

Everyday Economics

The Federal Reserve

Federal Reserve: The central bank of the United States; an independent organization created by Congress to keep our money valuable and our financial system healthy; one of three federal bank regulatory agencies in the United States; guardian of payments system efficiency and effectiveness; lender of last resort

Congress created the Federal Reserve System in 1913 to serve as the central bank of the United States and to provide the nation with a safer, more flexible and more stable monetary and financial system. Over the years, its role in banking and the economy has expanded, but its focus has remained the same. Today, the Fed's three functions are to provide and maintain an effective and efficient payments system, to supervise and regulate banking operations, and to conduct the nation's monetary policy. Although all three of these roles are important in maintaining a stable economy, monetary policy is the most visible to many citizens. Monetary policy is the strategic actions taken by the Federal Reserve to influence the supply of money and credit in order to foster price stability and maintain maximum sustainable economic growth. Through these actions, the Fed helps keep our national economy strong and the world economy stable.

Independent Within Government

The Federal Reserve System was structured by Congress as a distinctively American version of a central bank, established to carry out Congress' own constitutional mandate to "coin money and regulate the value thereof." Part of the Fed's uniqueness is that it is decentralized, with Reserve Banks and branches in 12 districts across the country, coordinated by a Board of Governors in Washington, D.C.

The Fed has a unique public/private structure that operates independently within government but not independent of it. The Board of Governors, appointed by the president and confirmed by the Senate, represents the public sector, or governmental side of the Fed. The Reserve Banks and the local citizens on their boards of directors represent the private sector. This structure provides accountability while avoiding centralized, governmental control of banking and monetary policy.

The Federal Reserve is fiscally independent because it receives no government appropriations. The Fed funds its activities with the interest earned from loans to banks and investments in government securities and from the revenue received from providing services to financial institutions. The Fed's financial goal in providing services is to generate only enough revenue to cover costs. Any excess earnings—money made above the cost of operations—is turned over to the U.S. Treasury.

The Fed's Structure. The seven-member Board of Governors is the main governing body of the Federal Reserve System. It is charged with overseeing the 12 District Reserve Banks and with helping implement national monetary policy. Governors are appointed by the president of the United States, one on Jan. 31 of every even-numbered year, for staggered, 14-year terms.

Each Federal Reserve Bank has a board of directors, whose members work closely with their Reserve Bank president to provide grassroots economic information and input on management and monetary policy decisions. These boards are drawn from the general public and the banking community and oversee the activities of the organization. They also appoint the presidents of the Reserve Banks, subject to the approval of the Board of Governors. Reserve Bank boards consist of nine members: six serving as representatives of nonbanking enterprises and the public (nonbankers) and three as representatives of banking. Each Federal Reserve branch office has its own board of directors, composed of three to seven members, that provides vital information concerning the regional economy.

Who Owns the Fed? Banks that hold stock in the Fed are called member banks. All nationally chartered banks hold stock in the Federal Reserve. State-chartered banks may choose to be members, upon meeting certain standards. However, holding Fed stock is not like owning publicly traded stock. Fed stock cannot be sold or traded. Member banks receive a fixed, 6 percent dividend annually on their stock, and they do not control the Fed as a result of owning this stock. They do, however, elect six of the nine members of Reserve Banks' boards of directors.

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Who owns the Fed then? Although it is set up like a private corporation and member banks hold its stock, the Fed owes its existence to an act of Congress and has a mandate to serve the public. So the most accurate answer may be that the Fed is “owned” by the citizens of the United States.

The Need for a Federal Reserve System

People who lived during the early 1900s used banks much as we do today. They deposited their money into savings accounts and borrowed money to build a home or start a business. When people borrowed money, banks issued them banknotes, which the borrowers spent the way we spend dollars today. The public valued these banknotes as money because banks promised to exchange them for gold or silver on demand.

Occasionally the public feared that banks would not or could not honor the promise to redeem these notes. Believing that a particular bank’s ability to pay was questionable, a large number of people in a single day would demand to have their banknotes exchanged for gold or silver. This was called a bank run, and the fear that these runs created often spread, causing runs on other banks and general financial panic.

Runs and Financial Panic. During a run, even the healthiest and most conservative bank could not redeem all of its notes at once. Banks then, just as now, used most of the money deposited with them to make loans. As a result, the money was not sitting in the banks’ vaults but was circulating in the community. In other words, the banks may have been solvent but not liquid. So when a bank run occurred, many times a bank had to close because it could not exchange the large number of notes presented in a single day.

