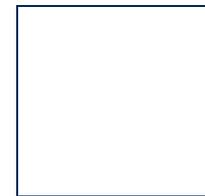
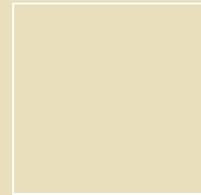


# The Federal Reserve System

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## **Maryland Voluntary Curriculum Content Standard 4.0: Economics**

**B.3** The student will evaluate the effectiveness of current monetary and fiscal policy on promoting full employment, price stability, and economic performance.

- f. Describe how the Federal Reserve System uses the 3 tools of monetary policy including open market operations, changes in the discount rate and changes in the reserve requirements to influence the economy.
- g. Describe the effectiveness of monetary policy in achieving economic growth, full employment and price stability.
- h. Explain how the Consumer Price Index (CPI), the unemployment rate, and the Gross Domestic Product (GDP) measure economic performance.
- i. Explain how economic instability, including periods of growth and recession, is part of the free enterprise system.
- j. Explain how inflation reduces the buying power and may contribute to a slow down in the economy.



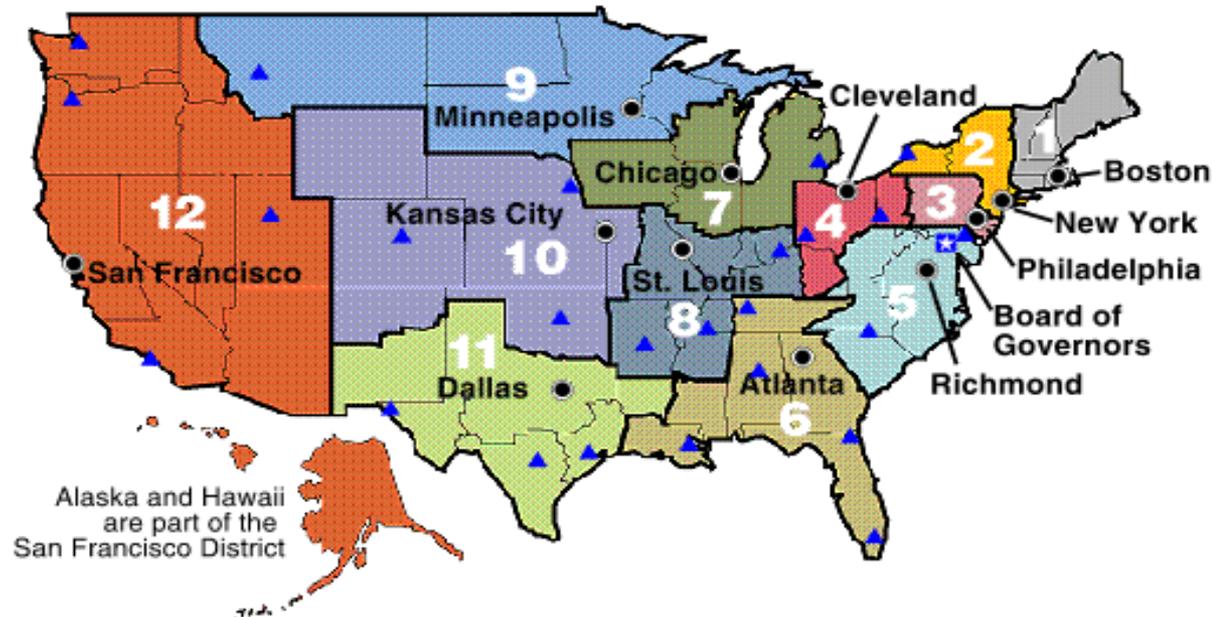


**What exactly is that institution or institutions otherwise referred to as the “Fed”?**



## What exactly is the “Fed”?

- **1913 Federal Reserve Act** created a central banking system known as the Federal Reserve System, a system of 12 regional banks overseen by the Federal Reserve Board, a government regulatory agency.





