Unit 5 Professional English by M. Belogash

CENTRAL BANKING

5.1 Getting started.

Among the most important players in financial markets throughout the world are central banks, the government authorities in charge of monetary policy. Central banks' actions affect interest rates, the amount of credit, and the money supply, all of which have direct impacts not only on financial markets, but also on aggregate output and inflation. To understand the role that central banks play in financial markets and the overall economy, we need to understand how these organizations work. In this unit we look at the institutional structure of major central banks and focus particularly on the Federal Reserve System of the USA. We start by focusing on the formal structure and then examine the more relevant informal structure that determines where the power within the Federal Reserve System lies.

Discuss the following points:

1. Who do you think controls central banks and determines their actions?
2. What motivates their behavior?
3. Who holds the reins of power in central banks?

5.2 Look through the following vocabulary notes which will help you understand the text and discuss the topic.

a Central bank	Центральный банк
an authority	орган власти, право, полномочие
government authorities	правительственные органы
bank panic	банковская паника
a monetary policy	монетарная/денежная политика

a fiscal policy	фискальная/налоговая политика
money supply	запас денежной массы
aggregate output	совокупный продукт
the Federal Reserve System (the Fed)	Федеральная резервная система
the Board of Governors	Совет управляющих
the Federal Open Market Committee	Комитет Федерального открытого рынка
the Federal Advisory Council	Федеральный консультационный совет
the Federal Reserve Bank	Федеральный резервный банк
(ir)relevant	(не)относящийся, (не)уместный
the reins of power	бразды правления
(de)centralized power	(де)централизованная власть
bank failure	крах/банкротство банка
hostile	враждебный
hostility	враждебность
elaborate	искусно сделанный, сложный
checks and balances	система сдержек и балансов
to diffuse	рассеивать, рассредоточить
open market operations	операции на открытом рынке
a discount rate	учетная ставка, ставка рефинансирования
a discount loan	дисконтированная ссуда, краткосрочная ссуда выданная Центробанком коммерческому банку за вычетом комиссионных и процента
a discount window	дисконтное окно, услуга представляемая Центробанком коммерческим банкам по выдаче краткосрочных дисконтированных ссуд
a prime rate	базисная ставка, ставка по кредитам для первоклассных заемщиков

a federal funds rate	ставка по федеральным фондам (для межбанковских ссуд)
reserve requirements	резервные требования
to advise on something	консультировать по (вопросам)
to direct	направлять, руководить
to set	устанавливать
to determine	определять
to review	проверять, пересматривать
to establish	создать, установить
Federal Reserve district	Федеральный резервный район
quasipublic membership	получастный, полугосударственный
to elect	избирать
election	избрание
to appoint	назначать
appointment	назначение
to approve	одобрить
approval	одобрение
to clear checks	проводить расчеты по чекам
to issue currency	выпускать/печатать деньги
to withdraw	изъять
to administer	обслуживать
a merger	слияние
a liaison	связь, посредничество
a state-charted bank	банк, получивший регистрацию в законодательном органе штата
a national bank	национальный банк, получивший регистрацию в федеральном законодательном органе
to conduct a policy	вести политику
to have a vote	иметь право голоса
Office of the Comptroller of the Currency	Управление контролера денежного обращения
to be on equal footing	быть в равных условиях
Congress	Конгресс (парламент США)

the Senate the House of Representatives	Сенат (верхняя палата Конгресса США); Палата представителей (нижняя палата Конгресса США)
a margin requirement	предписываемая законом маржа
a budget; budgetary	бюджет, бюджетный
a governor; a vice-governor	управляющий, вице-управляющий
a deputy governor	заместитель управляющего
dependent on	зависимый от
independent of/from	независимый от
a Board of Directors	Совет директоров
an executive director	исполнительный директор (член совета директоров компании, работающий одним из топ-менеджеров этой компании)
growth-sustaining policies	политика, стимулирующая экономический рост
grwth-decreasing policies	политика, сдерживающая экономический рост
a political business cycle	политический бизнес цикл экономического развития страны
a consensus	согласие, консенсус
to found a bank	основать банк
a term	срок
an opponent	оппонент, противник
a proponent	сторонник, защитник

5.3 Reading

The Federal Reserve System

Of all the central banks in the world, the Federal Reserve System probably has the most unusual structure. To understand why this structure arose, we must go back to before 1913, when the Fed was created.

Before the twentieth century, a major characteristic of American politics was the fear of centralized power. The 1907 bank panic resulted in such widespread bank failures and such substantial losses to depositors that the public was finally convinced that a central bank was needed to prevent future bank panics. The hostility of the American public to banks and centralized authority created great opposition to the establishment of a single central bank like the Bank of England. Because of the heated debates on this issue, a compromise was struck. In the great American tradition, Congress wrote an elaborate system of checks and balances into the Federal Reserve Act of 1913, which created the Federal Reserve System with its 12 regional Reserve banks.

