now, the real issue is: was the Central Bank unable to detect banking misconduct or was it not sufficiently insulated from political pressures to do what it is supposed to. That brings us to the issue of central bank independence.

The banks with solvency problems were bailed out by the Central Bank and absorbed by other banks. The Central Bank financed these operations by using reserve deposits of the banking system itself, not from the Central Bank or the Treasury, arguing that it was curbing a potential systemic crisis with possibly far reaching repercussions.

There is also a more chronic banking crisis that Brazil has dealt with in the last 25 years and still no solution has came out: the state-owned banks. The Brazilian Constitution allows the states to run their own banks. Supposedly, these banks would enhance competition with the private sector, foster local development and centralize the state cash-flow management.

Until the end of the 1970's, this arrangement seemed to work quite well. By that time the states were financing their budget deficits with easily-obtained external loans. After the 1982 Latin America Debt Crisis, the state governors, instead of balancing their budgets, used their banks deposit liabilities for pork-barrel activities, or even worse, as though it were tax revenue. Of course, such procedures would lead to bankruptcy unless the federal government intervened. That's exactly what happened.

The Central Bank interventions in state-owned banks have become very frequent. Once an intervention was lifted, everything started over again, especially in an election year.

This paper is part of a larger research project on the characteristics and institutional framework for the Brazilian financial system and its Central Bank. How can Brazil eliminate or reduce substantially any incentive for the banks, either private or public, to put public savings at risk. "Incentive" can be understood as the positive outcome of a confrontation between any illegal procedure and the risk of punishment. Also, the banks institutional framework should be able to end the moral hazard involved in repetitive Central Bank intervention in state banks.

Article 192 of the Brazilian Constitution of 1988, which requires that the national financial system be regulated by a supplementary law, is expected to be voted by the Congress in the near future. The paper's main objective is to review the institutional arrangement that enables the Federal Reserve to have a relative good record of low inflation and a stable financial system in the last few decades. Hopefully, that information will lead to some insights on what the Brazilian banking system should be like and what should be avoided. It is not the case of getting a recipe or rule of thumb for Brazil's financial system based on the American experience, especially since we have different historical and cultural backgrounds. Instead, the information can be helpful as a reference for the reform of our financial system.

Contents

Chapter 1

The Federal Reserve Mandate and Its Institutional Setting

The Federal Reserve System was established in 1913 after a series of banking crisis. A particularly severe one occurred in 1907, which helped to soften the historical opposition to government intervention in finance. The Congress formed the National Monetary Commission to design an institution which ended up limiting the power of the banking system by taking its central banking capabilities away from them.

That was accomplished by President Woodrow Wilson’s modifications on the Glass-Wills proposal by introducing the Board of Governors as the ultimate authority within the system. President Wilson wanted a central nonprivate board to control and coordinate the work of the regional banker-dominated Reserve Banks of the original proposal.

The Congress passed the Federal Reserve Act and President Woodrow Wilson signed it into law on December 23, 1913.

At the first onset, the Federal Reserve received a quite imprecise mandate: banking supervision, " furnish an elastic currency" and "other purposes".

Price stability was not expressly defined as a primary objective for the central bank to pursue. With such a vague statement, the Federal Reserve Act had to be supplemented. Several laws were introduced especially those during the New Deal which took power away from the Reserve Banks to Washington.

The Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978 set three-tiered mandate for the Federal Reserve: price stability, economic growth in line with the potential of the economy and a high level of employment. Since no one objective has priority over the others, this arrangement can bring about conflicts on what policy should be adopted in time of economic distress. Despite this, the Federal Reserve has been independent enough to target price stability as its primary goal. This autonomy of maneuver, however, can never be taken for granted because it does not come from statutes but, rather, from tradition.

The Structure of the Federal Reserve System

The Federal Reserve System has a three-level structure — Board of Governors, Federal Reserve Bank and its Branches — so that it is possible to have timely and accurate information on the economic activity all over the nation.

