The Federal Reserve: Who We Are, What We Do.

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Bottom Liners

Eric & Bill

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What is the Federal Reserve System?

- The Federal Reserve is the *central bank* of the United States.

- A *central bank* is the government agency that oversees the banking system and is responsible for the amount of money and credit in the economy.

What are the Federal Reserve's responsibilities?

1. To regulate bank holding companies and state chartered banks.
2. To supply money and credit to the economy to maintain stable prices and full employment.
3. To ensure the smooth functioning of the payments system.
4. To act as the government's bank.

How does the Federal Reserve differ from other central banks?

- Not all central banks have responsibility for bank regulation or the payments system.

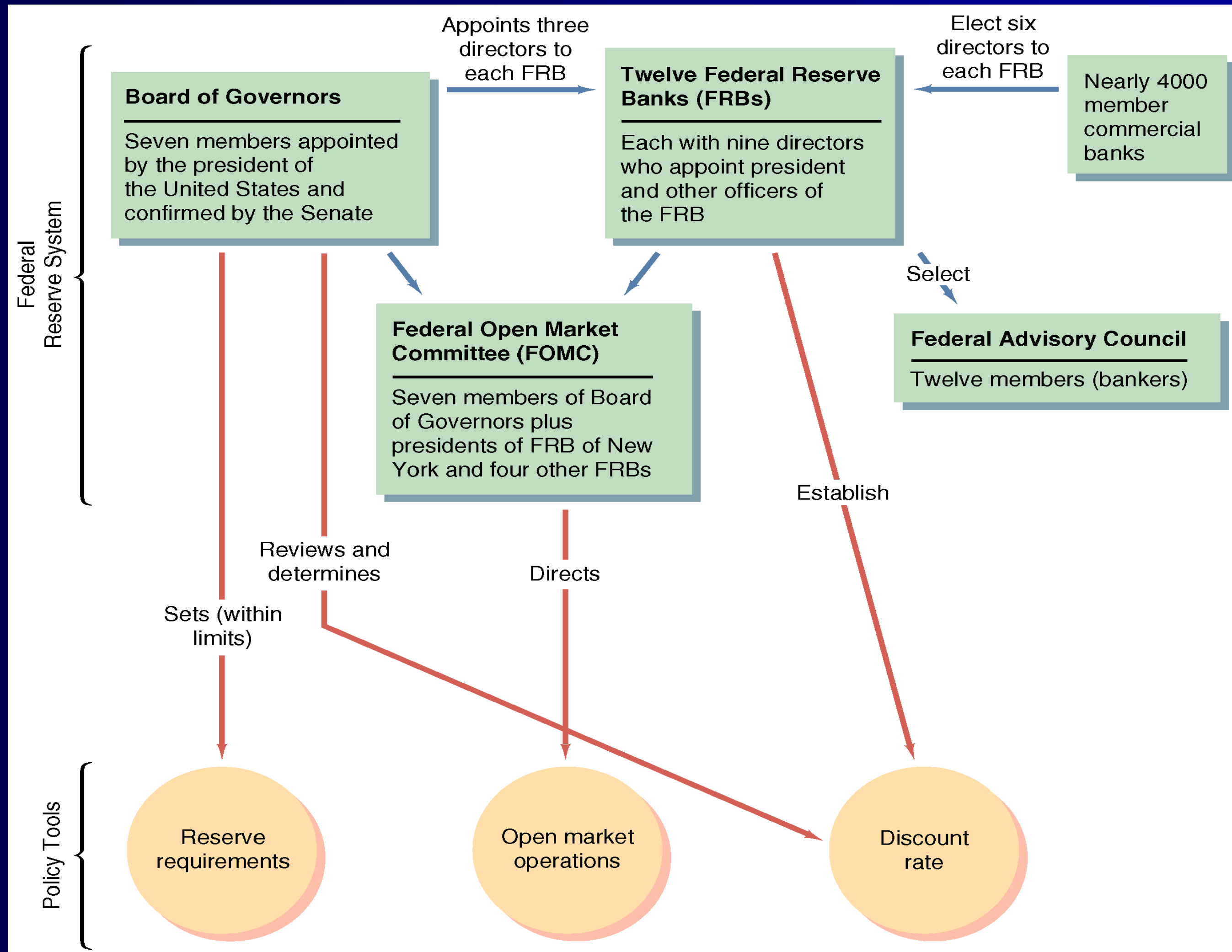
- The Fed is exceptionally decentralized.
  - Authority is vested in the Board of Governors and the Presidents of the 12 regional reserve banks.