The writers of the Federal Reserve Act wanted to diffuse power along regional lines, between the private sector and the government, and among bankers, business people, and the public. Thus the Fed includes the following entities: **the Federal Reserve banks, The Board of Governors, The Federal Open Market Committee, the Federal Advisory Council, and around 2,800 member commercial banks**. Figure 1 outlines the relationships of these entities to one another and to the three policy tools of the Fed: open market operations, the discount rate, and the reserve requirements.

Figure 1 Structure and Responsibility for Policy Tools in the Federal Reserve System

Each of the 12 Federal Reserve districts has one main Federal Reserve bank, which may have branches in other cities in the district. The locations of these districts, the Federal Reserve banks, and their branches are shown in Figure 2.

The Twelve Federal Reserve Districts

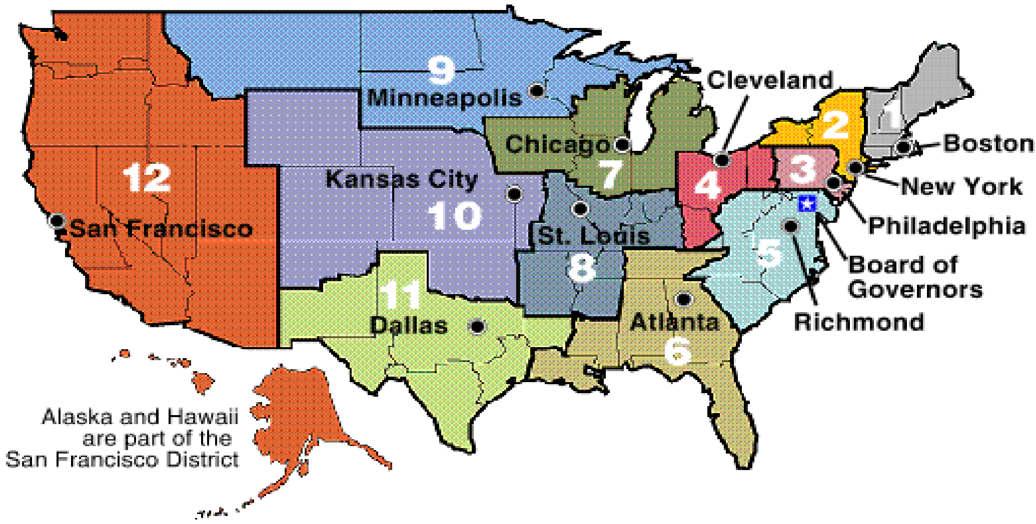

Figure 2 The Twelve Federal Reserve Districts

Each of the Federal Reserve banks is a quasi-public (part private, part government) institution owned by the private commercial banks in the district that are members of the Federal Reserve System. These member banks have purchased stock in their district Federal Reserve bank (a requirement membership), and the dividends paid by the stock are limited by law to 6% annually. The member banks elect six directors for each district bank; three more are appointed by the Board of Governors. Together, these nine directors appoint the president of the bank (subject to the approval of the Board of Governors).

The 12 Federal Reserve banks perform the following functions:

- clear checks;
- issue new currency;
- withdraw damaged currency from circulation;
- administer and make discount loans to banks in their districts;
- evaluate proposed mergers and applications for banks to expand their activities;
- act as liaisons between the business community and the Federal Reserve System;
- examine bank holding companies and state-charted member banks;
- collect data on local business conditions;
- use their staffs of professional economists to research topics related to the conduct of monetary policy.

The 12 Federal Reserve banks are involved in monetary policy in several ways:

- Their directors “establish” the discount rate (although the discount rate in each district is reviewed and determined by the Board of Governors).
- They decide which banks, member and nonmember alike, can obtain discount loans from the Federal Reserve bank.
- Their directors select one commercial banker from each district to serve on the Federal Advisory Council, which consults with the Board of Governors.
- Five of the 12 bank presidents each have a vote on the Federal Open Market Committee, which directs open market operations (the purchase and sale of government securities that affect both interest rates and the amount of reserves in the banking system).

All national banks (commercial banks charted by the Office of the Comptroller of the Currency) are required to be members of the Fed. Commercial banks charted by the states are not required to be members, but they can choose to join. Currently, 37% of the commercial banks in the United States are members of the Fed.

According to the Monetary Control Act of 1980 all depository institutions became subject to the same requirements to keep deposits at the Fed, so member and nonmember banks would be on equal footing in terms of reserve requirements. In addition, all depository institutions were given access to the Fed facilities such as the discount window and the Fed check clearing, on an equal basis.

At the head of the Federal Reserve System is the seven-member Board of Governors, headquatered in Washington, DC. Each governor is appointed by the president of the United States and confirmed by the Senate. The Board of Governors is actively involved in decisions concerning the conduct of monetary policy. All seven governors are members of the FOMC and vote on the conduct of open market operations. The Board also sets reserve requirements and effectively controls the discount rate. The Board also sets margin requirements, the fraction of the purchase price of securities that has to be paid for with cash rather than borrowed funds. Finally, the Board has substantial bank regulatory functions: it approves bank mergers and applications for new activities, specifies the permissable activities of bank holding companies, and supervises the activities of foreign banks in the United States.

Because open market operations are the most important policy tool that the Fed has for controlling the money supply, the FOMC is necessarily the focal point for policymaking in the Federal Reserve System.