The Board of Governors is placed on the top of the system. It is made up of seven members. They are nominated by the President of the United States and confirmed by the Senate for a non-renewable fourteen year term. The appointments are staggered in such a way that one term ends on January 31 of every even-numbered year. The Chairman and Vice-Chairman are chosen among the Governors by the President and confirmed by the U.S. Senate. They have a four year term and can be reassigned as long as they remain Governors.

The Chairman is the official authority to speak for the Federal Reserve. This prevents speculative waves caused by leakage to the market of conflicts of opinions within the Federal Reserve. The Chairman also represents the agency internationally as well as domestically. Internally, he is the speaker before the Congress, the Executive branch, and the public; abroad, he serves as the Alternate Governor for the United States at the IMF, World

Bank, BIS and G-7 meetings. the Chairman works as a consensus-builder within the Board. Without consensus, his position can no longer be sustainable.

The Federal Reserve System reaches all regions of the nation through the Federal Reserve Banks and their twenty-five branches. Each Federal Reserve Bank is located in a major city within a region over which it has jurisdiction over. Each region is called "Federal Reserve District" and is identified by a letter and a number (table 1.1).

Table 1.1 - **Federal Reserve District Banks and Branches**

Number	**Letter**	**Bank**	**Branch**
1	A	Boston	
2	B	New York	Buffalo, N.Y.
3	C	Philadelphia	
4	D	Cleveland	Cincinnati, Ohio Pittsburg, PA
5	E	Richmond	Baltimore, Md. Charlotte, N.C.
6	F	Atlanta	Birmingham, Ala Jacksonville, Fla. Miami, Fla. Nashville, Tenn. New Orleans, La
7	G	Chicago	Detroit, Mich.
8	H	St. Louis	Little Rock, Ark.
9	I	Minneapolis	Louisville, Ky. Memphis,Tenn.
10	J	Kansas City	Denver, CO Oklahoma City, Okla. Omaha, Nebr.
11	K	Dallas	El Paso, TX Houston, TX.

			San Antonio, TX
12	L	San Francisco	Los Angeles, CA Portland, Ore Salt Lake City, Utah Seattle, WA

Source: The Federal Reserve System: Purposes & Functions

They Operate a nationwide payments system, furnish currency and coin, supervise and regulate member banks and bank holding companies, and serve as banker for the U.S. Treasury.

The FRB of New York is the most important among the Federal Banks. It oversees the most prominent slice of the American financial system, the New York Fed has some privileges such as permanent voting right on open market decisions and a stronger voice before the Board of Governors.

The Reserve Banks have both private and public representatives seated on their own 9-member Board. The directors are divided up into classes. Three directors represents commercial banks that are members of the Federal Reserve System (class A Director); three other are also elected by the commercial banks but are supposed to represent the public (class B). Finally, the last three class C Directors are appointed by the Board of Governors which also chooses two of them to be the Chairman and the Chairman Deputy. An employee can be class C Director or even Chairman but is not allowed to represent commercial banks as a class A or B Director.

The Branches, in turn, have their own board whose members are nominated by the Branch’s Reserve Bank.

Note that the original selection of 12 Banks reflected U.S. economy in 1913, not 1996. Hence, the West is underrepresented. The entirely western United States is represented only by the Federal Reserve of San Francisco. Major economic centers like Seattle or Los Angeles have no Bank.

Federal Open Market Committee

The first two classical instruments of monetary policy are: the discount window, and reserve requirements which are decided by the Board of Governors alone.

Although they are very powerful, the third one seems to be more important: open market operations. Not only those been carried out domestically but foreign currency transactions associated with the open market as well.

Open Market operations are carried out by the Federal Reserve of New York under directions of a twelve member committee which decides by majority vote of its members.

Yet, the Board of Governors always has majority voting power. All seven members in the Board have a seat in the FOMC. The remaining 5 votes go to the Federal Reserve banks according to a rotating criteria, except for the Federal Reserve Bank of New York, which has permanent voting rights.

The FOMC holds eight meetings every year. A major decision to take is whether the Fed funds rate and the Fed discount rate are in their most appropriate level. Apparently, it is not a difficult task. However, considering the wide spread effects that a change in interest rates sets throughout the economy, it becomes a major issue. FOMC members have to be well acquainted with a very broad set of topics ranging from economics to politics in order to make their votes as accurate as possible.

