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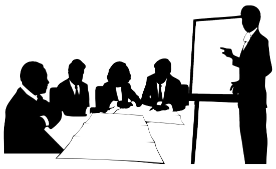


Lingua Nova

THE STRUCTURE OF THE FEDERAL RESERVE SYSTEM

In the May edition of the lesson we were discussing the central bank in England which is the Bank of England and the Federal Reserve in the USA.

WHAT IS THE STRUCTURE OF THE FEDERAL RESERVE SYSTEM?

At the base of the Federal Reserve System are the member commercial banks. All national, or federally chartered, banks are required to join the system; membership of state-chartered institutions is voluntary. Members have to purchase capital stock in their district Federal Reserve bank in the amount of 6 percent of their capital, excluding retained earnings, and get the right to vote for six of the nine directors of that district bank. Stock ownership does not convey control or the financial interest normally attached to stock in a corporation. The stock may not be sold or used as collateral and must be returned to the district reserve bank if the commercial bank ceases to be a member.

The Monetary Control Act of 1980 imposed a reserve requirement on all depository institutions, including nonmembers of the Federal Reserve, but it also permits them to borrow from the Federal Reserve and to use services provided by the Fed, such as check clearing, electronic funds transfer, and securities safekeeping. By enabling banks to borrow reserves from the Fed, the liquidity of the entire banking system is increased.

The 12 district reserve banks are located in the following cities: Boston, Massachusetts; New York City; Philadelphia, Pennsylvania; Cleveland, Ohio; Richmond, Virginia; Atlanta, Georgia; Chicago; St. Louis; Minneapolis, Minnesota; Kansas City, Missouri; Dallas, Texas; and San Francisco, California. Each bank is formally responsible to a nine-member board of directors, which is divided into three classes. Class A and B directors are elected by the member banks; class C directors are appointed by the Board of Governors. The board of directors is responsible for the administration of its bank and for appointing the bank's president and vice president (subject to the approval of the Board of Governors). The directors also set the discount rate—that is, the interest rate charged to banks for borrowing from the Reserve banks—again, subject to review by the Board of Governors.

Reserve banks implement the decisions made by the Fed's Board of Governors and by their own officers. Their staffs examine state member banks (national banks are examined by the staff of the Office of the Comptroller of the Currency; insured nonmember banks are subject to FDIC examination), decide on granting loans to members, and carry out the routine banking functions for the federal government. Decisions on whether to allow a bank to open branches, to merge with another bank, or to form a holding company (company that offers a broad range of financial services) are often handled by reserve bank officers. Sales and purchases of securities for the Federal Reserve System's own account are conducted by the Federal Reserve Bank of New York, which is also the operating arm for international financial activities.

At the top of the Federal Reserve System is the Board of Governors, which over the years has undergone significant change both in its responsibilities and its structure. The 1913 act established a seven-member Federal Reserve Board, consisting of five presidential appointees, each from a different Federal Reserve district, plus the secretary of the treasury and the Comptroller of the Currency. Terms of office for the appointees were initially set at ten years and were staggered, so that no two would end at the same time; board members could not be removed from office except for cause. These provisions were meant to help insulate the presidential appointees from day-to-day politics. The board's powers, nevertheless, were confined to supervising the reserve banks, with limited power over the discount rate and little discretion over the structure of the banking industry.

The Banking Act of 1935, which also finalized the creation of deposit insurance and the FDIC, centralized power in a Board of Governors, and made all seven members presidential appointees with the advice and consent of the U.S. Senate; the president also appoints a governor to serve as Fed chairman for a four-year term. The governors' terms were expanded to 14 years by the 1935 act, and their powers were also expanded. For example, discount rates now had to be approved periodically by the board. Sales and purchases of government securities—the open-market operation that previously had been managed solely at the discretion of the presidents of the reserve banks—were centralized in the Federal Open Market Committee (FOMC), consisting of the seven governors, the president of the Federal Reserve Bank of New York, and four other reserve bank presidents serving on a rotating basis. Since 1935, Congress has given additional powers to the Board of Governors. These powers include control over mergers, bank holding companies, U.S. offices of international banks, and the reserves of all depository institutions.

ONE OF THE MAIN FUNCTIONS OF THE FED IS MONETARY CONTROL.

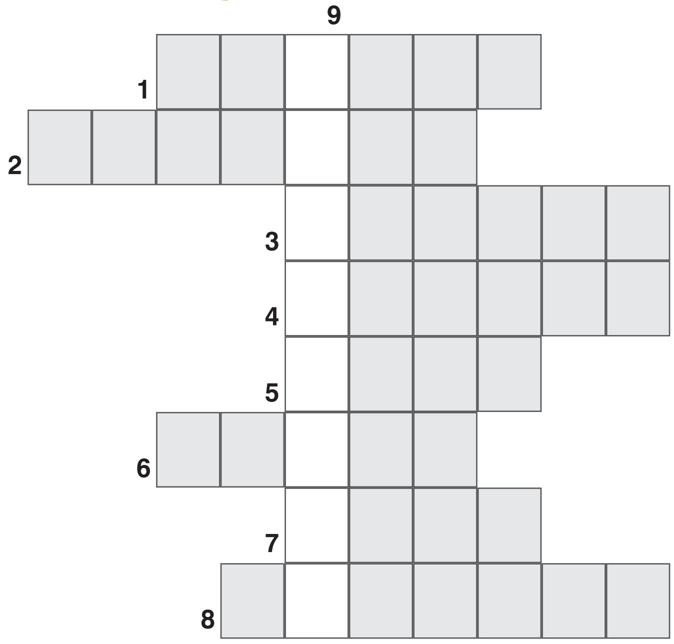
The Fed is best known to the public for the influence it has on interest rates by "loosening" or "tightening" the money supply. The term money supply has various technical definitions but basically it is the amount of currency, coin, and checking account balances available at any one time in the U.S. financial system. The interest rate that Fed policymakers focus on primarily is the federal funds rate, the interest rate at which banks lend money to other banks that need to make loans.