5.4 Comprehension

5.4.1 Answer the questions using the active vocabulary.

1. Why do you think of all central banks in the world the Federal Reserve System probably has the most unusual structure?
2. How can you account for the fear of centralized power in the United States before the 20th century?
3. Why do you think the foundation of the Fed was a result of a social and political compromise in 1913?
4. Why can the Fed be referred to as an elaborate system of checks and balances?
5. What was the main reason for the foundation of thr Federal Reserve System of the United States?
6. What did the writers of the Federal Reserve Act seek to do?

7. Judging by the information in Figure 1, can we say that the founders of the Fed managed to comply with the provisions of the Federal Reserve Act?
8. What are the major institutions of the Fed?
9. How is the power of each entity in the Fed checked and balanced?
10. What are the three basic policy tools of the Fed?
11. Which entity is responsible for each of the policy tools?
12. What are the reasons for splitting the country into 12 Federal Reserve Districts?
13. What are the requirements for membership in the Fed?
14. Explain the term ‘quasi-public’ in reference to Federal Reserve banks.
15. What are the functions of the Federal Reserve banks?
16. How are they involved in monetary policy-making?
17. What is the difference between national banks and state-charted banks?
18. Do you think the current percentage of commercial bank-members in the United States is large enough to enable the Fed to control the money supply and conduct the monetary policy efficiently?
19. What do you know about the Board of Governors? What is it involved in? What functions does it perform?
20. Why is the Federal Open Market Committee considered the most important policy-making body?

5.4.2 Mark these statements T(true) or F(false) according to the information in the Text and Glossary. If they are false say why.

1. The Federal Reserve System probably has the most common structure.
2. Federal Reserve banks perform deposit, payment, and credit functions like commercial banks.
3. FOMC advises the Fed on discount rates.
4. Reserve requirements are both set and established by the Board of Governors.

5. Discount rates are the most important policy tool that the Fed has for controlling the money supply.
6. National banks are federally charted banks.
7. State charted banks are required to be members of the Fed.
8. Monetary policy is the management of money supply and interest rates.
9. Open market operations are activities that involve trading financial instruments and generation of income from fees.
10. The Board of Governors consists of twelve members, one from each district.
11. Reserve requirements, open market operations, and discount rates are the main policy tools.
12. Member and nonmember banks are subjects to reserve requirements.
13. Each FOMC member is appointed by the president of the United States and confirmed by the Senate.
14. Margin requirement is a sum of money that must be kept in an account at a brokerage firm.
15. Reserve requirements are regulations making it obligatory for depository institutions to keep a certain fraction of their deposits in accounts with the Fed.
16. A discount loan is a bank's borrowing from the Fed.
17. Only member banks can use the Fed's check clearing services.
18. Federal Reserve banks are owned by by the private commercial banks in the district that are nonmembers of the Federal Reserve System.

5.5 Language practice

5.5.1 Match the English terms in the left-hand column with the definition in the right-hand column.

1	Bank panic	A	The government agency that oversees the banking system and is responsible for the amount of money and credit supplied in the economy.

2	Open market operations	B	A committee that makes decisions regarding the conduct of open market operations.
3	Prime rate	C	Short-term deposits bought or sold between banks.
4	Money supply	D	The market used by banks to borrow and lend bank reserves.
5	Margin requirement	E	The Federal Reserve facility at which discount loans are made to banks.
6	Fiscal policy	F	One of 12 Federal Reserve Banks.
7	Federal funds rate	G	Simultaneous failure of many banks, as during a financial crisis.
8	Discount rate	H	The system in the United States in which banks supervised by the federal government and banks supervised by the states operate side by side.
9	Central bank	I	A term applied in many countries to a reference interest rate used by banks.
10	Discount loans	J	A group consisting of Presidents from 12 commercial banks, one from each of the 12 Federal Reserve Districts.
11	Federal Advisory Council	K	The interest rate banks charge each other for loans.
12	FOMC	L	A sum of money that must be kept in an account at a brokerage firm.
13	Federal funds market	M	Buying and selling of government securities in the open market that affect both interest rates and the amount of reserves in the banking system.
14	Dual banking system	N	The use of government expenditure and revenue collection to influence the economy.
15	Discount window	O	The total amount of money available in an economy at a particular point in time.
16	Federal	P	A bank’s borrowings from the Federal

	funds		Reserve System.
17	Federal Reserve District bank	Q	The interest rate that the Federal Reserve charges banks on discount loans.

5.5.2 Complete the following text using the suitable words or phrases from the box.

A	monetary operations	E	budgets
B	centralized	F	supervision
C	similar to	G	referred to
D	conducted	H	the Board of Governors

Differences between the European System of Central Banks and the Federal Reserve System

In the popular press, the European System of Central Banks is usually ____(1)____ as the European Central Bank (ECB) or Eurosystem. Although the structure of ECB is ____(2)____ that of the Fed, some important differences distinguish the two. First, the budgets of the Federal Reserve Banks are controlled by ____(3)____, while the National Central Banks control their own ____(4)____ and the budget of the ECB in Frankfurt. The ECB has less power than does the Board of Governors in the Fed. Second, the ____(5)____ of the Eurosystem are ____(6)____ by the National Central Banks in each country, so monetary operations are not ____(7)____ as they are in the Fed. Third, in contrast to the Fed, the ECB is not involved in ____(8)____ and regulation of financial institutions; these tasks are left to the individual countries in the European Monetary Union.