During the preceding 2 weeks before the September 24, 1996 FOMC meeting, the Wall Street Journal coverage on foreign exchange matters gives some indications on what would possibly have influence on their votes:

September 10

"The Dollar hit its highest level against the Deutsche Mark since July 16, when it plunged amid stock market volatility. Yesterday performance was a continued response to last week's strong US job growth data and expectations of higher interest rates."

" Mr. Tietmeyer, speaking as a Chairman of the group of ten central banks governors meeting in Basle, Switzerland, warned against overestimating Germany's economic recovery."

September 11, 1996

"Oil futures prices jumped in commodities trading amid indications that Iraq is rebuilding its air defense. Iraq is ignoring US warnings and rebuilding damaged air defense systems, and President Clinton will probably order another attack in coming days."

September 12, 1996

"Labor markets tightened and wages rose modestly, but price increases were notably absent according to a Federal Reserve Survey of economic conditions around the nation.

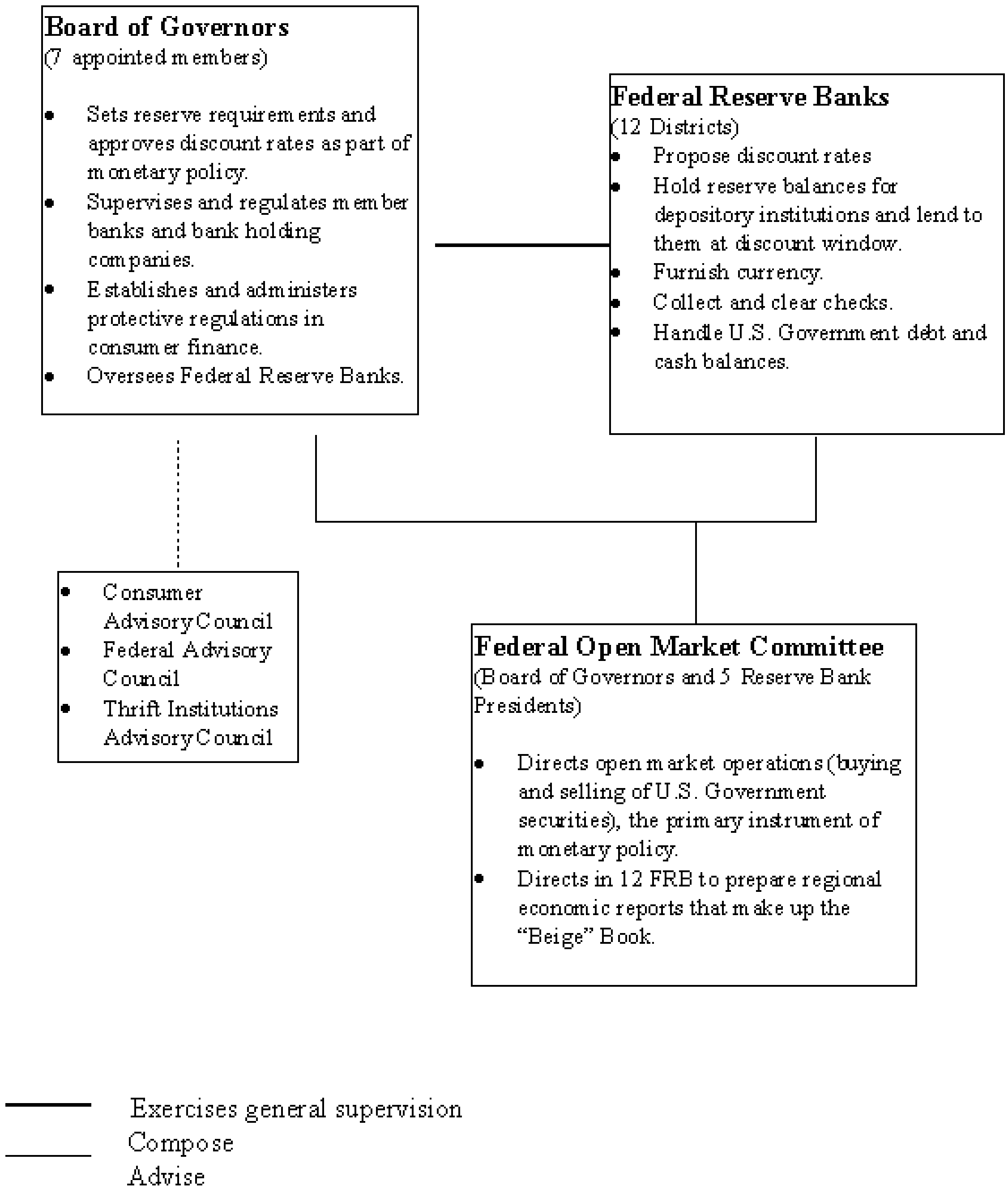
"The Fed is closely watching for two inflationary red flags: a rapidly accelerating economy or notable wages pressures and this latest report known as the Beige Book offered a little confort on both points".