## “The Federal Reserve has 4 basic overall functions:

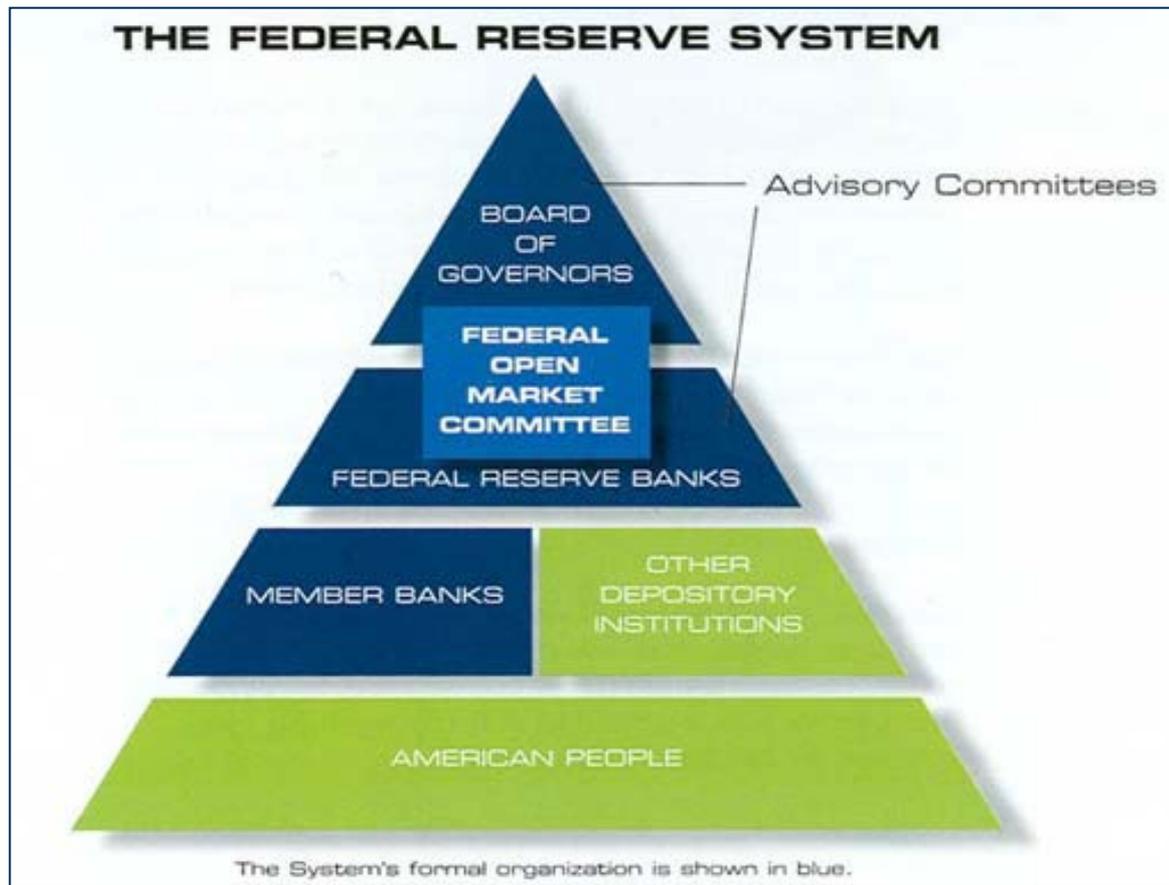
- Serving as a "banker's bank,
- Serving as the banker and fiscal agent for the federal government,
- Regulating and supervising financial institutions,
- Conducting monetary policy.”
- Based on 1977 Amendment...Dual Mandate...price stability and maximum sustainable output; full employment

*[http://www.richmondfed.org/publications/educator\\_resources/federal\\_reserve\\_today/](http://www.richmondfed.org/publications/educator_resources/federal_reserve_today/)*





# Organization of the Federal Reserve System





## Myth #1 The Federal Reserve System is solely a government agency.

- “The Fed is an unusual mixture of public and private elements.”
- “The Board of Governors, located in Washington, D.C., provides the leadership for the System. Twelve regional Federal Reserve Banks and their branch offices carry out many of the System’s day-to-day activities.”
- “The banks are legally private but functionally public corporations. This means that they are owned by member commercial banks in their region (that is, member banks hold stock in their Federal Reserve Bank) but they serve public goals.”
- ([http://www.richmondfed.org/publications/educator\\_resources](http://www.richmondfed.org/publications/educator_resources))



# Duties of The Board of Governors

- Provides centralized authority.
- Establishes regulations.
- Supervise activities of the Federal Reserve Banks.
- Oversees and approves merger applications.
- Discount Rate.
- Margin Requirements.
- Reserve Requirements.





## Duties of Individual Reserve Banks...

- Monitor District Economy.
- Convey regional economic perspectives to the Board of Governors (Beige Book).
- Examine and Supervise banks.
- Lend to banks (Discount Window).
- Provide financial services to banks and the U.S. Treasury in the region.
- Recommend Discount Rate changes.
- Nine Board of Directors representing banks, business, and the public.