5.5.3 Complete the texts. Replace the Russian words and phrases by the English equivalents.

Text 1

Bank of Canada

Canada was late in establishing a ***центральный банк***: The Bank of Canada ***был основан*** in 1934. Its directors ***назначаются*** by the ***правительством*** to three-year terms, and they ***назначают*** the governor, who has a ***семилетний срок***. A governing council, ***состоящий из*** the four deputy governors and the ***управляющий***, is the policymaking body comparable to the FOMC that ***принимает решения*** about ***денежная политика***.

The Bank Act was amended in 1967 to give the ultimate ***ответственность за денежную политику*** to the government. So on paper, ***Банк Канады*** is not as instrument-independent as the ***Федеральная Резервная Система***. In practice, however, the Bank of Canada does essentially ***управляет денежной политикой***. In the event of ***несогласия*** between the bank and the government, the ***министр финансов*** can issue a directive that the bank must follow. However, none has been to date. The ***цель денежной политики***, a target for ***инфляция***, is set jointly by the Bank of Canada and the government, so the Bank of Canada has less ***независимость*** than the Fed.

Text 2

Bank of England

Founded in 1694, the ***Банк Англии*** is ***один из старейших центробанков***. The Bank Act of 1946 gave the government statutory ***полномочие*** over the Bank of England. The Court (equivalent to a ***совет директоров***) of the Bank of England ***состоит из*** the ***управляющего*** and twe deputy governors, who ***назначаются на пятилетний срок***, and sixteen non-executive directors, who are appointed for three-year terms.

Until 1997, the Bank of England ***был наименее независимым*** of the ***центральных банков*** because the ***решение*** to raise or to lower ***процентные ставки*** was made by the Chancellor of the Exchequer (the equivalent of the U.S. Secretary of Treasure). All of this ***изменилось*** when the current Labor ***правительство*** came to power in 1997. The Bank of England was given ***власть устанавливать***

процентные ставки, ***однако***, not totally ***независимо***: the government can overrule the Bank of England and ***устанавливает ставки*** "in extreme ***экономических*** circumstances" and "for a limited period."

Because the United Kingdom ***не является членом Европейского Денежного*** Union, the Bank of England makes its ***решения в денежной политике*** independently from the European Central Bank.

Text 3

Bank of Japan

The Bank of Japan (Nippon Ginko) ***был основан*** in 1882. ***Денежная политика определяется*** by the Policy Board, which ***состоит из управляющего, двух вице-управляющих***, and six outside members ***назначаемых*** by the cabinet and approved by the parliament, all of whom ***служат в течение пятилетнего срока***.

Until recently, the ***Банк Японии*** was not formally ***независим от правительства***, with the ultimate power residing with the Ministry of Finance. However, the Bank of Japan Law, which took effect in 1998 ***изменил ситуацию***. The law granted greater ***независимость Банку Японии***: ***представители правительства*** at the ***заседании совета директоров Банка Японии*** no longer have voting rights. In addition, the ***Министерство Финансов*** no longer oversees many of the ***операций Банка Японии***.

5.5.4 Text for discussion.

a. Look up the dictionary or Unit 6 Glossary for the meaning and pronunciation of the following words and word-combinations and use them to discuss the problems outlined in the text.

A politician; to be short-sighted; election; to be (un)likely to do smth; a political business cycle; growth-sustaining policies; to pursue a policy; growth-decreasing policies; in the public interest; a proponent; an opponent; an elite group; economic wellbeing; to achieve economic stability; a fiscal policy; a consensus; public support; output fluctuations.

b. Briefly scan the text and outline the list of major points.

c. Read the text more carefully and comment on the following items:

- the importance of central bank independence from the government;
- the importance of central bank dependence on the government;
- the bad effects of the political business cycle on the economy;
- the trend towards greater independence.

The Case For Independence And The Case Against Independence

There is an opinion that politicians in a democratic society are shortsighted because they are motivated by the need to win their next election. With this as primary goal, they are unlikely to focus on long-term objectives. The political process could lead to a political business cycle, in which just before an election, growth-sustaining policies are pursued to lower unemployment and interest rates. After the election, the bad effects of these policies – high inflation and high interest rates – come back, requiring growth-decreasing policies that the politicians hope the public will forget before the next election. An independent central bank can pursue policies that are politically unpopular yet in the public interest.

Proponents of the central bank under the control of the government argue that it is undemocratic to have the monetary policy controlled by an elite group that is responsible to no one. The public holds the government responsible for the economic wellbeing of the country, yet the public lacks control over the central bank which is the most important factor in determining the health of the economy. In addition, to achieve economic stability, the monetary policy must be coordinated with the fiscal policy.