September 19, 1996

"The US Trade deficit widened by US$ 3.49 billion in July to US$ 11.68 billion, its worst level since 1992. A surge in crude-oil imports added to the gap."

A subcommittee formed by the Chairman, Vice-Chairman and the President of the Federal Reserve Bank of New York can deliberate, if they are allowed to by the full Committee, upon intervention in the foreign exchange market.

The institutional setting of the Federal Reserve System alone (table 1.2) gives only a blurred picture of the institutional framework affecting the banking system. To have a sharper image, one has to have a bird's-eye view of the macrosystem comprising not only the Fed but all public agencies related to it.



Chapter 2

Other Agencies Related to the Federal Reserve

Although the Federal Reserve has a very autonomous decision make process. It shares some of its functions with other related agencies within government.

U.S Congress

Congress has the most influence upon Federal Reserve since it is the ultimate democracy representative which Fed should be accountable for. Congress transfer some legitimacy to the Fed through the ratification of its unelected Chairman and Vice-Chairman who were appointed by the President. The flip side of this is that they can use that prerogative as a way to gain some influence on monetary policy. Besides that, the Congress has a permanent, though rarely used, ability to change the law that gave birth to the Fed: the Federal Reserve Act. That represents a potential threat to its mandate. The Board Chairman also reports to the Congress twice a year on monetary growth and its correlation with the prospects of economy.

Executive Branch

There are some episodes in Fed history supporting the thesis that the Treasury and the Federal Reserve have battled for monetary autonomy.

During the Second World War, the Federal Reserve abandoned monetary policy as it monetized all Treasury debt issued to power the warfare economy. After the war, in a resort to keep its independence, the Fed compromised to pay the Treasury about 90 percent of its earnings (Jackson, 1989).

For similar reasons, the monetary and fiscal authorities came to an agreement in 1951 during the Korean War. As Federal Reserve refused to go in line with Government spending.

" The Treasury and the Federal Reserve System have reached full accord with respect to debt management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the government's requirements and, at the same time, to minimize the monetization of the public debt"

The Federal Reserve took this unclear jointed announcement (The Accord, as it became known) by fiscal and monetary authority as an independence certificate to do whatever was necessary to get inflation down.

Conflicts involving Fed and other agencies bring about the issue of coordination. How can they cooperate when they have different objectives?

Chapter 3

The Problem of Coordination of Economic Policy

Coordination can be thought of as a non-conflict combination of Treasury and Fed policy toward common objectives. In that sense, the fiscal policy and its pattern of revenues/expenditures carried out by the Treasury should be reasonably compatible with Fed's target on money supply and interest rates to achieve the common goals.

Modern macroeconomic theory accepts the intimate connection between monetary and fiscal policy and that each policy must be designed and implemented taking the other policy into account. Leeper argues that people will lend to government only if they have no doubts about government's capacity to pay it off. Therefore, monetary and fiscal policy should cooperate to assure government solvency. One may question whether government solvency should be a primary objective, regardless of the quality of expenditures on the fiscal side. The downside regarding government indebtedness is that it creates a perverse incentive for the government to inflate the currency and, by doing so, taking wealth away from the lenders to the borrowers.