How does the Federal Reserve differ from other central banks?

- The Fed is more independent of elected officials than most central banks.

- The new European Central Bank shares many of the characteristics of the Federal Reserve System.
  - Decentralized, independent.

Structure of the Federal Reserve



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The Fed’s Objectives

- “Stable prices”
- “Maximum employment”
- Moderate long-term interest rates

The Fed’s Monetary Policy Tools

- The federal funds rate
- The discount rate
- Reserve requirements

The Fed’s Main Tool

- The federal funds rate
  - An interbank overnight interest rate
- How does the Fed control it?
  - Open Market Operations: Buying and selling U.S. government securities to raise and lower the interest rate.
  - OMO change the amount of “base money,” cash plus bank reserves with the Fed.

The Fed's Main Tool

- What are the consequences?
  - Lower interest rates/more money leads to more spending and investment, higher prices in the long run.
  - Higher interest rates/less money leads to less spending and investment, lower prices in the long run.
  - Volatile monetary policy leads to uncertainty about future economic conditions and discourages economic activity.

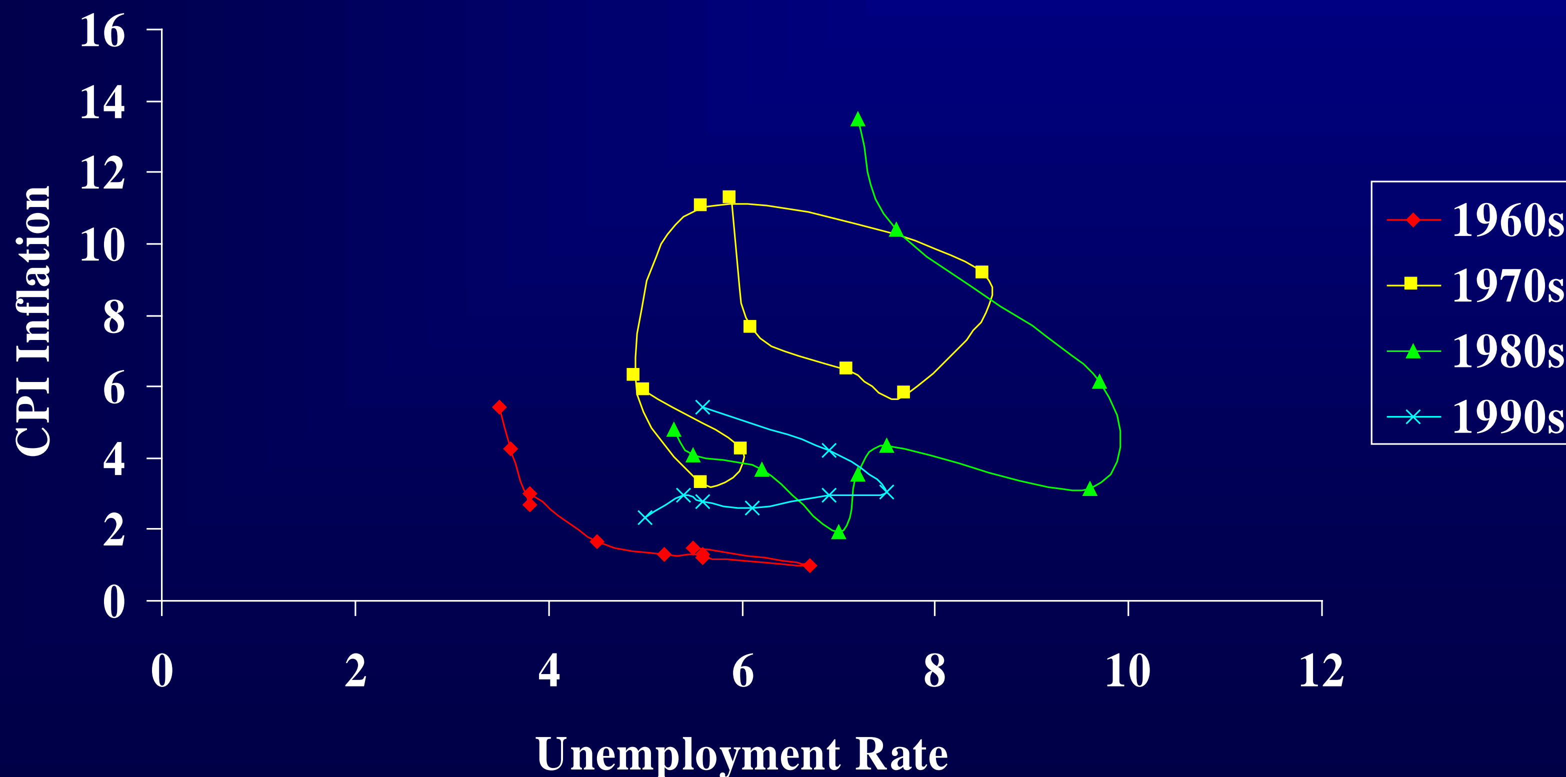
