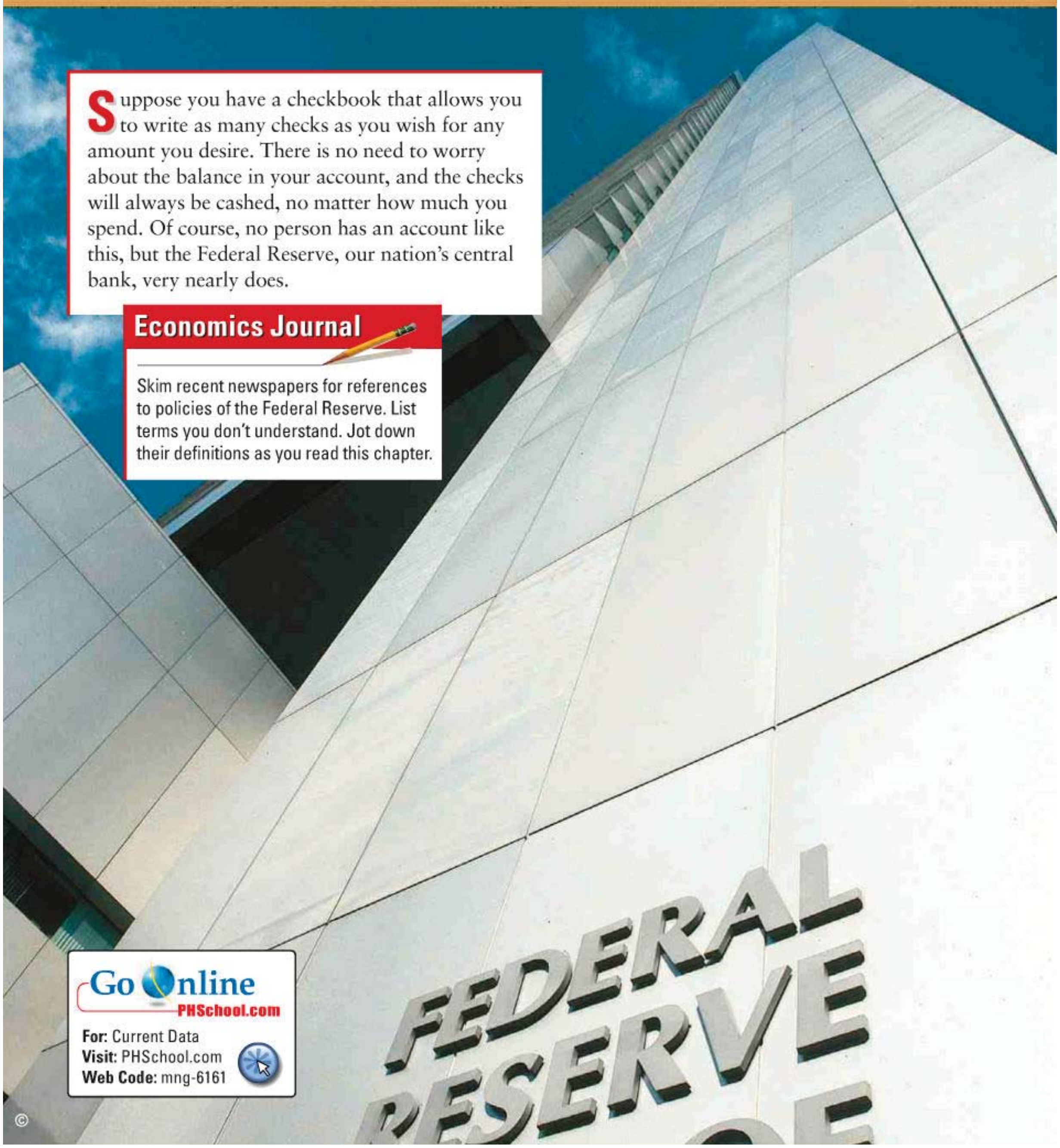
Chapter 16 The Federal Reserve and Monetary Policy



Suppose you have a checkbook that allows you to write as many checks as you wish for any amount you desire. There is no need to worry about the balance in your account, and the checks will always be cashed, no matter how much you spend. Of course, no person has an account like this, but the Federal Reserve, our nation's central bank, very nearly does.

Economics Journal

Skim recent newspapers for references to policies of the Federal Reserve. List terms you don't understand. Jot down their definitions as you read this chapter.

Go Online
PHSchool.com

For: Current Data
Visit: PHSchool.com
Web Code: mng-6161

Section 1 The Federal Reserve System

Preview

Objectives

After studying this section you will be able to:

1. **Understand** banking history in the United States.
2. **Explain** why the Federal Reserve Act of 1913 led to further reform.
3. **Explain** the structure of the Federal Reserve System.

Section Focus

To stabilize the nation's banking system, Congress created the Federal Reserve System in 1913. The Federal Reserve is owned by individual member banks. It is overseen by a small but powerful Board of Governors. As a private institution serving a public function, the Federal Reserve is a central bank relatively free from government control.