To prevent this moral hazard some countries have traded-off coordination with more independence for the monetary authority. The price for that independence can be very high when the central bank pursued the wrong policy. Right after the oil prices skyrocketed in 1973, a severe downturn occurred in the American economy. During that time Federal Reserve fought price hikes based on shortage on energy with tight monetary policy (Jackson, 1989). That policy was not only totally ineffective, it actually worsened the bust.

After that, Congress passed a nonbinding resolution requiring the Board of Governors to consult with Congress on semiannual hearings before both House and Senate Committees on Banking about the Board of governors' and Federal Open Market Committee's objectives and plans with respect to the ranges of growth or diminution of monetary and credit aggregates in the upcoming twelve months.

Congress always seems to change the rules when the damage is already on the way. In 1922, Congress reacted to the supposed inability of Fed to prevent the economic downturn in the two preceding year by change the Board's composition. They added members to represent the financial, agricultural, industrial, commercial and geographical divisions of the country. This new arrangement showed its weakness in 1927, when speculation led to bust and implosion of the banking system (Jackson, 1989). The monetary advisory to the Federal Reserve of New York noted that 1920s monetary policy :

"...failed to restrain the speculative credit boom of 1929, which culminated in the stock market crash. Federal Reserve actions to raise interest rates in order to stem a gold outflow in the fall of 1931 contributed to the catastrophic collapse in the economy that led to widespread bank failures and raised unemployment from 3 percent of the civilian labor force in 1929 to 25 percent in 1933."

United States Congress have distributed macropolicy powers with many agencies. In the case of Treasury and Federal Reserve, they are independent to choose whatever policy they consider necessary to achieve their goals.

According to the so-called "intertemporal budget constraint", monetary and fiscal policy should not collide in the long-run because the current net worth of the government equals the discounted value of its expected future net income. Therefore, the inflation-adjusted value of government debt, which is related to monetary policy, and fiscal choices for the future, which are defined by the fiscal policy, are bound together. The policies must interact in such a way that real government debt increases should be offset sometime in the future by higher revenues or lower expenditures

Of course, this is a long-run perspective which sometimes is overruled by short-run objectives. That has happened in Japan recently. The Minister of Finance has ran an expansionary fiscal policy while the Bank of Japan pushed interest rates down so that the common objective of boosting the aggregate demand can be fulfilled. They change the coordination in the short-run, not in the long-run. In the case of United States, by and large, interests of the monetary policy and fiscal authorities do not clash, except for a few episodes (some of them mentioned before), but when it does, the administration's preferences sometime prevail in USA (Burdekin, 1988).

Chapter 4

The Federal Reserve Independence and Accountability.

Roughly speaking, a central bank is independent when it is free to adopt whatever monetary policy is appropriate and capable of enforcing it until its long-run effects take place, regardless of the short-run pressures or the political cycle. In that sense, the Federal Reserve System enjoys a considerable degree of independence but is still behind the Deutsche Bundesbank. The weaker political stand of the Federal Reserve among the public results in a less secure independence as opposed to the Bundesbank, which is highly respected by the Germans (Henning, 1994, p 101).

In terms of the institutional setting of an independent central bank, some characteristics are always present: the long terms of its governors and the fact that the institution has its own funding, making it more likely to be less responsive to swings in public opinion.

One may argue that such framework does not fit into the democratic system. Yet, independent central banks like Bundesbank and Federal Reserve are always subjected to a legislative amendment in their statutes. Most of the arguments for central bank independence come from the peculiarities of monetary policy and its effects.

There is a short-run and a long-run monetary policy effects. When central bank increases money supply, the employment expands in the short- run but inflation eventually rises in the long-run. Conversely, a tight monetary policy delivers low inflation only after a lag during which unemployment is worsened. If pressures on the central bank lead to a premature reversal of a tight monetary policy, chances are that only the negative short-term unemployment effect is accomplished without any changes in inflation.