The Federal Reserve's open market operations are the most flexible and most frequently used instrument of controlling the money supply and the federal funds rate. When the FOMC decides that the money supply is growing too slowly to meet the economy's needs or that interest rates are too high, the Fed purchases U.S. Treasury securities on the open market—that is, from the public and banks—thus injecting cash into the financial system and expanding bank reserves and lowering the federal funds rate. This process enables banks to loan more money, which helps businesses and consumers and helps the economy grow faster. Conversely, should the money supply or economy grow more rapidly than is desired or should interest rates be too low, which may lead to inflation (a sustained increase in prices), the FOMC will sell securities of the Department of the Treasury on the open market. Such sales reduce bank reserves and raise the federal funds rate and thus slow down the economy. Generally, this reduces the money supply and protects against inflation.

Complete the crossword. The letters in the middle column, when you read them down spell out a noun. All other words in this crossword are nouns as well.

Fill in the missing words in the crossword puzzle. All the words this time are verbs in their infinitive form. To help you more you can find of all them in the first two paragraphs of the text above.

CROSSWORD PUZZLE



Across:

1. to officially order that something should be forbidden, restricted, taxed etc, or that someone should be punished
2. to deliberately not include something, especially a particular group of people or things
3. to keep something or continue to have something
4. to communicate information or a message
5. to possess
6. to stop doing something or stop happening
7. to give something to someone in exchange for money
8. to need something

Down:

9. to buy something, especially something big or expensive

ANSWERS

1.impose, 2.exclude, 3. retain, 4. convey, 5.have, 6.cease, 7.sell, 8.require, 9.impose

Although the open-market operation is the most flexible and the most frequently used instrument of monetary policy, similar results can be achieved by changing the required reserve ratio—that is, the percentage of deposits that banks must maintain on reserve as cash deposits at the Federal Reserve banks. When the required reserve ratio is raised, banks are unable to create as much money as they previously were able to because a larger portion of their assets must be held in reserve; the converse is true when the reserve ratio is reduced.

Also among its general controls, the Federal Reserve can make changes in the discount rate, the rate of interest at which the Fed lends money to banks. By raising the discount rate, the Fed discourages banks from borrowing money from the Fed. The Fed does this typically when it wants to reduce the money supply and slow the economy. Conversely, to increase the money supply and expand the economy, the Fed lowers the discount rate. A discount rate change may, at times, reinforce open-market operations. It may also, at times, have an “announcement effect,” signaling a change in the Federal Reserve’s underlying evaluation of economic conditions.

The Federal Reserve also has a narrow role in regulating operations of the stock market. It may selectively lower or raise the margin requirement, which is the percentage of a stock price that must be provided in cash by someone who buys the stock on credit. The margin requirement, a legacy of depression legislation, aims to curb market speculation.

The Credit Control Act of 1969 authorized the U.S. president to give additional controls to the Federal Reserve. In 1980 the act was used as a means of controlling various types of consumer credit. The Gramm-Leach-Bliley Act of 1999 gave the Fed regulatory authority over the new financial services holding companies. These companies can offer banking, issue securities (stocks and bonds) and insurance, and other financial services all “under one roof.” The Glass-Steagall Act of 1933 had prohibited banks from engaging in many of these activities, such as underwriting securities and insurance, because they were deemed risky at the time.

WHAT ARE THE EFFECTS OF THE FEDERAL RESERVE POLICY?

Most economists today tend to believe that the policy record of the Federal Reserve has had mixed results during the Fed’s history and that occasionally Fed actions have increased rather than decreased economic instability. Many economists would agree, for example, that the Federal Reserve is partly to blame for the severity of the Great Depression of the 1930s because the Fed allowed the money supply to shrink dramatically. On the other hand, many economists believe that the record of price stability during the late 1950s, 1960s, and 1990s was partly due to the Fed’s effective monetary policy. Even this successful anti-inflation policy, however, had its critics who argued that the tight monetary policy raised interest rates to unusually high levels. Criticism was muted when both inflation and interest rates steadily dropped through the mid- and late 1980s and into the early 1990s. Most economists recognize that some economic problems, such as the negative economic impact of the oil shortage of the 1980s, are supply-related phenomena that the Federal Reserve is powerless to resolve.

WHAT ARE THE RELATIONS OF THE FED WITH THE GOVERNMENT?

The Federal Reserve is sometimes considered a fourth branch of the U.S. government because it is made up of a powerful group of national policymakers freed from the usual restrictions of governmental checks and balances. Indeed, the Board of Governors is formally independent of the executive branch and protected by tenure well beyond that allotted to the U.S. president. In practice, the president will typically listen carefully to the Fed’s policy suggestions. The Fed and the president frequently share the same economic agenda, but sometimes they have different agendas.

The relationship between the Federal Reserve and Congress is more complex. On the one hand, because it was created by Congress, the central bank is unmistakably a creature of Congress, being responsible to it for its mandate and its continued existence. On the other hand, the self-financing feature of the Federal Reserve prevents Congress from exercising influence through its budgetary authority. Thus, the Federal Reserve is relatively free from the partisan political pressures that operate in the Congress, although the Fed must report frequently to Congress on the conduct of monetary policy. ■