Output and Inflation

- What is the relationship between inflation and employment?
  - Expansive monetary policy can cause both temporarily higher employment and permanently higher prices.
  - Low unemployment does not cause inflation.

- An environment of stable prices is the best way to promote employment in the long run.

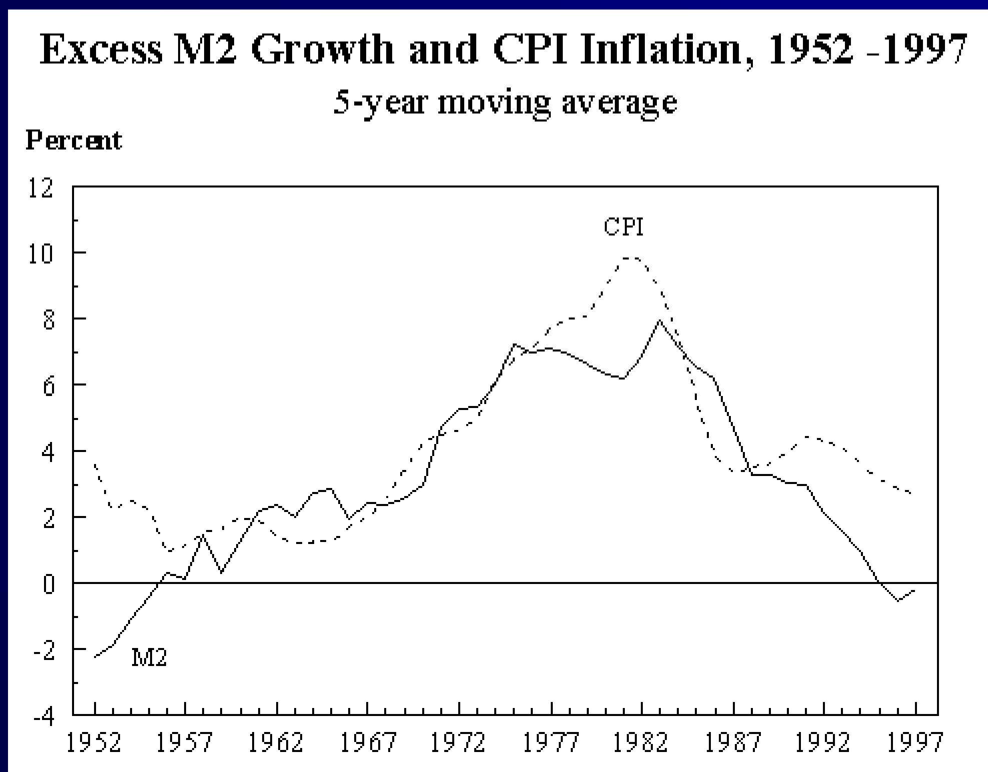
What does the Fed control?

- In the short run, the Fed can mostly control real economic activity.
  - This is called "monetary neutrality."



What does the Fed control?

- In the long run, the Fed can only change the average rate of inflation.
  – "Inflation is always and everywhere a monetary phenomenon." — Milton Friedman



International Cooperation

- While the U.S. Treasury has ultimate legal responsibility for foreign exchange intervention, in practice the Federal Reserve shares that responsibility.
- The Federal Reserve maintains swap lines with foreign governments and central banks.

Questions and Answers

- What is the outlook for the U.S., Japanese and European economies?
  - Is the U.S. in a bubble economy?
- Is the Fed a “World Central Bank?”
- Can the Fed take credit for the expansion?
- What caused the financial crisis of 1998?
- Is a strong dollar or a weak dollar better for the U.S.?

The End