A less independent central bank is more likely to change monetary policy back and forth before the long term effects come up. By doing so, it raises the costs of adjustment because the economic agents no long trust the central bank to carry out unfriendly policies. The more credible the central bank is, the least the cost to implement such policies.

Independence brings the issue of discretion, that is, whether central bank should react based on a pre-defined function set by the Congress or should they have absolute discretion . To avoid discretion, Congress would have to specify a policy to be carried out. Friedman suggested rules of growth for the monetary aggregates instead of monetary authority:

If we can achieve our objectives neither by relying on the working of a thoroughly automatic gold standard nor by giving wide discretion to independent authorities, how else can we establish a monetary system that is stable and at the same time free from irresponsible governmental tinkering, a system that will provide the necessary monetary framework for a free enterprise economy and political freedom?

The only way that has already been suggested that offers promise is to try to achieve a government of law instead of men by legislating rules for the conduct of monetary policy that will have the effect of enabling the public to exercise control over monetary policy through its political authorities, while at the same time it will prevent monetary policy from being subject to the day-to-day whim of political authorities."

Lester Thurow has a similar reasoning :

"If the president is competent enough to have his finger on the nuclear button, he is competent enough to control the money supply... If the Congress is competent enough to control taxes and expenditures, it is competent enough to approve changes in the rate of growth of the money supply.."

The problem is that usually presidents or legislative bodies do not have the skills nor the information to set policies *ex-ante*. But even if they do, the short and medium-term relationships between money and the potential of the economy to grow is unpredictable as the rules change the economic environment based on which they rules were set.

Nigel Lawson, during his time as Counselor of Exchequer and mentor of monetary policy, became an advocate of an independent Bank of England that could:

" *be seen locking in an anti-inflationary force into the system, as a counterweight to the strong inflationary pressures which are always lurking and to depoliticize interest rate changes*... " Even an anti-inflationist politician like Mrs. Thatcher had a *"... profound hostility to raising interest rates [and] never objected to lower interest rates".*

In other words, central banks have more market credibility than governments to implement monetary policy.

Many countries have granted their central banks more independence. The modern financial system allows investors to shield themselves against state's inflationary propensity by quickly moving their capital from one nation to another when the red light turns on (Solomon,1995, p 498). In that sense, an independent central bank is more likely to deliver a safe and sound financial system, improving the nation's attractiveness for mobile capital.

The United States is a very peculiar case regarding monetary policy and central bank independence. Bretton Woods granted the Dollar the status of international currency as it emerged from the Second World War overwhelmingly strong, backed by three-fourths of the world gold reserves. By that time, no currency in the world could parallel Dollar in soundness. This situation changed dramatically until 1971 when president Nixon declared the Dollar was no longer freely convertible into gold at the thirty-five Dollars an ounce parity. Even though, Dollar is still perceived as a safe heaven by foreigners trying to preserve their assets from inflation. Net foreign-dollar amounts to more than US$ 600 billion as opposed to the US$ 90 billion domestic-dollar. Fed independence is the best way to make sure the US Government will not be able to give in to the natural temptation to inflating it away.

Chapter 5

Modern central bank roles and the Federal Reserve.

Monetary Policy

The Fed conducts monetary policy in roughly the same way most central banks do in other developed countries. Federal Reserve Act lays out the goals of monetary policy: "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates".

Such a broad mandate often brings about conflicts between short and long-term objectives. In the short-term, price stability policies can hamper output but in the long they reconcile.

To achieve its goals for the economy, the Federal Reserve influences the market for reserves. The Fed is able to manage both supply and demand for reserves at all depository institutions.

In the demand side, there are the required reserves, which can be either held at the
Federal Reserve Banks or retained on the bank premises; and the excess reserves, which are used to cushion possible overdrafts in the bank’s account at the Federal Reserve.

The supply of reserves has two components: borrowed reserves through the discount window and non-borrowed reserves as a result of Open Market operations carried out by the Fed. The net effect of the Fed policies will pressure interest rates toward Fed’s objectives. Some difficulty arises as the Fed has to evaluate whether or not its operations in the reserve market are consistent with those objectives.