# Duties of Individual Reserve Banks...

## Supervision & Regulation

Supervision – Inspecting the safety and soundness of banking organizations

### CAMELS Rating

C – Capital

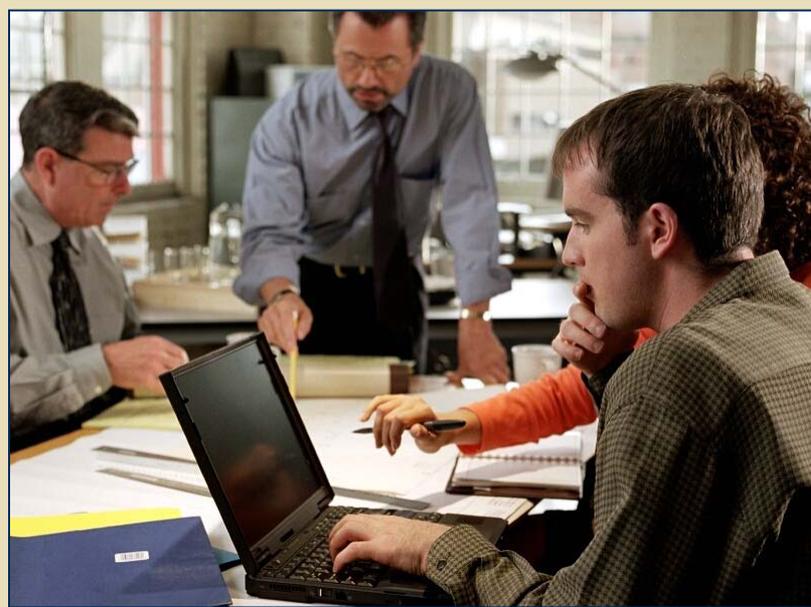
A – Assets

M – Management

E – Earnings

L – Liquidity

S – Risk Sensitivity



# Regulation

- Reviewing bank compliance with laws and regulation.

Examples:

- Truth in Lending Act (1968)
- Equal Credit Opportunity Act (1974)
- Community Reinvestment Act (1977)
- Right to Financial Privacy Act (1978)



# Individual Reserve Banks...

## Financial Services



### *Government's Bank*

- Maintains the U.S. Treasury's account, processing tax payments, disbursing Social Security Checks.
- Invests tax monies for U.S. Government.
- Redeems government savings bonds.





# Individual Reserve Banks..

## Financial Services

### *Banker's Bank*



**Fedwire Funds Transfer**



**Automated Clearing House**



**Check Processing**



**Cash Processing**





## Federal Open Market Committee (FOMC)- Organization & Directive...



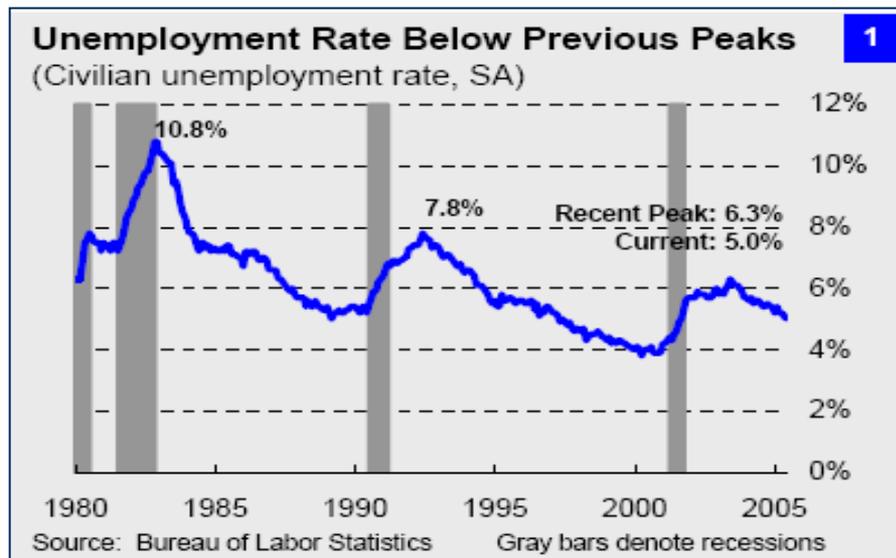
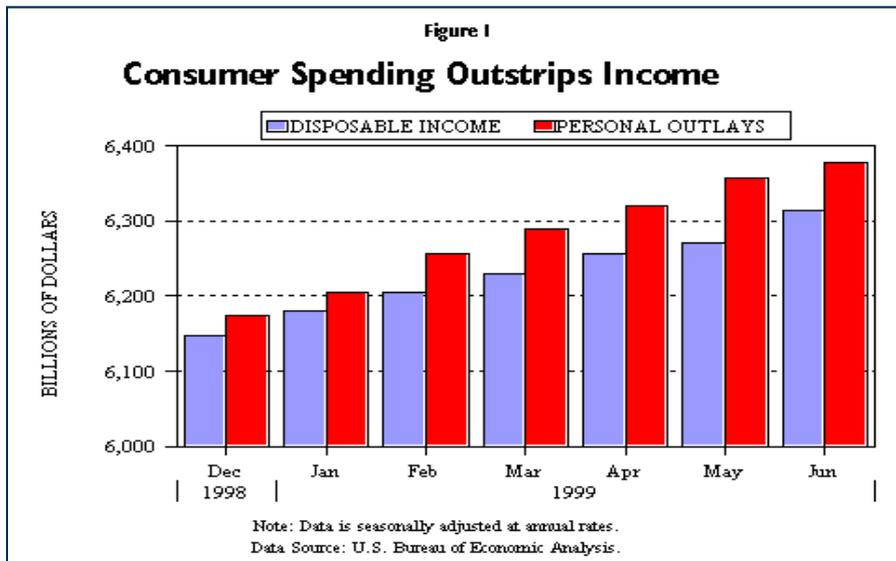
- **Major Policy Making Institution created by Congress to conduct monetary policy.**
- **Consists of 7 member Board of Governors and Federal Reserve Bank Presidents- 5 of whom are voting members who serve for a one year term; one of which is always the New York Fed's Bank President. (other 4 presidents; serve in rotation on the committee)**
- **Make policy recommendations about Fed Funds Rate and thus, open market operations, as well as the discount rate based on the latest economic data.**
- **Most commonly used tool= Open Market Operations.**
- **Meet 8 times a year.**