There is yet no consensus on whether the central bank independence is a good thing, although public support for independence of the central bank seems to have been growing in both the United States and abroad. Recent research seems to support the proponents of the central bank independence: inflation performance is found to be the best for countries with the most independent central banks. However, countries with independent central banks are more likely to have high unemployment or greater output fluctuations than countries with less independent central banks.

5.6 Render the passage in English using the English equivalents of the italicised phrases given in Russian. Express the main idea of the passage in one sentence or entitle it.

Федеральная Резервная Система США *была создана* **(was created)** *для того, чтобы уменьшить* **(to lessen)** *частоту* **(the frequency)** банковских паник. Из-за *враждебного отношения общественности* **(public hostility)** к центральным банкам и централизации власти, Федеральная Резервная Система была создана с многими сдержками и противовесами *для того, чтобы рассредоточить* **(to diffuse)** власть. Формальная структура Федеральной Резервной Системы состоит из 12 региональных Федеральных Резервных банков, около (around) 2800 коммерческих банков, Совета Управляющих Федеральной Резервной Системы, Комитета по Федеральному Открытому Рынку и Федерального Консультационного Совета. *Хотя* **(although)** на бумаге *ФРС* **(the Fed)** *кажется децентрализованной* **(appears to be decentralized)**, *на практике* **(in practice)** она *функционирует как единый* **(functions as a unified)** центральный банк, контролируемый Советом Управляющих. ФРС более независима от правительства, чем *большинство органов* **(most agencies)** правительства США, но *она все-таки подвергается политическому давлению* **(it is still subject to political pressures)**, так как *законодательство* **(legislation)**, которое *структурирует* **(structures)** ФРС, пишется *Конгрессом* и может быть изменено в любое время.

Professional English
Unit 5 Reading Self – Control Test
The Federal Reserve System

1. Which of the following is the main idea of the text?

(A) Board of Governors of the Federal Reserve System.

(B) Central banking and the conduct of monetary policy.

(C) Origins of the Federal Reserve System.

(D) The Federal Reserve System as an elaborate system of checks and balances and the relationships of its entities to the three policy tools of the Fed.

2. What is most likely the audience the text is addressed to?

(A) commercial bankers

(B) finance students

(C) government officers

(D) bank officers

3. It can be derived from the text that

(A) the founders of the Fed decided to set up a centralized system with 12 Federal Reserve banks spread throughout the country to make sure that all regions of the country were presented in monetary policy deliberations.

(B) with its unusual structure, the Fed might have been far less popular with the public, making the institution far less effective than a centralized system.

(C) the history of the United States has been one of public hostility to banks and especially to a central bank.

(D) no serious disagreements existed over whether the central bank should be a private bank or a government institution.

4. It cannot be inferred from the text that

(A) the Fed is subject to the influence of Congress, because the legislation that structures it is written by Congress and is subject to change any time.

(B) the Fed is completely independent of the president and Congress.

(C) the power that the president enjoys through his appointments to the Board of Governors is limited.

(D) the public support for the actions of the Fed plays a very important role.

5. Judging by what you have derived from the text, which do you think of the following defines the term 'open market operations'?

(A) Activities that involve trading financial instruments and generation of income from fees.

(B) Offering to buy Treasury securities without specifying a price.

(C) The buying and selling of government securities in the open market that affect both interest rates and the amount of reserves in the banking system.

(D) Guaranteeing prices on securities to corporations and then selling the securities to the public.

6. Judging by what you have derived from the text, how do you think 'Federal Reserve System' can be described?

(A) The entity that makes decisions regarding the conduct of open market operations.

(B) The central banking authority responsible for monetary policy in the United States.

(C) The 12 Federal Reserve District banks.

(D) A board with seven governors that plays an essential role in decision making within the Fed..

7. It can be derived from the text that

(A) Federal Reserve banks review and determine discount rates.

(B) The Board of Governors advises on reserve requirements.

(C) The Board of Governors sets reserve requirements.

(D) FOMC advises on open market operations.

8. It cannot be derived from the text that

(A) discount window is the Federal Reserve facility at which bills are discounted.

(B) discount rate is the interest rate that the Fed charges banks on discount loans.

(C) discount loans are banks' borrowings from the Fed.

(D) central banking is conducted to oversee the banking system and control the amount of money and credit supplied in the economy.

9. Which of the following statements would the author most probably disagree with?

(A) The Fed is completely free from presidential and congressional pressures.

(B) The decline in the Fed membership at the end of the late seventies was a major concern of the Board of Governors because it lessened the Fed's control over the money supply, making it more difficult for the Fed to conduct monetary policy.

(C) The Board has a staff of professional economists, which provides economic analysis the board uses in making its decisions..

(D) Although reserve requirements and the discount rate are not actually set by the FOMC, decisions in regard to these policy tools are effectively made there.

10. What is most likely the subject of the extract which is missing from this text?

(A) The special role of the Federal Reserve Bank of New York.

(B) Demand and supply in the market of reserves.

(C) The Federal funds rate.

(D) Operation of the discount window.

Unit 5 Glossary

ADVANCES: see *discount loans*

AGGREGATE OUTPUT: the macroeconomy's total production of final goods and services. You may recognize it by its official term gross domestic product.