The Fed also has considerable power over the interest rate by which banks borrow money from each other. The so-called Fed Funds rate is currently set to 5.5 % a.a. while discount rate is 5%. Despite the discount rate is lower, banks are not expected to resort to the Fed whenever they face liquidity problems. Banks fear that market may perceive successive use of discount window as a sign of weakness.

Therefore, equilibrium is reached in the reserves market when the demand for required and excess reserves equals the supply of borrowed and non-borrowed reserves. Any change in the supply of reserves starts a chain of events that eventually affects the real economy.

Although the Fed can act with secrecy to achieve its goals of monetary policy, the goals themselves have to be publicized. The Humphrey-Hawkins Act requires the Fed to announce publicly its objectives for growth in money and credit and revise them, if necessary, at midyear.

The Bretton Woods granted the American economy a very distinctive feature. As the dollar became the currency used in all international transactions, even today, after the breaking down of the Bretton Woods system, the US dollar constitutes more than half of other countries official foreign exchange reserves.

In such environment, the United States benefit from that when it prints dollars which not necessarily impact monetary base. In that sense, the United States are capable of non-inflationary money creation.

Currently, the American dollar held domestically amounts to about 90 billion while the foreign dollars totals about 600 billion. The downside to that is the potential impact of the international flows of dollars in the monetary policy. The Board of Governors and the FOMC screen changes in public policies or in economic conditions abroad that affect U.S. economy.

Since the 1980's, the major countries recognized how interdependent they were at the 1986 Tokyo Economic Summit when they agreed upon formal procedures to improve coordination of policies and the multilateral surveillance of their economic performance.

Foreign Exchange Management

The U.S Treasury is formally responsible for the U.S. international financial policy. However it is the Fed who actually conducts foreign currency operations in response to changes in the international monetary system. One of such changes occurred in 1971 when President Nixon declared the dollar was no longer convertible at a fixed rate to the gold and a managed flexible regime would prevail from then on. In such environment, the Fed assumed a more important role by carrying out intervention in the exchange market to prevent violent fluctuation in the value of the dollar.

To enhance its power in this very wild market whose turnover is 12 trillion dollars daily, the Federal Reserve has been part of a reciprocal currency (SWAP) network. This arrangement consists of bilateral agreements between central banks so that they can temporarily borrow foreign currency from each other and, in doing so, boost their intervention power. A swap transaction involves both a spot transaction of purchasing foreign currency for dollars and a forward transaction selling foreign currency for dollars.

During the 80's, the dollar had basically two trends: an upward trend during the first half when a tight monetary policy to take on inflation, led to a rise of the dollar and a downward trend during the second half when representatives of the 5 major countries agreed on the Plaza Accord on exchange rates. The Federal Reserve intervened so frequently by purchasing foreign currency in order to get the dollar down that it eventually became able to support dollar's external value without resorting to swap lines.

Government Financing and Domestic Debt Management

The monetary and control act of 1980 curtailed the Treasury's right to instruct the Fed to purchase a limited amount of Treasury bonds above prior Fed holdings. Currently, the Federal Reserve do not extend credit to the Treasury although it is not prohibited from doing so. A landmark in the Fed policy toward government bonds purchasing occurred during the 40's and early 50's when the Fed depart from its previous policy of purchasing U.S. bonds on the primary market. The Fed came to an accord with the Truman administration under the Congress scrutiny. Since then, the Federal Reserve purchases government bonds only for reserve management purposes in the secondary market.

Lender of Last Resort

This is the one of the very basic and unnoticed functions of central banks, except during banking crisis when it suddenly becomes The issue. The Fed carries it out through the discount window.

Since it involves increases in the demand for reserves, the central bank bailing out of troubled financial institution is limited to the point where currency is about to crash due to excessive money creation.

Promoting Stability of the Financial System

The banking industry is the only one which can never be in financial crisis in an ongoing basis. Actually, they do not need only to be sound, they must be perceived as so too by its customers Its duration mismatch between assets and liabilities make them very fragile in times of distrust.

