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SUPPLEMENTARY MATERIAL

Top 4 Central Banks Dominating the World Economy¹

By [Matthew Johnston](#) | August 12, 2015 — 12:50 PM EDT



Central banks play an integral role in today's market economies by maintaining the stability and credibility of the national currencies used in those economies. While a stable currency is important for achieving price stability conducive to stable economic growth within the domestic economy, it's also important in achieving stable exchange rates with common international trading partners. Volatile exchange rates with common

¹ Extracted from: <http://www.investopedia.com/articles/investing/081215/top-4-central-banks-dominating-world-economy.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186>

trading partners mean unstable prices for imports and exports creating a vacillating economic environment in this increasingly globalized economy.

As the U.S. dollar, euro, Japanese yen, and British pound are the four most commonly [used](#) currencies in global payments, the monetary policies of their respective issuers (i.e., central banks) are most important for maintaining international economic stability. (See also [Get To Know The Major Central Banks](#).)

Below are the “Big Four” central banks and their respective stances on monetary policy.

U.S. Federal Reserve

The Federal Open Market Committee ([FOMC](#)) is responsible for devising U.S. monetary policy, which, according to [Federal Reserve documents](#), is mandated to be “promoting maximum employment, stable prices, and moderate long-term interest rates.” The 12 [members](#) of the FOMC meet a minimum of eight times a year in order to determine the most appropriate level for the federal funds rate, the overnight interest rate at which depository institutions lend to each other.

Through the use of a set of monetary tools, the FOMC can affect the federal funds rate, which then affects other interest rates and, consequently, other economic variables, including price level and unemployment. Currently, the FOMC [sees](#) a 2% inflation rate as the most consistent with its statutory mandate and long-run normal rate of unemployment between the range of 5.2% and 5.5%.

Dollar usage: USD [used](#) for 44.64% of global payments as of December 2014.

European Central Bank

The European Central Bank ([ECB](#)) is responsible for the monetary policy of the 19 European Union [countries](#) that use the euro. Comprised of six executive board members and the governors of the 19 central banks of the euro-area nations, its proclaimed mandate is maintaining price stability and safeguarding the euro’s value.

Meeting [twice](#) a month, this governing council analyzes and assesses recent economic developments to determine the appropriate level for key interest rates. The appropriate level of these interest rates is crucial for maintaining the ECB's mission of price stability and maintenance of the euro's purchasing power, which is currently seen as being achieved at a medium-term inflation rate below — but close to — 2%.

Euro's usage: EUR used for 28.30% of global payments as of December 2014.

Bank of England

The monetary policy committee (MPC) of the Bank of England ([BoE](#)) is responsible for the nation's monetary policy, currently [recognized](#) as the maintenance of price stability and confidence in the currency. Traditionally, the BoE achieved its monetary objectives through the interest rate, but in March 2009, it claimed it would begin directly injecting money into the economy through quantitative easing or the direct purchasing of financial assets.

The nine-member committee [meets](#) monthly to assess the economic climate and vote on the appropriate level for Bank Rate — the interest rate the BoE pays on reserve balances — as well as on any [quantitative easing](#) measures to be taken. Through these tools, the MPC looks to [maintain](#) price stability, currently defined as achieved at an inflation rate of 2%.

British pound usage: GBP used for 7.92% of global payments as of December 2014.

Bank of Japan

Japan's monetary policy is decided by the policy board whose stated [mandate](#) is the maintenance of price stability, which constitutes "the foundation for the nation's economic activity." Money market operations are the primary tool used by the [Bank of](#)

[Japan](#) (BoJ). They're how the BOJ controls the amount of funds available in the money market, which consequently affects interest rates within the economy.

Meeting once or twice a month at Monetary Policy Meetings (MPMs), the board discusses the current economic and financial climate and then determines an appropriate guideline for its money market operations. The board's inflation target (at which it sees the achievement of price stability) is currently set at 2%.

Japanese yen usage: JPY used for 2.69% of global payments as of December 2014. (See also [How Central Banks Control The Supply of Money.](#))

The Bottom Line

Unstable prices make consumption and investment decisions by individuals and firms extremely difficult because many of these decisions are based on expectations about future prices. No wonder one of the primary monetary policy objectives common to the Big Four central banks is price stability. One of the essential characteristics of money is that it acts as a stable store of value; any instability in this store-of-value quality of the above currencies could lead to its decreasing use and, consequently, declining influence in the global economy.