BANK FAILURE: in principle, this results when a bank's liabilities exceed assets for an extended period and the bank is forced to go out of business. This is comparable to other types of business that go bankrupt. However, because banks are heavily regulated by government entities, including the Federal Reserve System, Federal Deposit Insurance Corporation, and Comptroller of the Currency, bank failure does not necessarily mean that the bank ceases to operate. In many cases, such a failure means the operation of the bank is taken over by one of the government entities. The troubled bank might also be allowed or "encouraged" to merge with another, healthier bank.

BANK HOLDING COMPANIES: companies that own one or more banks but do not necessarily engage in banking themselves. In the United States, a bank holding company, as provided by the Bank Holding Company Act of 1956, is broadly defined as any company that has control over a bank. All bank holding companies in the US are required to register with the Board of Governors of the Federal Reserve System. The Federal Reserve Board of Governors has responsibility for regulating and supervising bank holding company activities, such as establishing capital standards, approving mergers and acquisitions and inspecting the operations of such companies. Becoming a bank holding company makes it easier for the firm to raise capital than as a traditional bank. The holding company can assume debt of shareholders on a tax free basis, borrow money, acquire other banks and non-bank entities more easily, and issue stock with greater regulatory ease. It also has a greater legal authority to conduct share repurchases of its own stock.

BANK PANIC: the simultaneous failure of many banks, as during a financial crisis.

BANK PANIC OF 1907: a relatively serious economic downturn, that is business-cycle contraction, in 1907 that was caused by serious, big-time, instability in the banking system. This major bank panic was so severe (the term depression is more applicable than recession) that it prompted Congress to establish the Federal Reserve System, which came into existence in 1913.

BANK REGULATION: bank regulation is a form of government regulation which subjects banks to certain requirements, restrictions and guidelines. The objectives of bank regulation, and the emphasis, vary between jurisdictions. The most common objectives are: prudential—to reduce the level of risk bank creditors are exposed to (i.e. to protect depositors); systemic risk reduction—to reduce the risk of disruption resulting from adverse trading conditions for banks causing multiple or major bank failures; to avoid misuse of banks—to reduce the risk of banks being used for criminal purposes, e.g. laundering the proceeds of crime; to protect banking confidentiality.

BANK RUN: a situation in which a relatively large number of a bank's customers attempt to withdraw their deposits in a relatively short period of time, usually within a day or two. While common throughout the 1800s and early 1900s, government deposit insurance has largely eliminated bank runs in the modern economy. Historically a bank run was prompted by fears that the bank was on the verge of collapse, causing deposits to become worthless. Ironically a bank run often caused the bank to fail. Bank runs were often infectious, leading to economy-wide bank panics and business-cycle contractions.

BANK SUPERVISION: overseeing who operates banks and how they are operated.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM: a board with seven governors (including the chairman) that plays an essential role in decision making within the Federal Reserve System.

BUSINESS CYCLE: refers to economy-wide fluctuations in production or economic activity over several months or years. These fluctuations occur around a long-term growth trend, and typically involve shifts over time between periods of relatively rapid economic growth (an expansion or boom), and periods of relative stagnation or decline (a contraction or recession). Business cycles are usually measured by considering the growth rate of real gross domestic product. Despite being termed cycles, these fluctuations in economic activity do not follow a mechanical or predictable periodic pattern.

CHECKS AND BALANCES: separation of powers.

CENTRAL BANK: the government agency that oversees the banking system and is responsible for the amount of money and credit supplied in the economy; in the United States, the Federal Reserve System.

DISCOUNT LOANS: a bank's borrowings from the Federal Reserve System. Also known as *advances*. A loan on which the interest and financing charges are deducted from the face amount when the loan is closed. The borrower only receives the principal after the financing charges and interest are taken out but must repay the full amount of the loan. For example: If you close a loan for the amount of 50,000. If the interest and financing charges were 10,000, you would receive 40,000 from the lender, but still have to pay back the whole 50,000. This is primarily used for short term loans.

DISCOUNT RATE: the interest rate that the Federal Reserve charges banks on discount loans. This is an interest rate a central bank charges depository institutions that borrow reserves from it, for example for the use of the Federal Reserve's discount window.

DISCOUNT WINDOW: the Federal Reserve facility at which discount loans are made to banks. This is an instrument of monetary policy (usually controlled by central banks) that allows eligible institutions to borrow money from the central bank, usually on a short-term basis, to meet temporary shortages of liquidity caused by internal or external disruptions. The term originated with the practice of sending a bank representative to a reserve bank teller window when a bank needed to borrow money. The interest rate charged on such loans by a central bank is called the discount rate, base rate, or repo rate, and should not be confused with the *Prime rate*. It is also distinct from the *federal funds rate* and its equivalents in other currencies, which determine the rate at which banks lend money to *each other*. In recent years, the discount rate has been approximately a percentage point above the federal funds rate.

DUAL BANKING SYSTEM: the system in the United States in which banks supervised by the federal government and banks supervised by the states operate side by side.