Bankers tried to prepare for increasing depositor withdrawals by building up their reserves of gold or silver and by restricting credit. They stopped making loans, and panic ensued as everyone scrambled to redeem notes. Businesses had difficulty operating normally. The country’s economic activity slowed, and many people lost their jobs and life savings.

Financial panics such as these occurred frequently during the 1800s and early 1900s. One of the most serious bank panics occurred in 1907. The large number of bank failures and the subsequent loss of savings prompted cries for reform. People wanted a central banking authority to ensure the operation of healthy banks that might otherwise fail because of a bank panic and to supervise bank activities so banks would not engage in unsound business practices that might lead to more bank failures. The public also wanted a more elastic currency and an improved payments system, which would contribute to economic stability.

Creating the Fed. In response, Congress set up the National Monetary Commission to study the nation’s financial system and pinpoint its weaknesses. One of the primary weaknesses identified was that the United States lacked an elastic currency. This meant the banking system did not have a way to supply currency if demand for it increased significantly in a short time, so panics occurred. In 1912, the commission presented Congress with a monetary reform plan that recommended the establishment of the National Reserve Association, which would hold the reserves of commercial banks and could make short-term loans to banks to ensure credit availability. Congress responded by drafting the Federal Reserve Act, creating the Federal Reserve System. President Woodrow Wilson signed the act into law on Dec. 23, 1913.



The Fed and Monetary Policy

The Fed’s primary mission is to ensure that enough money and credit are available to sustain economic growth without inflation. If there is an indication that inflation is threatening our purchasing power, the Fed may need to slow the growth of the money supply. It does this by using three tools—the discount rate, reserve requirements and, most important, open market operations.

Responsibility for open market operations rests with the Federal Open Market Committee (FOMC). The committee, consisting of the seven-member Board of Governors and five of the 12 Reserve Bank presidents, meets eight times a year. The governors and the president of the New York Fed are permanent voting members; the other Reserve Bank presidents fill the four remaining voting-member positions in rotation. All 12 presidents participate fully in FOMC discussions. Reserve Bank boards of directors, research departments and regional business leaders contribute grassroots information and insights that are used to formulate monetary policy. The Reserve Bank boards recommend changes in the discount rate to the Board of Governors, and the Board of Governors has jurisdiction over reserve requirements. In this way, both the public and the private sectors contribute to these decisions.

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Open Market Operations. The Fed's primary monetary policy tool is open market operations, which is the buying and selling of U.S. government securities on the open market for the purpose of influencing short-term interest rates and the growth of the money and credit aggregates. Once the FOMC has established policy, the Federal Reserve Bank of New York implements the Fed's open market operations daily. Whenever an increase in the growth rate of the money supply and credit is needed to stimulate the economy, or downward pressure on short-term interest rates is desired, the Fed buys securities from brokers or dealers. Each transaction is handled electronically. Dealers send securities to the Fed over an electronic network, and the Fed adds money to the reserve accounts of the banks of the brokers or dealers. The banks, in turn, credit the accounts of the brokers and dealers, thereby increasing the amount of money and credit available in the market.

Whenever it is necessary to slow the growth of money and credit, this process works in reverse. The Fed sends securities to brokers and dealers electronically and takes payment by debiting the accounts of banks with which the brokers and dealers do business. These reserves leave the banking system, thereby reducing the money supply and curtailing the expansion of credit.



The Discount Rate. The discount rate (officially the primary credit rate) is the interest rate the Federal Reserve Banks charge financial institutions for short-term loans of reserves. The volume of reserve balances supplied is usually only a small portion of the total supply of Federal Reserve balances. However, at times of market disruption, such as the September 11, 2001, terrorist attacks, loans extended through the discount window can supply a considerable volume of Federal Reserve balances.

The Reserve Requirement. The reserve requirement is the percentage of deposits in demand deposit accounts that financial institutions must set aside and hold in reserve. If the Fed raises the reserve requirement, banks have less money to lend, which restrains the growth of the money supply. On the other hand, if the Fed lowers the reserve requirement, banks have more money to lend and the money supply increases. The Fed rarely changes the reserve requirement. In fact, it is the least-used monetary policy tool because changes in the reserve requirement significantly affect financial institution operations. Reserve requirement changes are seen as a sign that monetary policy has swung strongly in a new direction.