Should Central Banks Be Independent?²

By [Sean Ross](#) | August 24, 2016 — 1:00 PM EDT



Central banks were not very popular in mid-2016. In years past, the Federal Reserve and its contemporary banks remained in the background of public discourse. Debate about central bank activity was contained to academic white papers and peer-reviewed journals. Those days have given way to an ever-increasing number of vocal central bank critics, ranging from high-profile politicians to leading financial experts, who question the bank's policies and oft-touted independence.

Critics of Central Banks

Consider the May 2016 [thought leadership piece](#) by PIMCO Global Economic Advisor Joachim Fels, "The Downside of Central Bank Independence," which argued that independent bankers ran amok with "second-best interventions such as quantitative easing (QE) or negative interest rate policy (NIRP), which distort financial markets and

² Extracted from: <http://www.investopedia.com/articles/insights/082416/should-central-banks-be-independent.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186>

can have severe distributive consequences. Also, examine the March 2016 proposal by Joseph T. Salerno, professor of economics at Pace University in New York, called “A Modest Proposal to End Fed Independence.” Salerno pointed out “a number of benefits of stripping the Fed of its quasi-independent status and transforming it into a handmaiden of the Treasury.”

Why Central Banks Are Independent

Historically, governments do not responsibly handle the duty of conducting monetary policy. The most infamous [modern cases](#), Argentina, Hungary, Zimbabwe and pre-WWII Germany, ended in brutal hyperinflation. This is because it is tempting for governments to explode beyond their own budget constraints or for politicians to enrich themselves at the expense of their citizens' purchasing power. In short, the Fed theoretically needs independence to make neutral, politics-free monetary policy decisions without direct political pressures.

For these reasons and several more, most serious policy analysts of the 20th century considered independence a prerequisite for any effective central bank. Calls for reform have only come after the recent and disastrous failures of [contemporary central banks](#), especially the big three: The Federal Reserve, European Central Bank (ECB) and Bank of Japan (BOJ).

Failures of Central Banking

The Fed has had difficulty on two fronts. First there was the massive data leak by Goldman Sachs Group (NYSE: GS). Former managing director Joseph Jiampietro allegedly obtained and shared confidential Fed information to win new contracts, a move that eventually forced Goldman to pay \$36.3 million in a settlement. This episode followed a \$50 million settlement in October 2015 when a different Goldman employee obtained 35 confidential Fed documents.

The second issue is performance. As Mohamed El-Erian wrote for Bloomberg in June 2016, "unconventional central bank policies are overstretched and near exhaustion." More than a half-decade of desperate asset purchases and [interest rate reductions](#) by central banks left the world with unprecedented debt loads, over-inflated asset markets

and rising inequality. The great concern of unchecked government control over the money supply, namely unchecked expansion based on economically dubious experiments, is now official policy for independent central banks.

Calls for Reform

The loudest critics of Fed independence have been House Republicans, particularly those on the Financial Services Committee. In February 2015, Committee Chair Jeb Hensarling (R – TX) opened a hearing by telling Fed Chairwoman Janet Yellen he doubted the Fed’s efficacy and excoriated the central bank for a lack of transparency and accountability. “Fed reform is coming,” Hensarling told Yellen. In July 2016, the Republican party announced that its platform for the 2016 elections will include “advance legislation that brings transparency and accountability to the Federal Reserve.”

Yellen, as with former Chairman Ben Bernanke, has maintained a public profile during her tenure in an effort to appear more transparent. She regularly meets with the White House and Congress, and often gives policy speeches and holds press conferences to highlight Fed activity.

What a New Central Bank Could Look Like

Opinions are shifting quickly. As recently as April 2014, the International Monetary Fund (IMF) held a conference on “Rethinking Macro Policy,” from which the general consensus was “central banks should retain full independence with respect to traditional monetary policy.” By August 2015, the World Economic Forum openly questioned central bank independence and argued that policymakers should go beyond the taboo of coordinating fiscal and monetary policies.

Dr. Salerno recommends a more transparent and limited process controlled by administrative orders between treasury departments and central banks, stealing away the moral hazard of the [lender of last resort](#) and ridding central banks of their coordination with huge financial corporations. Voters would exercise much greater control over the political fortunes of such a process. Mr. Fels shares similar sentiments, contending that it would make more sense if central banks worked in close collaboration with governments and under the control of the democratic process.