Key Terms

Board of Governors
monetary policy
Federal Reserve Districts
Federal Advisory Council (FAC)
Federal Open Market Committee (FOMC)

The American banking system is a compromise between supporters and opponents of a central bank. As a symbol of this compromise, the Federal Reserve System is the privately owned, publicly controlled central bank of the United States.

Banking History

As you read in Chapter 10, the issue of a central bank has been debated hotly since 1790, when Federalists lined up in favor of a central bank. The first bank of the United States issued a single currency. It also reviewed banking practices and helped the federal government carry out its duties and powers. Partly because of the continued debate over state versus federal powers, however, the first bank lasted only until 1811. At that time, Congress refused to extend its charter.

Congress established the Second Bank of the United States in 1816 to restore order in the monetary system. However, many people feared that a central bank placed too much power in the hands of the federal government. Political opposition toppled the Second Bank in 1836 when its charter expired.

A period of confusion followed. States chartered some banks, while the federal government chartered and regulated others. Reserve requirements—the amount of reserves that banks are required to keep on hand—were difficult to enforce, and the nation experienced a series of serious bank runs. The Panic of 1907 finally convinced Congress to act.

▲ **The Federal Reserve System is headed by the Federal Reserve Board of Governors. The first Federal Reserve Board of Governors, here, was seated in 1914.**

The nation's banking system needed to address two issues. First, consumers and businesses needed access to increased sources of funds to encourage business expansion. Second, banks needed a source of emergency cash to prevent depositor panics that resulted in bank runs.

Federal Reserve Act of 1913

Congress created the National Monetary Commission (NMC) in 1908 to propose solutions to the nation's banking problems. Based on the NMC's recommendations, Congress passed the Federal Reserve Act in 1913. The resulting Federal Reserve System, now often referred to simply as "the Fed," was composed of a group of twelve independent regional banks. This central group of banks could lend to other banks in times of need.

Continued Need for Reform

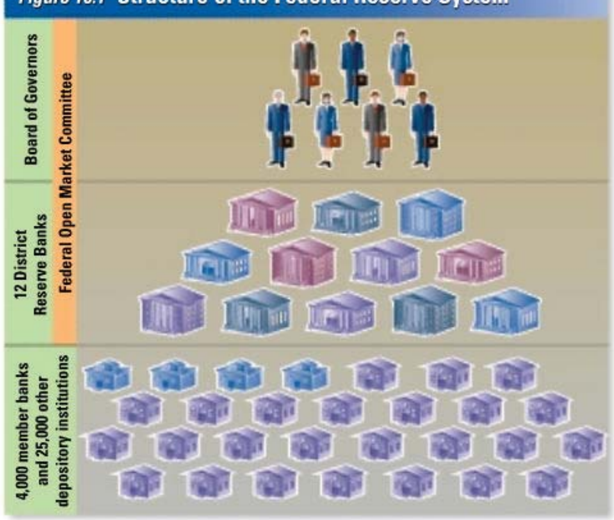
Although the Federal Reserve System helped to restore confidence in the banking system beginning in 1914, it has also learned through trial and error the best ways to fulfill its responsibilities. During the Great Depression, the financial crises of 1930–1933 were exactly the kinds of problems that the NMC had hoped to avoid by creating the Federal Reserve System. The system did not work well, however, because the twelve regional banks each acted independently. Their separate actions often canceled one another out. The Governor of the Federal Reserve Bank of New York (a bank with a close relationship to Wall Street and the investment community) believed that to counteract the growing recession, the government needed to pump money into investment and help Americans get back to work. Many of the other regional governors disagreed about what kinds of action to take. They were more concerned about maintaining gold reserves and with administrative issues than with helping the economy to recover from the widespread recession. By the time Congress forced the Fed to take strong action in 1932, it was too little, too late. The financial crisis had deepened to the point that recovery became long and difficult.

Board of Governors *the seven-member board that oversees the Federal Reserve System*

A Stronger Fed

In 1935, Congress adjusted the Federal Reserve's structure so that the system could respond more effectively to future crises. These reforms created the Federal Reserve System as we know it today. The new Fed enjoys more centralized power so that the regional banks can act consistently with one another while still representing their own districts' banking concerns.

Figure 16.1 **Structure of the Federal Reserve System**



About 40 percent of all United States banks belong to the Federal Reserve. These members hold about 75 percent of all bank deposits in the United States.

BUILDING KEY CONCEPTS **Government How does the structure of the Fed reflect a compromise between centralized power and regional powers?**

Structure of the Federal Reserve

Member banks themselves own the Federal Reserve System. Like so many American institutions, the structure of the Federal Reserve System represents compromises between centralized power and regional powers. (See Figure 16.1.)

The Board of Governors

The Federal Reserve System is overseen by the **Board of Governors** of the Federal Reserve. The Board of Governors is headquartered in Washington, D.C. Its seven members are appointed for staggered fourteen-year terms by the President of the United States with the advice and consent of the Senate. The terms are staggered to prevent any one President from appointing a full Board of Governors and to protect board members from day-to-day political pressures. Members cannot be reappointed after serving a full term. Geographical restrictions on these appointments ensure that no one district is over-represented.

