

Congress created the Federal Reserve System in 1913 to serve as the central

# Federal Reserve (Fed'

bank of the United States and to provide the nation with a safer, more

# central bank of the United

the Fed's role in banking and the economy has expanded, but its focus has

# organization created by

and maintain an effective and efficient payments system, to supervise

# money valuable and our

policy. Although all three of these roles are important in maintaining a

# one of three federal bank

Monetary policy is the strategic actions taken by the Federal Reserve to

# the United States; guard

maintain maximum sustainable economic growth. Through these actions, the

# efficiency and effective

er əl) (Ri zər v) n. the

flexible and more stable monetary and financial system. Over the years,

d States; an independent

remained the same. Today, the Fed's three functions are to provide

Congress to keep our

and regulate banking operations, and to conduct the nation's monetary

financial system healthy;

stable economy, monetary policy is the most visible to many citizens.

regulatory agencies in

influence the supply of money and credit in order to foster price stability and

ian of payments system

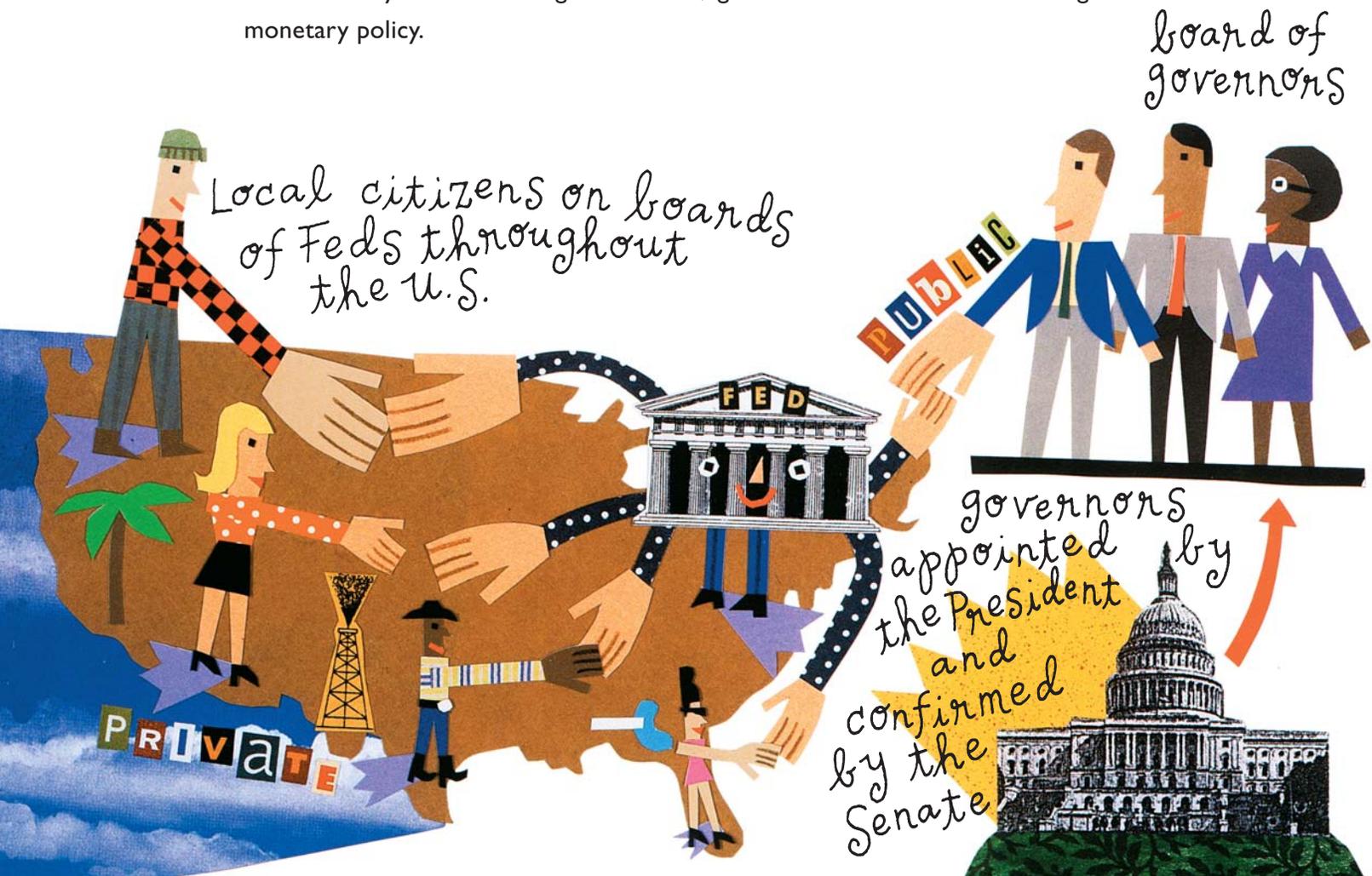
Fed helps keep our national economy strong and the world economy stable.