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How Central Banks Control The Supply Of Money³

By [Prableen Bajpai, CFA \(ICFAI\)](#) | May 31, 2015 — 1:18 PM EDT

If a nation's economy were a human body, then its heart would be the [central bank](#). And just as the heart works to pump life-giving blood throughout the body, the central bank pumps money into the economy to keep it healthy and growing. Sometimes economies need less money and sometimes they need more. In this article, we'll discuss how central banks control the quantity of money in circulation. (*Related reading* [What Are Central Banks?](#))

The methods central banks use to control the quantity of money vary depending upon the economic situation and power of the central bank. In the United States, the central bank is the Federal Reserve, often called the Fed. Other prominent central banks include the [European Central Bank](#), [Swiss National Bank](#), [Bank of England](#), [People's Bank of China](#), and [Bank of Japan](#). (*Related reading* [Get To Know The Major Central Banks](#))

Why the Quantity of Money Matters

The quantity of money circulating in an economy affects both micro and macroeconomic trends. At the micro level, a large supply of free and [easy money](#) means more personal spending. Individuals also have an easier time getting loans such as personal loans, car loans, or [home mortgages](#).

At the macroeconomic level, the amount of money circulating in an economy affects things like gross domestic product, overall growth, interest rates, and [unemployment rates](#). The central banks tend to control the quantity of money in circulation to achieve

³ Extracted from:

<https://index.investopedia.com/index/?q=central%20bank&o=40186&qo=investopediaSiteSearch&qsrc=998&page=3>

economic objectives and effect the [monetary policy](#). Through this article, we take a look at some of the common ways that central banks control the quantity of money in circulation.

1. Print More Money

As no economy is pegged to a [gold standard](#), central banks can increase the amount of money in circulation by simply printing it. They can print as much money as they want, though there are consequences for doing so. Merely printing more money doesn't affect the output or production levels, so the money itself becomes less valuable. Since this can cause inflation, simply printing more money isn't the first choice of central banks.

2. Set the Reserve Requirement

One of the basic methods used by all central banks to control the quantity of money in an economy is the [reserve requirement](#). As a rule, central banks mandate [depository](#) institutions to keep a certain amount of funds in reserve against the amount of net transaction accounts. Thus a certain amount is kept in reserve and this does not enter circulation. Say the central bank has set the reserve requirement at 9 percent. If a [commercial bank](#) has total deposits of \$100 million, it must then set aside \$9 million to satisfy the reserve requirement. It can put the remaining \$91 million into circulation.

When the central bank wants more money circulating into the economy, it can reduce the reserve requirement. This means the bank can lend out more money. If it wants to reduce the amount of money in the economy, it can increase the reserve requirement. This means that banks have less money to lend out and will thus be pickier about issuing loans.

In the United States (effective January 22, 2015), smaller depository institutions with net transaction accounts up to \$14.5 million are exempt from maintaining a reserve. Mid-sized institutions with accounts ranging between \$14.4 million and \$103.5 million must set aside 3 percent of the liabilities as reserve. Depository institutions bigger than \$103.6 million have a 10 percent reserve requirement.

3. Influence Interest Rates

In most cases, a central bank cannot directly set interest rates for loans such as mortgages, auto loans, or personal loans. However, the central bank does have certain tools to push interest rates towards desired levels. For example, the central bank holds the key to the policy rate—this is the rate at which commercial banks get to borrow from the central bank (in the United States, this is called the [federal discount rate](#)). When banks get to borrow from the central bank at a lower rate, they pass these savings on by reducing the cost of loans to its customers. Lower interest rates tend to increase borrowing and this means the quantity of money in circulation increases.

4. Engage in Open Market Operations

Central banks affect the quantity of money in circulation by buying or selling [government securities](#) through the process known as [open market operations](#) (OMO). When a central bank is looking to increase the quantity of money in circulation, it purchases government securities from commercial banks and institutions. This frees up bank assets—they now have more cash to loan. This is a part of an expansionary or easing monetary policy which brings down the interest rate in the economy. The opposite is done in case where money needs to be taken out from the system. In the United States, the Federal Reserve uses open market operations to reach a targeted [federal funds rate](#). The [federal funds rate](#) is the interest rate at which banks and institutions lend money to each other overnight. Each lending-borrowing pair negotiates their own rate and the average of these is the federal funds rate. The federal funds rate, in turn, affects every other interest rate. Open market operations are a widely used instrument as they are flexible, easy to use, and effective.

