

Federal Reserve System

Money and Monetary Policy

Some Things to Know – Unit II

Nature and Functions of Federal Reserve

Fed is this country's "central bank" (like Bank of England, Bank of Japan, European Central Bank, etc.)

Chief purpose: to conduct monetary policy

Serves as: Fiscal agent to Treasury (U.S. government/ Treasury's bank)

Also serves as: Banking system's bank privately owned, but not privately controlled

Serves as financial system regulator (limited duties)

Structure and Governance

Board of Governors—the Fed's chief governing body

Structure of the Board of Governors

Number of Governors: 7

How does one become a Governor?

Appointed by President; must be confirmed by Senate

Length of full term: 14 years (staggered terms)

Membership conditions/restrictions

No two Governors from same Reserve district

Cannot be re-appointed to second full term

(but may be appointed to full term after serving out an unexpired term—thus possible to serve more than 14 years, though rarely done)

(Generally) cannot be fired from Board

Chairman of Board of Governors

CEO of the System

Designated by President; subject to Senate confirmation
4 year term as Chairman
Can be re-appointed Chairman

Federal Open Market Committee: chief policy-making group

Chief duty/function: draws up policy directive—sets course of monetary policy

Number of members: 12

Membership: 7 Governors

5 Reserve Bank presidents

(NY; Cleve/Chicago; Dallas/St.L./Atlanta; etc)

Meets—about every 6 - 8 weeks

Federal Advisory Committee

Role is strictly advisory (relatively unimportant)

12 members—one from each Federal Reserve district

Appointed by district Federal Reserve banks

No significant policy-making powers

Federal Reserve Banks

12 F.R. banks—most have branches

Each has nine member Board of Directors

6 elected by member banks

3 appointed by Board of Governors

Directors select Bank President (who runs bank, serves 5 year term)

(All important “decisions” by Boards of Directors subject to approval of Board of Governors—thus little real power)

Independence of the Fed?

Long terms, conditions of service make Fed less politically dependent than most regulatory/policy making agencies in U.S.

Not having to rely on Congress/President for budget makes Fed considerably less politically dependent than other agencies

Congress can amend Federal Reserve Act—so how independent?

What seems to be the major advantage of a central bank that is politically independent?

Tools of the Fed

General Monetary Control Instruments

1. Reserve requirement policy

Reserve requirement set by Board of Governors

Reserves held against deposits of banks (Fed sets percent)

Reserves may be held as deposits at Fed or bank vault cash

Least often used tool for changing monetary conditions

Effect of change in reserve requirement considered too sudden, too blunt. Increase could cause hardship on banking system.

2. Discount rate policy

Discount rate—interest rate that Fed charges banks when they borrow reserves from Fed

Weakest and least certain impact of three tools

Primary impact once considered to be “announcement effect”

Open market operations

Involves buying and selling of securities (initiated by Fed)

By far the most important and most often used tool of monetary policy—virtually the only tool today

All open market operations go through New York Fed

Open market operations go through “primary dealers”

When Fed buys securities: reserves, monetary base increases

When Fed sells securities: reserves, monetary base decreases

Open market transactions may be classed as:

dynamic—aimed at bringing about change

defensive—aimed at preventing external factors (such as “float” or movement of Treasury balances) from bringing about unwanted changes in financial conditions

Terms of open market transactions:

outright purchases and sales

transactions involving repurchase agreement—most common

Conducting Monetary Policy

Account Manager: So, what do I do today?

For conducting day to day operations, Fed can attempt to control (as an operating target) either:

reserves and/or the monetary base

federal funds rate

with an eye toward controlling/affecting
monetary aggregates (the Ms; spendable stuff)
interest rates

Which approach (set of targets) does the Fed seem to favor today? Why?

A few questions on details

What exactly are federal funds (and thus the fed funds rate)

Mechanically/administratively, how does changing the discount rate
differ from changing the fed funds rate?

What is the duration of most federal funds transactions?

What is the collateral for most fed funds transactions?

How does a fed funds transaction affect total bank reserves?

How does a discount loan affect total bank reserves?

What is the most commonly used method to transfer (fed) funds?

Generally, how would the Fed go about raising the fed funds rate?

The Fed does not have to go to Congress to get its operating funds.

What is the source of most of its funding?

Is the fed funds rate normally higher than/ lower than the discount rate?

What is the most common category of loan from the discount window?

What is the duration of “primary credit” loans from the Fed?

Who may/may not receive “seasonal credit” from the Fed?

Who, specifically, sets the discount rate? How often?

How often must a bank meet its reserve requirement, i.e., does
the bank have to have the required percentage in reserves each day?
each week?

What is the normal reserve requirement (percent) against time
deposits?

17. Does the Fed pay interest on required reserve deposits of banks?

18. Why do most open market transactions involve a repurchase agreement?

19. What is the monetary base? What are its components? How is it linked
to open market operations?

20. Distinguish between an intermediate target and an operating target
relative to the implementation of monetary policy? What are some of
the major targets of each type? What role does each type play?

21. How does an open market purchase by the Fed affect bank reserves?
the monetary base? the fed funds rate?

22. Where does the Treasury keep most of its money?

23. Why does the Fed make a daily call to the Treasury?

Money

How is money generally defined?

What are the functions of money? Be able to recognize and identify the various functions of money in use.

What is the primary advantage of using money as a medium of exchange?

What are the various statistical measures of money? (Know the major components of M1 and M2.

What is the nature of the relationship between money growth and overall economic activity in the U.S.?