The President also appoints, from among these seven members, the chair of the Board of Governors. The Senate confirms the

Figure 16.2 **Federal Reserve Districts**

BUILDING KEY CONCEPTS

Most Federal Reserve Districts contain a variety of agricultural, manufacturing, and service industries as well as rural and urban areas.

Government How does the makeup of the Federal Reserve Districts help ensure that no single region is dominant?

appointment. Chairs serve four-year terms, which can be renewed. The chair acts as the main spokesperson for monetary policy for the country. **Monetary policy** refers to the actions the Fed takes to influence the level of real GDP and the rate of inflation in the economy.

Recent chairs of the Fed have been economists from business, academia, or government. Alan Greenspan, whose previous career was in building economic forecasting models, has been the most notable chair of the Fed in recent years. He took office in 1987, serving both Republican and Democratic administrations. (See page 424 for a profile of Greenspan.)

Twelve District Reserve Banks

The Federal Reserve Act divided the United States into twelve **Federal Reserve Districts,** as shown on Figure 16.2. One Federal Reserve Bank is located in each of the twelve districts.

Each Federal Reserve Bank monitors and reports on economic and banking conditions in its district. Each Federal Reserve District is made up of more than one state. The Federal Reserve Act aimed to establish a system in which no one region could exploit the central bank's power at another's expense.

Congress also regulated the makeup of each Bank's board of nine directors to make sure that many groups' interests would be represented. Member banks elect three bankers and three leaders in industry, commerce, or other businesses to their district boards. The remaining three directorships, appointed by the Board of Governors of the Federal Reserve, represent broad public interests. The district president is then elected from among these nine directors.

Member Banks

All nationally chartered banks are required to join the Federal Reserve System. The remaining members are state-chartered banks that join voluntarily. Since 1980, all banks have equal access to Fed services like

monetary policy *the actions the Federal Reserve takes to influence the level of real GDP and the rate of inflation in the economy*

Federal Reserve Districts *the twelve banking districts created by the Federal Reserve Act*

FAST FACT

In 1913, when the Fed was established, economic and financial power was concentrated in the East and Midwest. Notice that no Federal Reserve Bank exists in Los Angeles, now one of the largest cities in the country.

Federal Advisory Council (FAC) *the research arm of the Federal Reserve*

Federal Open Market Committee (FOMC) *Federal Reserve committee that makes key decisions about interest rates and the growth of the United States money supply*

check clearing and reserve loans, whether or not they are Fed members.

Each of the approximately 4,000 Fed member banks contributes a small amount of money to join the system. In return, they receive stock in the system. This stock earns them dividends from the Fed at a rate of up to 6 percent.

A research arm of the Fed, the **Federal Advisory Council (FAC)**, collects information about each district and reports to the Board of Governors about economic conditions within their districts. It consists of one member from each Federal Reserve District—twelve members in all. The FAC's main function is to provide feedback and advice to the Board of Governors concerning the overall financial health of each district. The FAC meets with the Board of Governors four times a year.

The fact that the banks themselves, rather than a government agency, own the Federal Reserve gives the system a high degree of political independence. This independence helps the Fed to make decisions that best suit the interests of the country as a whole.

The Federal Open Market Committee

The **Federal Open Market Committee (FOMC)** makes key decisions about interest rates and the growth of the United States money supply. The committee meets about eight times a year in private to discuss the cost and availability of credit, for business and consumers, across the country. Announcements of the FOMC's decisions can affect the financial markets, the rates for home mortgages, and many other economic institutions around the world. You will read more about the effects of monetary policy later in this chapter.

Members of the Federal Open Market Committee are drawn from the Board of Governors and the twelve district banks. All seven members of the Board of Governors sit on the FOMC. Five of the twelve district bank presidents also sit on the committee. The president of the New York Federal Reserve Bank is a permanent member. The four other district presidents serve one-year terms on a rotating basis. The Board of Governors holds a majority of the seats on the FOMC, giving them effective control over the committee's actions.

After meeting with the FOMC, the chair of the Board of Governors announces the committee's decisions to the public. The Federal Reserve Banks and financial markets spring into action as they react to Fed decisions. In the next section, you will read about how the Fed's decisions are carried out and what functions the Federal Reserve serves.

Section 1 Assessment

Progress Monitoring *Online*
For: Self-quiz with vocabulary practice
Web Code: mna-6165

Key Terms and Main Ideas

HINT 1. Who serves on the **Board of Governors** of the Federal Reserve?

HINT 2. What is **monetary policy?**

HINT 3. Describe the makeup of the **Federal Reserve Districts.**

HINT 4. What does the **Federal Advisory Council (FAC)** do?

HINT 5. What is the role of the **Federal Open Market Committee (FOMC)**?

Applying Economic Concepts

6. ***Critical Thinking*** How does the banking system of the United States reflect a free enterprise economy?

7. ***Try This*** Locate your Federal Reserve District on the map on page 417. What states make up your district? What mixture of agricultural, manufacturing, and service industries does your district contain? Is it made up of both rural and urban areas?

Go Online
PHSchool.com
For: Current Events Activity
Visit: PHSchool.com
Web Code: mnd-6161