One reason why preventing banking crisis has become so important is that it always has ripple-offs effects throughout the whole economy, affecting other industries with no relation with the original cause of the crisis. Banking crisis can be an isolated phenomenon, restricted to one institution or can be a symptom of a more structural problem affecting the banking industry or the entire economy.

Central banks should be able to identify whichever the case is and set the appropriate measures.

A market-based approach solution for isolated, small bank failures could be liquidation but this certainly is not the case when large banks suffer from lack of public confidence and large segments of the banking industry are in liquidity shortages. In such scenario, liquidation would make things even worse.

The United States have faced several banking disruption in its monetary history, including the one which made easier the creation of the Federal Reserve System. But in recent times, the savings and loans crisis during the 80's took the attention. Despite the supposed advanced supervisory system, there were 1,100 commercial banks failures and 630 thrift. By 1991, more than US$ 80 billion were spent to bail out thrift industry not to mention the 1991 FDIC Improvement Act which upgrades its insurance fund in more US$ 70 billion. Still, more demands are expected in the future.

Shengs poses a very important question:

How could a debacle of this magnitude occur in a system of this size and sophistication, where no less than five federal and fifty state regulatory agencies oversee deposit-taking activities, and where comprehensive deposit insurance has existed for more than fifty years?

Changes in technology, moral hazard risks of the comprehensive deposit insurance, recession in the early 80's are some of the explanations for the crisis but, of course, the regulatory overlaps should be given some credit. Banks and thrifts can be chartered by federal or state authorities. Over time, however, supervision has fallen on the federal level who guarantees, though not finances, the deposit insurance.

There are 4 federal supervisory agencies: The Office of Thrift Supervision authorizes national thrifts and savings banks, the Office of the Comptroller of the Currency, attached to the the U.S. Treasury, supervises national banks; the Board of Governors of the Federal Reserve oversees bank holding companies and the Federal Reserve Banks are responsible for state-chartered banks that are members of the Federal Reserve System. For the state-chartered banks that are nor members of the Federal Reserve System, FDIC (Federal Deposit Insurance Corporation) take supervision along with state regulatory agencies. The Federal-chartered thrifts are supervised by the SAIF (Savings Association Insurance Fund) which replaced the Federal Savings and Loan Insurance Corporation (FSLIC), extinguished in 1992.

Chapter 6

Insights for the institutional framework of the Brazilian financial system

The 1988 Brazilian Constitution requires a supplementary law to establish the institutional framework to its financial system. That is, the legal set up for the Central Bank, how it interacts with member banks, the role of the public sector in the banking industry (if any), rules for government financing (if so), degree of insulation of the Central Bank from political pressures supporting constituency interests as opposed to the general interest, Central Bank accountability, and especially the scope in which Central Bank will act.

Nowadays, the Central Bank of Brazil carries out a bunch of activities with virtually no relation with most of central banks do around the world. Agricultural insurance, mortgage system, *consorcio*, etc. Moreover, the Board of Directors has no stability and can be fired at President of Republic's will. With such institutional design, the Central Bank has not succeded in what it is mostly expected to do: mantain a stable currency and a sound financial system.

Up to now, Congress did not enact such legislation but when it comes to the agenda. The Federal Reserve settings can give some hints either in what should be pursued or in what should be avoided.

The Federal Reserve independence to seek its legal objectives is something Congress should not disregard. Although the democratic political system has threatened the Federal Reserve, the fact that the independence was not touched is a recognition of its importance for the nation in the long term when all the short term demands looks nearsighted.

Another positive insight is the amount of publication about central banking, the Fed delivers to the market. It a very effective way to get credibility. The quality of the policy research groups are recognized in the financial community.

In the negative side, excessive overlapping in the supervision, although offers some checks and balances to the system, also brings along a very serious problem of coordination not only for the prevention but also in dealing with banking crisis.

The excessive growth in the number of employees is also a important issue. Federal Reserve System has about 18,000 people in its payroll. Even supervising a huge and very sophisticated banking system, are all those people really necessary to carry out its mandate?

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