ness; lender of last resort.

## 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.



# MEMBER BANK

*All banks that hold stock in the Federal Reserve. This includes all*

*state-chartered financial institutions that choose to be members of the Fed and all nationally chartered banks.*

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.

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.

# BOARD OF

The Board of Governors consists of seven members, who are appointed by the president of the United States and confirmed by the Senate. They are typically economists or business/banking leaders with extensive understanding of the national economic and financial system.



The Federal Advisory Council consists of 12 banking leaders from around the country (one from each Reserve District), who advise the Board of Governors on matters of interest.



federal advisory council

advises

appoints 3 members of each Reserve Bank's board

The Federal Open Market Committee is the Fed's principal body for setting monetary policy. The FOMC is composed of the seven members of the Board of Governors and five of the 12 Reserve Bank presidents. The president of the Federal Reserve Bank of New York is a permanent member; the other presidents serve one-year terms on a rotating basis. All presidents participate fully in FOMC deliberations, but only the five presidents who are committee members vote on policy decisions.

# FEDERAL OPEN

Each Reserve Bank has a nine-member board of directors, whose members work closely with their Fed president to provide economic information and input on Reserve Bank management and monetary policy. Members are drawn from the general public and the financial community.



board of directors

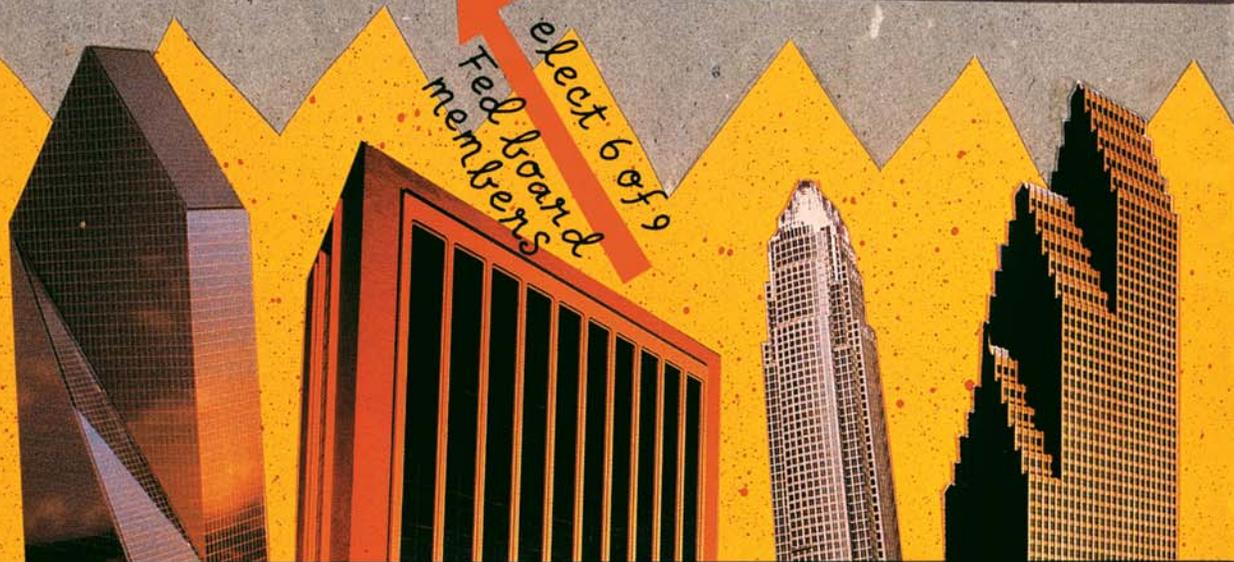
appoints