Beyond Monetary Policy

The Federal Reserve is also responsible for ensuring the U.S. payments system is efficient and effective, that it supports the economic needs of our country's citizens, and that its services are available to all commercial banks—regardless of size or location—so they can meet the payment needs of their customers. This places the Fed in the often difficult position of competing with some of the institutions it regulates and regulating the payments system in which it is an active participant. In addressing this challenge, integrity and equity are the Fed's mainstays.

The Banker's Bank. As the “banker's bank,” the Fed provides services to financial institutions in much the same way commercial banks serve their customers. This role promotes the smooth functioning of the financial system, contributes to the implementation of monetary policy, and drives the efficiency and technological development of the payments system.

Every business day, Reserve Banks process billions of dollars through currency, check and electronic payments services. The money the Treasury prints or mints is put into circulation by the Fed, which also ensures that it is in good physical condition by removing from circulation notes and coins that are damaged, counterfeit or simply worn-out.

An important operation in the Fed system is check clearing. Every day, millions of checks are moved around the country, sorted, tabulated, and credited or debited to the accounts of financial institutions. To speed the collection of

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checks, these operations take place 24 hours a day.

Another way to increase the speed of payments collection and reduce the cost of processing and transporting paper checks is the use of electronic payments. Leading the way in electronic checking and the development of check imaging technology, the Fed's nationwide electronic network enables institutions to transfer funds to other institutions anywhere in the country within seconds. This network also serves as an infrastructure for final payment, or "settlement," between financial institutions.

The Government's Bank. In addition to these services for financial institutions, Reserve Banks serve as banks for the U.S. government by maintaining accounts and providing services for the Treasury and by acting as depositories for federal taxes. The Fed also handles the sale and redemption of original issues of government securities to assist the Treasury Department in financing the national debt. These Treasury bills, notes and bonds are sold to the public and to financial institutions.

Banking Supervision. The Federal Reserve has supervisory and regulatory authority over a wide range of financial institutions and activities. It works with other federal and state entities to promote safety and soundness in the operation of financial institutions, stability in the financial markets, and fair and equitable treatment of consumers in their financial transactions. This hands-on experience with supervision and regulation provides the Federal Reserve with essential knowledge for monetary policy deliberations and enhances the Fed's ability to forestall and/or manage financial crises as needed.

The Fed is one of four federal organizations responsible for supervising financial institutions. Federal Reserve Banks supervise bank holding companies, state member banks and certain nonbank operations. They also supervise the foreign activities of these organizations and the U.S. activities of foreign banking organizations.

Bank supervision involves the monitoring, inspecting and examining of banking organizations to assess their condition and their compliance with laws and regulations. When an institution is found to be in noncompliance or to have other problems, the Federal Reserve may use its authority to have the institution correct the situation. Bank regulation entails making and issuing specific rules and guidelines governing the structure and conduct of banking, under the authority of legislation.

The Lender of Last Resort. Through its discount and credit operations, Reserve Banks provide liquidity to banks to meet short-term needs stemming from seasonal fluctuations in deposits or unexpected withdrawals. Longer term liquidity may also be provided in exceptional circumstances. The rate the Fed charges banks for these loans is the discount rate (officially the primary credit rate).

In making these loans, the Fed serves as a buffer against unexpected day-to-day fluctuations in reserve demand and supply. This contributes to the effective functioning of the banking system, alleviates pressure in the reserves market and reduces the extent of unexpected movements in the interest rates.

The Economy: The Fed as Inflation Fighter

The Fed's most important job is making sure there is enough money and credit to allow the economy to grow, but not so much money that the currency loses its value. Inflation is the continuing, broad-based rise in the price of goods and services. Put in a slightly different way, inflation is an erosion in the purchasing power, or value, of a nation's currency.

The goal of monetary policy is to fight inflation so that sustainable long-term growth can be maintained. One way of doing this is by letting the money supply grow as fast as the economy grows, but no faster. If the money supply grows too rapidly, inflation will result, reducing your purchasing power. This would mean that your dollar, which bought 100 jelly beans yesterday, might buy only 95 today. The Fed fights this decline in purchasing power by influencing the amount of money and credit flowing through the financial system. One way to relieve mounting inflationary pressures is by slowing the growth of the money supply. If the Fed expands the flow of money and credit, bankers will be able to make more loans to their customers. If money and credit are restricted, banks will have less money to lend, causing a decrease in the money supply.