# Economic Indicators

- GDP
- Inflation (CPI & PCE)
- Unemployment Rate
- Other relevant information:
  - Housing Starts
  - Capital Investment
  - Retail Sales
  - Personal Savings
  - Balance of Trade
  - Manufacturing- Industrial Production Index
  - Dow Jones Industrial Average
- Economic Conditions





# Traditional Tools of Monetary Policy





# Reserve Requirements

- **Least used tool-** Has not been adjusted significantly since 1982 (minor changes in early 1990's)
- **Technology & impact of "shocks" to the system have discouraged use of this tool.**
- **Currently set at approximately 10% of demand deposits (M1).**

## Reserves of Depository Institutions

June 2001

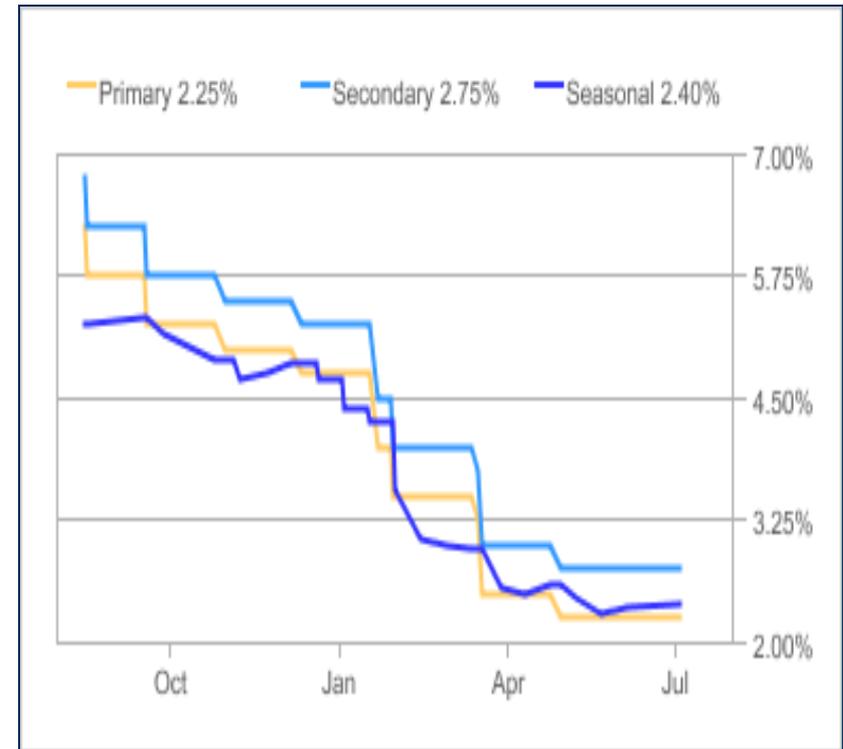
Required reserves	\$36.9 billion
Reserve balances with Federal Reserve Banks	\$7.1 billion
Vault cash used to satisfy required reserves	\$31.7 billion
<i>Net Transaction Deposits*</i>	<i>\$566.5 billion</i>