hires Fed president



Member banks own stock in the Federal Reserve. All national banks own stock, and all state-chartered banks may choose to if they meet certain requirements. As members of the Fed, these financial institutions elect six of the nine board members at each Federal Reserve Bank; however, they do not control the actions of the Fed.

elect 6 of 9 Fed board members



# MEMBER BANKS

# G O V E R N O R S

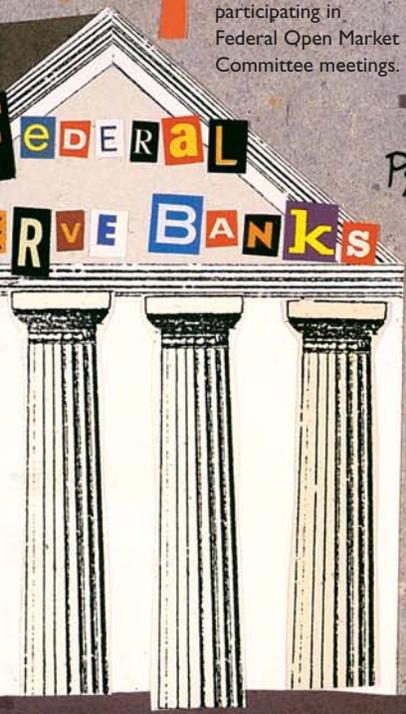


# T H E F E D

The Federal Reserve System, often called the Fed, is the nation's central bank. It is the principal monetary authority of the United States, responsible for issuing currency and managing the supply of money and credit in the economy. It was established by an act of Congress in 1913 and consists of the Board of Governors in Washington, D.C., and 12 Federal Reserve District Banks—located in Atlanta, Boston, Cleveland, Chicago, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, San Francisco and St. Louis—plus branch offices in 25 other cities.

# M A R K E T C O M M I T T E E

Federal Reserve Bank presidents contribute to the formulation of monetary policy by participating in Federal Open Market Committee meetings.



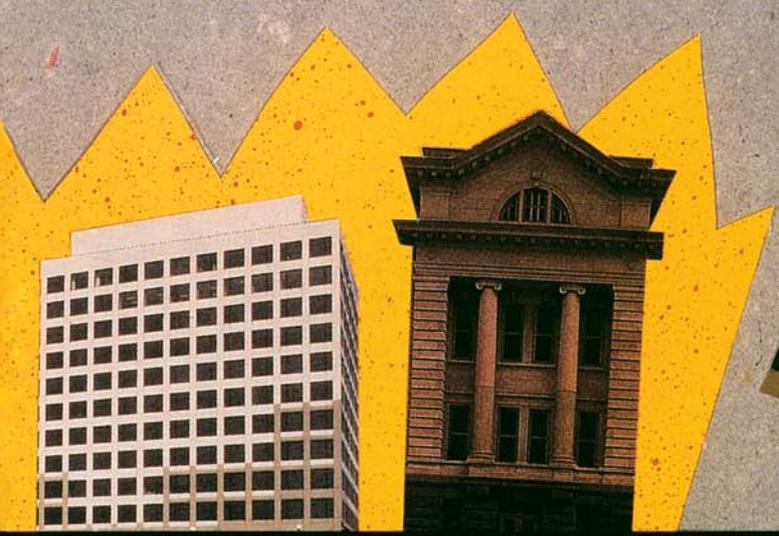
Fed President  
approves appointments & salaries  
for President & First V.P.

Fed employees



serve Fed customers

The 12 Federal Reserve Banks, and their 25 branch offices around the country, provide services to financial institutions and supervise banks and bank holding companies. They also contribute input on monetary policy. The Reserve Bank presidents contribute through participation on the Federal Open Market Committee, while the banks' directors do so through recommendations to the Board of Governors on the discount rate.