EUROPEAN CENTRAL BANK: the central bank for the European Union and Economic and Monetary Union this is charged with monitoring monetary policy and introducing the euro into circulation (beginning in 2002). The European Central Bank has a comparable, but perhaps somewhat less powerful, role as the Federal Reserve Board of Governors in the United States. It took over for the European Monetary Institute in 1998 and is the executive body of the European System of Central Banks.

EUROPEAN SYSTEM OF CENTRAL BANKS: the consolidation of the central banks of the member nations of the European Union, together with the European Central Bank, to oversee monetary policy. A major aspect of the Economic and Monetary Union has been to coordinate the actions of distinct, independent nations under a single authority, which could probably not be achieved without the European System of Central Banks. The European System of Central Banks is comparable to the Federal Reserve System of the United States.

EUROPEAN UNION: the economic and political integration of a dozen European nations created by the Maastricht Treaty signed in 1992. The twelve nations forming the European Union (commonly abbreviated EU) are Belgium, Denmark, Greece, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Great Britain. Three additional nations that have joined the original dozen are Austria, Finland and Sweden. The Economic Union was actually one of several steps by European nations after the end of World War II to promote integration. This Economic Union was established to reduce or eliminate many tariffs and nontariff barriers, create a single monetary unit (the euro), establish of a common military and defense policy, and centralize monetary policy.

FEDERAL ADVISORY COUNCIL: a group consisting of Presidents from 12 commercial banks, one from each of the 12 Federal Reserve Districts. This council has no policy-making role, but merely offers advice, suggestions, and feedback on how Federal Reserve policies are affecting commercial banks and their customers in non-bank public.

FEDERAL FUNDS: short-term deposits bought or sold between banks.

FEDERAL FUNDS MARKET: the market used by banks to borrow and lend bank reserves. In particular, a substantial part of the reserves held by banks are deposits with the Federal Reserve System. On many occasions some banks will have more deposits than they need to meet the Fed's reserve requirements, while other banks find themselves a little short. It's a simple matter then for one bank to lend some of these extra reserves to another--usually for no more than a few days. Working on instructions from the banks, the Fed electronically switches funds from one account to another and a federal funds market loan has been completed. The interest rate tacked on by the lending bank is termed the federal funds rate.

FEDERAL FUNDS RATE: is the interest rate at which private depository institutions (mostly banks) lend balances (federal funds) at the Federal Reserve to other depository institutions, usually overnight. It is the interest rate banks charge each other for loans.

FEDERAL OPEN MARKET COMMITTEE (FOMC): the committee that makes decisions regarding the conduct of open market operations; composed of seven members of the Board of Governors of the Federal Reserve System, the president of the Federal Reserve Bank of New York, and the presidents of four other Federal Reserve banks on a rotating dasis.

FEDERAL RESERVE BANK: one of 37 Banks (12 District and 25 Branch) that comprise the Federal Reserve System. These Banks are largely responsible for supervising, regulating, and interacting with commercial banks and carrying out the policies established by the Federal Reserve Board of Governors. The large number of banks, spread across the country is what helps make the Federal Reserve System a very decentralized central bank.

FEDERAL RESERVE BRANCH BANK: one of 25 Federal Reserve Banks that assists Federal Reserve District Banks in carrying Federal Reserve policies. Most Branch banks are located in the expansive western states. For example, 11 Branch banks are located in just 3 Districts, San Francisco, Kansas City, and Dallas.

FEDERAL RESERVE DISTRICT BANK: one of 12 Federal Reserve Banks, each in charge of banking activity within its Federal Reserve District. The 12 Districts are centered in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Mineapolis, Kansas City, Dallas, and San Francisco. Presidents from 5 of these 12 Banks serve on the powerful Federal Open Market Committee that conducts monetary policy.

FEDERAL RESERVE DISTRICTS: the 12 geographic areas of the United States that form the administrative division of the Federal Reserve System. Each of the 12 Districts is headed by a Federal Reserve District Bank and is generally designated by the Reserve Bank City--Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. Federal Reserve Branch Banks are located in 10 of the 12 Districts.

FEDERAL RESERVE SYSTEM (the FED): the central banking authority responsible for monetary policy in the United States.

FISCAL POLICY: is the use of government expenditure and revenue collection (taxation) to influence the economy.

FRACTIONAL - RESERVE BANKING: fractional-reserve banking is a type of banking whereby the bank does not retain all of a customer's deposits within the bank. Funds received by the bank are generally on-loaned to other customers. This creates discrepancy between the quantity of deposits at the bank and available funds, known as the reserve ratio. Because most bank deposits are treated as money in their own right, this means that banks are said to create money, are able to increase the money supply. Due to the potential instabilities sometimes created by the practice of fractional-reserve banking the government in most countries provides back-up protection in the form of central banks. These protect against major bank runs by providing deposit insurance and act as lender of last resort to commercial banks in their jurisdiction. Fractional-reserve banking is a very common form of banking and is practiced in most countries.