\* Includes demand deposits and other checkable deposits as defined on H.6 Release.  
 Sources: Federal Reserve Statistical Releases, H.3 and H.6, August 30, 2001.  
<http://www.federalreserve.gov/releases/H3/20010830/>  
<http://www.federalreserve.gov/releases/H6/20010830/>



# Discount Rate

- The discount rate is the interest rate that the Federal Reserve Banks' charge to member banks for a short term loans, usually overnight.
- Primary Credit, Secondary Credit, Seasonal Credit...address short term liquidity needs.
- (<http://www.newyorkfed.org/>)

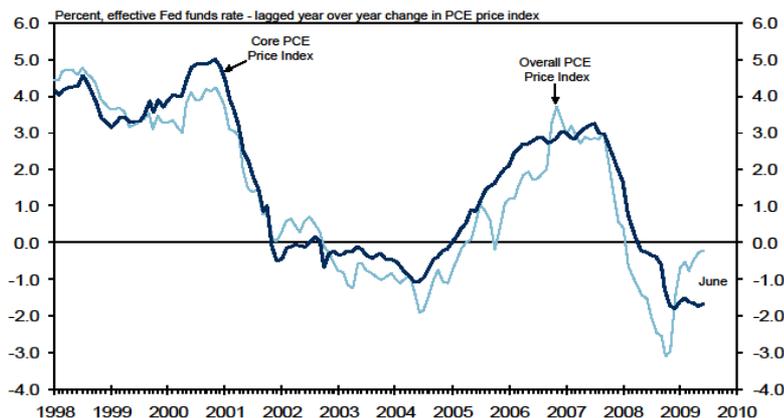


Discount Window 7/08  
New York Federal Reserve Bank



# Open Market Operations

## Real Federal Funds Rate



Notes: Most recent observation uses expected Fed funds rate as implied by Fed funds futures contracts.



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Source: Bureau of Economic Analysis, Board of Governors, Haver Analytics 44

## Fed Funds Rate June 2009 Federal Reserve Bank of Richmond

- The Federal Reserve primarily influences monetary policy through open market operations.
- **Open market operations** is the buying and selling of government securities on the open market to influence short-term interest rates and the growth of the money supply.
- This tool is used to influence and achieve the Fed's target Federal Funds Rate; the rate at which member bank banks may lend other banks excess reserves; usually overnight in order for a given institution to maintain its required reserves.



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# Open Market Operations

## Loose Monetary Policy

The Fed *buys* Treasury securities,  
*adding* money to the economy

This creates *downward* pressure on the federal funds rate

Short-term interest rates may go *down*  
because banks have *more* money to lend

Consumers and businesses may borrow *more* money

Consumers and business spending may *increase*

Employment and economic growth may *increase*  
in the short-term





# Open Market Operations

## *Tight Monetary Policy*

The Fed *sells* Treasury securities,  
*taking* money out of the economy

This creates *upward* pressure on the federal funds rate

Short-term interest rates may go *up* because banks have *less* money to lend

Consumers and businesses may borrow *less* money

Consumers and business spending may *decrease*

Employment and economic growth may *decrease*  
in the short-term





## The Creation of New Innovations, New Tools

- Term Auction Facility (TAF)
- Changes in the Discount Window Lending
- Term Securities Lending Facility (TSLF)
- Primary Dealer Credit Facility (PDCF)



## Myth #2 When the Fed prints money for banks it increases the national debt.



- The Federal Reserve Banks do not print money. The Bureau of Printing and Engraving is responsible for printing U.S. currency.
- Federal Reserve Banks manage the inventory of the existing stock of currency.
- The amount of borrowing, measured by the deficit, is not decided by the Fed.
- The U.S. government's debt and deficit are the result of budgetary decisions of the Congress and the President.



# Fiscal and Monetary Policy Defined

## Fiscal Policy

- It's the taxing and spending plan of the government.
- Government spends money to provide goods and services.
- Government pays for those expenditures through taxation and borrowing.

## Monetary Policy

- The actions of a central bank to influence the availability of money and cost of credit to help promote national goals.
- Through primarily Open Market Operations, the FOMC attempts to influence the Federal Funds Rate, and thus bank excess reserves, to affect the cost of credit.





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