Members of the public serve on Reserve Bank boards of directors and elect the U.S. president and senators who name and confirm the members of the Board of Governors.

# t h e p u b l i c

## 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.

LENDER of LAST RESORT

*A party prepared to make short-term loans to all illiquid, but*

**Bank 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.

*solvent, financial institutions unable to obtain the money from another source.*

**ILLiquid**

*Not having enough cash to meet*

*all current and short-term obligations.*

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 Economy

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.

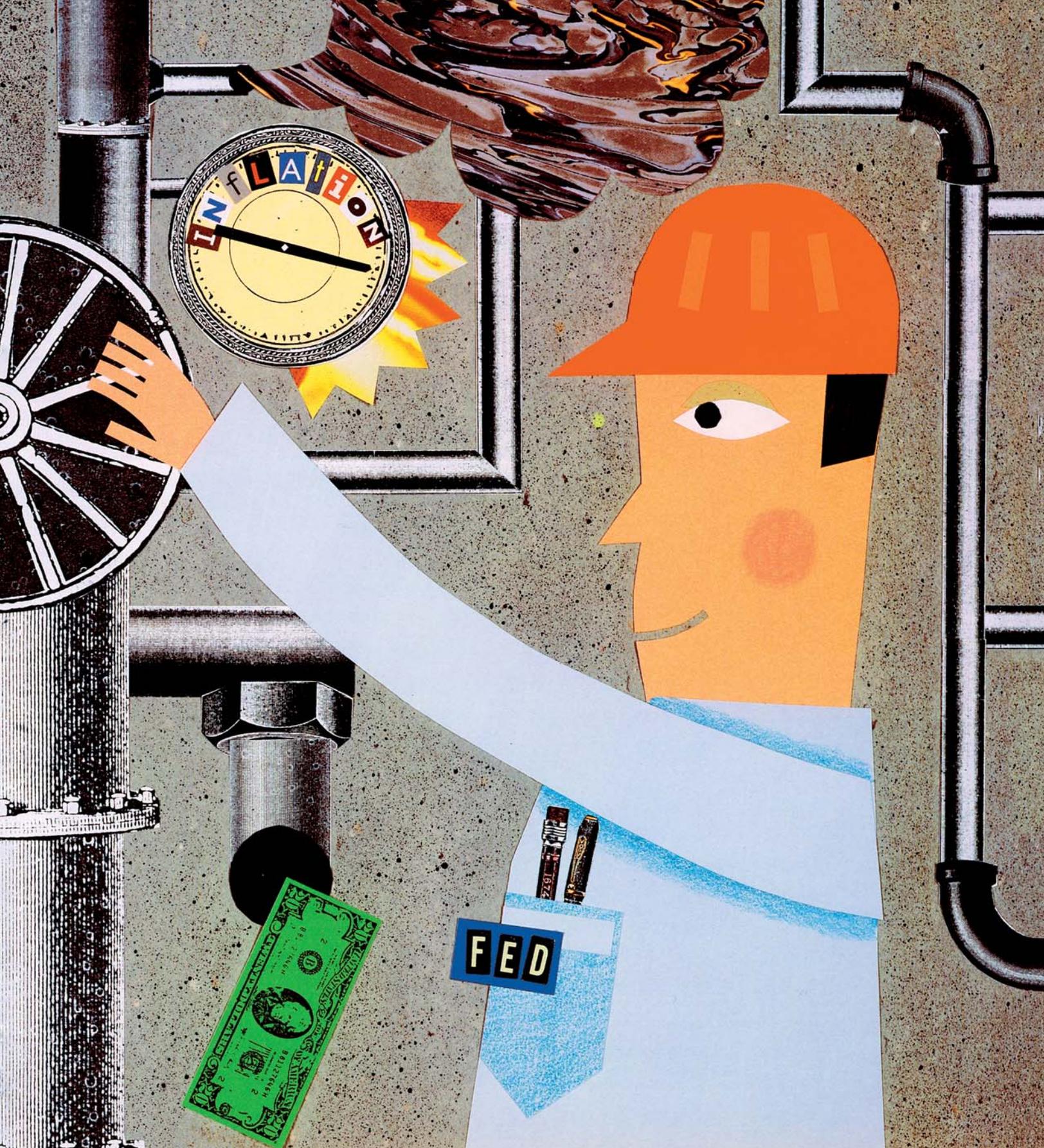
the Fed

as

INFLATION

FIGHTER





# InFLaTion

*A general rise in the prices of goods and services, which reduces the purchasing power of money. Inflation generally results when the increase in the supply of money exceeds the economy's ability to increase the production of goods and services.*