5. Introduce a Quantitative Easing Program

In dire economic times, central banks can take open market operations a step further and institute a program of quantitative easing. Under [quantitative easing](#), central banks create money and use it to buy up assets and securities such as [government bonds](#). This money enters into the banking system as it is received as payment for the assets purchased by the central bank. The [bank reserves](#) swell up by that amount, which

encourages banks to give out more loans, it further helps to lower long-term interest rates and encourage investment. After the [financial crisis](#) of 2007-2008, the Bank of England and the Federal Reserve launched quantitative easing programs. More recently, the European Central Bank and the Bank of Japan have also announced plans for quantitative easing.

The Bottom Line

Central banks work hard to ensure that a nation's economy remains healthy. One way central banks do this is by controlling the amount of money circulating in the economy. They can do this by influencing interest rates, setting reserve requirements, and employing open market operation tactics, among other approaches. Having the right quantity of money in circulation is crucial to ensuring a healthy and sustainable economy.



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Yes, Central Banks Can Create Inflation. Just Ask Argentina⁴

Argentina's experience illustrates why central banks are so reluctant to employ 'helicopter money'



Argentine Finance Minister Alfonso Prat-Gay, shown earlier this month at an event in Washington, D.C., wants to restore the traditional boundaries between monetary and fiscal policy.

PHOTO: NICHOLAS KAMM/AGENCE FRANCE-PRESSE/GETTY IMAGES



By **GREG IP**

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⁴ Extracted from: <http://www.wsj.com/articles/yes-central-banks-can-create-inflation-just-ask-argentina-1461767299>

With inflation in the U.S., Japan and the eurozone stuck below their 2% targets, central banks are asked regularly if they have the tools to prod it higher. A better question would be: Do they have the will?

There is a tool virtually guaranteed to create inflation. It's called helicopter money—named for the image of dropping cash from helicopters—and consists of a central bank explicitly printing money to finance increased government deficits.

Embracing helicopter money would erase the boundary between highly politicized fiscal policy and scrupulously independent monetary policy. That boundary is sacred not just to central bankers, but also to governments that correctly view it as a bulwark against economic adventurism. That's why the world economy will have to look a lot worse before central banks and governments go down that road.

To understand the taboo, examine a country—Argentina—only now extricating itself from years of de facto helicopter money, which is also called monetary finance.

After Argentina defaulted in 2001, some bondholders refused to accept the government's settlement and, through the U.S. courts, locked Argentina out of global capital markets. Unable to borrow from underdeveloped domestic markets and unwilling to cut its deficit through lower spending or higher taxes, the government turned to the central bank. Central bank temporary advances and transfers of profits to the treasury, both forms of money printing, shot from 4 billion pesos in 2007 to 159 billion pesos last year, equal to 3% of gross domestic product.

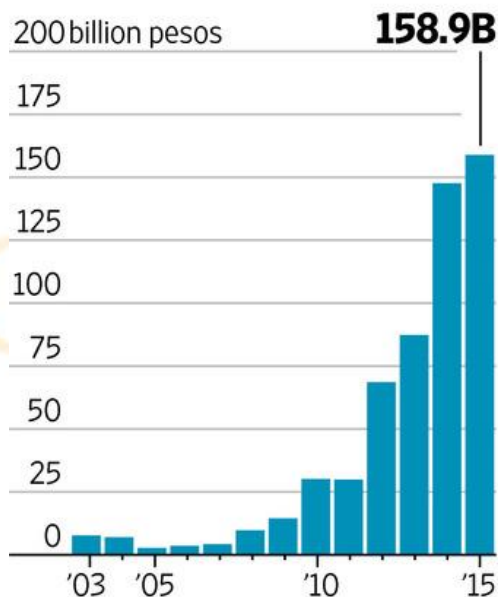
"The central bank was lender of first resort to the treasury," Alfonso Prat-Gay, who ran the central bank from 2002 to 2004 and is now the country's finance minister, said in a recent interview.

Money printing had the predicted effect: Inflation skyrocketed. Exactly how much is not known because under the previous president, Cristina Kirchner, the data was manipulated. Elypsis, a private firm, reckons inflation was 25% last year, up from 6% in 2009. Other factors fueled the rise, including import and capital controls that undermined the economy's productive potential.