LENDER OF LAST RESORT: provider of reserves to financial institutions when no one else would provide them to prevent a financial crisis. It is an institution willing to extend credit when no one else will. The term refers especially to a reserve financial institution, most often the central bank of a country, intended to avoid bankruptcy of banks or other institutions deemed systemically important or 'too big to fail'. A lender of last resort serves as a stopgap to protect depositors, prevent widespread panic withdrawal, and otherwise avoid disruption in productive credit to the entire economy caused by the collapse of one or a handful of institutions. Borrowing from the lender of last resort by commercial banksis is usually not allowed except in times of crisis. This is because borrowing from the lender of last resort indicates that the institution in question has taken on too much risk, or that the institution is experiencing financial difficulties (since it is often only possible when the borrower is near collapse).

MARGIN REQUIREMENT: a sum of money that must be kept in an account (the margin account) at a brokerage firm.

MARRIED PUT: The purchase of a put option on a stock that is already owned. A married put protects against a decline in the price of the underlying stock. If the price declines, the stock can be sold at the higher price any time before expiration. Of course, if the stock price remains neutral or increases, the option is worthless and the premium is lost.

MERGER: the consolidation of two separately-owned businesses under single ownership. This can be accomplished through a mutual, "friendly" agreement by both parties, or through a "hostile takeover," in which one business gets ownership without cooperation from the other. Mergers fall into one of three classes -- (1) horizontal--two competing firms in the same industry that sell the same products, (2) vertical--two firms in different stages of the production of one good, so that the output of one business is the input of the other, and (3) conglomerate--two firms that are in totally, completely separated industries.

MONETARY POLICY: is the process by which the monetary authority of a country controls the supply of money, often targeting a rate of interest for the purpose of promoting economic growth and stability. The official goals usually include relatively stable prices and low unemployment. Monetary theory provides insight into how to craft optimal monetary policy. Monetary policy is referred to as either being expansionary or contractionary, where an expansionary policy increases the total supply of money in the economy more rapidly than usual, and contractionary policy expands the money supply more slowly than usual or even shrinks it. Expansionary policy is traditionally used to try to combat unemployment in a recession by lowering interest rates in the hope that easy credit will entice businesses into expanding. Contractionary policy is intended to slow inflation in hopes of avoiding the resulting distortions and deterioration of asset values.

MONEY SUPPLY: is the total amount of money available in an economy at a particular point in time. There are several ways to define "money," but standard measures usually include currency in circulation and demand deposits (depositors' easily-accessed assets on the books of financial institutions). Money supply data are recorded and published, usually by the government or the central bank of the country. Public and private sector analysts have long monitored changes in money supply because of its possible effects on the price level, inflation and the business cycle.

NATIONAL BANKS: traditional banks that are chartered by the Comptroller of the Currency and are automatically members of the Federal Reserve System. The contrast to national banks are state banks, which are chartered by one of the fifty states. National banks tend to be larger than state banks and whether justified or not tend to be slightly more prestigious. In the modern economy this distinction is less important than it was a few decades ago when state banks were subject to lesser state regulations than national banks.

OPEN MARKET OPERATIONS: the buying and selling of government securities in the open market that affect both interest rates and the amount of reserves in the banking system.

POLITICAL BUSINESS CYCLE: a business cycle that results primarily from the manipulation of policy tools (fiscal policy, monetary policy) by incumbent politicians hoping to stimulate the economy just prior to an election and thereby greatly improve their own and their party's reelection chances. Expansionary monetary and fiscal policies have politically popular consequences in the short run (tax cuts, falling unemployment, falling interest rates, new government spending on services for special interests, etc.). Unfortunately these very policies, especially if pursued to excess, can also have very unpleasant consequences in the longer term (accelerating inflation, an unsustainably low rate of savings to support future investment, damage to the foreign trade balance, long-term expansion of government's share of the GNP at the expense of people's disposable incomes, etc.). So immediately after the election is over, politicians tend to reverse course by raising taxes, cutting spending, slowing the growth of the money supply, allowing interest rates to rise, etc. Thus the regular holding of elections tends to produce a boom-and-bust pattern in the economy because of the on-again-off-again pattern of government stimulus and restraint encouraged by trying to schedule an artificial boom at every election time.

PRIME RATE: is a term applied in many countries to a reference interest rate used by banks. The term originally indicated the rate of interest at which banks lent to favored customers, *i.e.*, those with high credibility, though this is no longer always the case. Some variable interest rates may be expressed as a percentage above or below prime rate.

RESERVE REQUIREMENT: (or cash reserve ratio) is a central bank regulation that sets the minimum reserves each commercial bank must hold (rather than lend out) of customer deposits and notes. It is normally in the form of cash stored physically in a bank vault (vault cash) or deposits made with a central bank. The reserve ratio is sometimes used as a tool in the monetary policy, influencing the country's borrowing and interest rates by changing the amount of loans available. Western central banks rarely alter the reserve requirements because it would cause immediate liquidity problems for banks with low excess reserves; they generally prefer to use open market operations (buying and selling government-issued bonds) to implement their monetary policy. The People's Bank of China uses changes in reserve requirements as an inflation-fighting tool, and raised the reserve requirement nine times in 2007. As of 2006 the required reserve ratio in the United States was 10% on transaction deposits and zero on time deposits and all other deposits.

RESERVES: banks' holding of deposits in accounts with the Fed, plus currency that is physically held by banks (vault cash).