## 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.

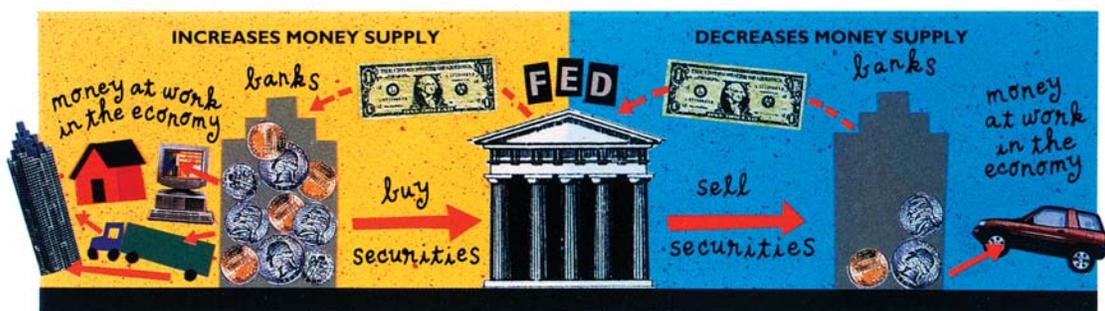
Responsibility for open market operations rests with the Federal Open Market Committee (FOMC). The committee, consisting of the seven-member Board of Governors and five of the 12 Reserve Bank presidents, meets eight times a year. The governors and the president of the New York Fed are permanent voting 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.

### DEMAND DEPOSITS

Money deposited in a financial institution that is

**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

### OPEN MARKET OPERATIONS



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

## RESERVES

*A depository institution's vault cash plus balances in its reserve account at a Federal Reserve Bank.*

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.

*payable on demand and transferable by check.*

## 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

*households, businesses, the government and financial institutions exchange funds.*

*The institutional structure through which*

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 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.

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*An organization that owns or has controlling interest in one or more banks.*

**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.

*cash available to meet all current and short-term obligations.*

**Liquidity**

*Having enough*

## FEDERAL RESERVE DISTRICTS



**EVERYDAY** economics

*Federal Reserve Bank of Dallas*

*Dallas El Paso Houston San Antonio*

The Federal Reserve System consists of the Board of Governors in Washington, D.C., and 12 district banks plus their 25 branch offices located around the country.

- 1A Federal Reserve Bank of Boston**
- 2B Federal Reserve Bank of New York**  
Buffalo Branch
- 3C Federal Reserve Bank of Philadelphia**
- 4D Federal Reserve Bank of Cleveland**  
Cincinnati Branch  
Pittsburgh Branch
- 5E Federal Reserve Bank of Richmond**  
Baltimore Branch  
Charlotte Branch
- 6F Federal Reserve Bank of Atlanta**  
Birmingham Branch  
Jacksonville Branch  
Miami Branch  
Nashville Branch  
New Orleans Branch
- 7G Federal Reserve Bank of Chicago**  
Detroit Branch
- 8H Federal Reserve Bank of St. Louis**  
Little Rock Branch  
Louisville Branch  
Memphis Branch
- 9I Federal Reserve Bank of Minneapolis**  
Helena Branch
- 10J Federal Reserve Bank of Kansas City**  
Denver Branch  
Oklahoma City Branch  
Omaha Branch
- 11K Federal Reserve Bank of Dallas**  
El Paso Branch  
Houston Branch  
San Antonio Branch
- 12L Federal Reserve Bank of San Francisco**  
Los Angeles Branch  
Portland Branch  
Salt Lake City Branch  
Seattle Branch