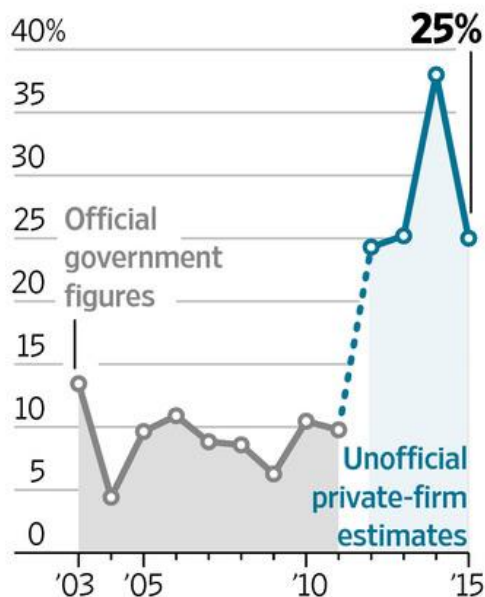
A Surefire Way to Ignite Inflation

For years, Argentina's central bank was forced to print money to finance the government deficit. That sent consumer prices sharply higher.

Central-bank advances and transfers to the government



Annual consumer-price inflation



Note: Official inflation estimates become increasingly unreliable after 2012, at which point the rate is better captured by unofficial estimates.

Sources: Central Bank of Argentina (loans and transfers), IMF (inflation before 2012), Elypsis (inflation 2012 and after)
THE WALL STREET JOURNAL.

Mauricio Macri ousted Ms. Kirchner as president last November and set out to undo her epic mismanagement of the economy. As his finance minister, Mr. Prat-Gay quickly worked out a settlement with the holdouts from the 2001 default. Last week, he oversaw

Argentina's return to global capital markets with an oversubscribed \$16.5 billion bond issue, proceeds of which were used to pay the holdouts.

Regaining access to the markets is essential to ending the treasury's dependence on monetary finance and thus bringing inflation down to earth. Mr. Prat-Gay has promised to limit borrowing from the central bank this year. Inflation, after spiking as utility subsidies are withdrawn, should fall sharply next year.

Mr. Prat-Gay wants to restore the separation between monetary and fiscal policy that is taken for granted in other countries. Indeed, when I asked him a question about monetary policy, he admonished me, "You would not ask that question of Jack Lew, would you?" (No, the U.S. Treasury Secretary doesn't comment on the independent Federal Reserve.)

Just because monetary finance was disastrous for Argentina doesn't mean it has to be. In 1942, the Fed promised to buy as much debt as necessary to finance the U.S. war effort and by 1945, it had bought debt equal to 9% of annual GDP, most of which it never sold. To meet both military and civilian demands, the economy went into overdrive. The resulting boom in productivity and employment lasted well after the war ended.

It also resulted in inflation which, despite wartime wage and price controls, averaged 7% from 1940 to 1948. That was enough to make the Fed determined to wriggle out of the Treasury's grasp, which it did, in 1951.

If the Fed could create inflation then and Argentina's central bank can now, why has it proven so difficult for the Fed, the European Central Bank and the Bank of Japan? It's not enough to print money; the money has to be spent. Whereas Argentina printed money because the government needed it to finance spending, the Fed, ECB and Bank of Japan acted independently, at a time when their governments have been trying to rein in their borrowing.

True helicopter money means the government announces a big spending boost or tax cut and the central bank promises to print money to finance it, and to never withdraw that money from circulation. This persuades households that taxes won't go up but prices will. That amplifies the impact on both spending and, by altering inflation expectations, actual inflation. This is not a surgical operation; once expectations become unanchored, there's no guarantee inflation will rise to 2% and stop.



The Argentinian central bank's temporary advances and transfers of profits to the treasury, both forms of money printing, shot from 4 billion pesos in 2007 to 159 billion pesos last year, equal to 3% of gross domestic product.

PHOTO: VICTOR R. CAIVANO/ASSOCIATED PRESS

These are bridges today's central banks aren't ready to cross. Bank of Japan governor Haruhiko Kuroda will try almost anything to raise inflation. But not helicopter money, he insisted in a recent interview: "No. Monetary policy and fiscal policy are decided and managed by separate authorities."

Most central banks today feel the same way. The ECB is constitutionally barred from monetary finance. Asked about helicopter money last week, its president, Mario Draghi, noted it is "fraught with operational, legal and institutional difficulties."

Monetary independence is not itself a goal; it's a means to an end, which means low unemployment and inflation around 2%. Unhappy as they are with today's low inflation and weak growth, central banks and the public are not unhappy enough to risk 7% inflation, much less 25%. Things are going to have to get a whole lot worse.