



THE FEDERAL RESERVE TODAY

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Federal Reserve
Bank of Richmond

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The Federal Reserve System opened its doors for business nearly 60 years ago. During the intervening years, it has undergone many changes as its role has expanded from one of limited scope to one that affects the lives of every American. This is the story of the System today—its objectives, its structure, and its actions.

SYSTEM

FUNCTIONS

AND

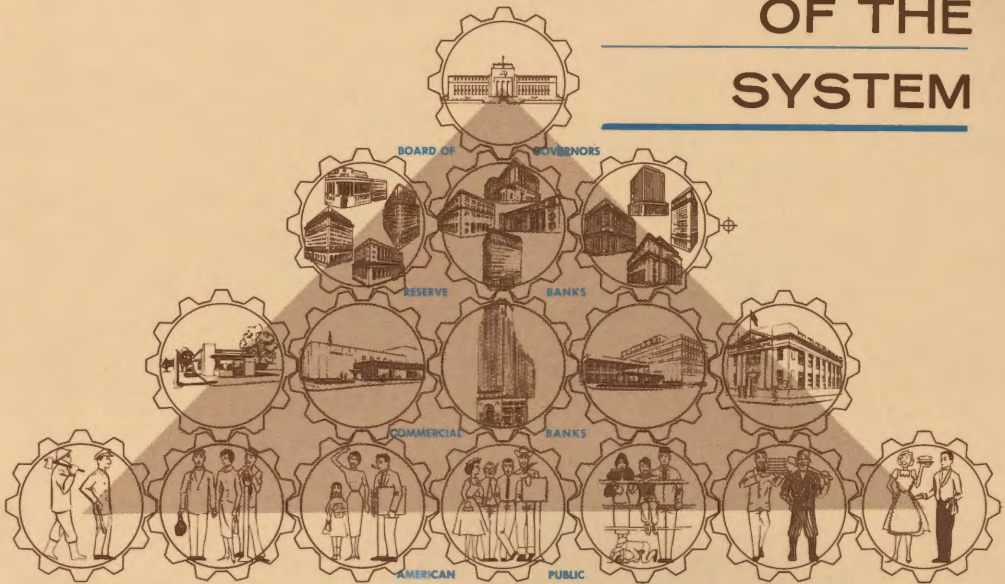
OBJECTIVES

The System has two basic functions: (1) providing the Treasury and the public with several basic services and (2) regulating the flow of money and credit in order to contribute to economic growth and stability. Of the two, its monetary policy actions—the steps it takes to influence economic conditions—are the more important.

System policy actions have several major objectives: to contribute to high levels of employment, to encourage economic growth, to foster price stability, and to help maintain a sound international balance of payments position. System policy alone cannot achieve these objectives since many other factors play important roles. It can, however, do a great deal to create a monetary and credit climate conducive to the attainment of these goals.

These objectives are mutually interdependent over the long run. Without full employment, the country cannot realize its growth and prosperity potentials. If there is continuing inflation, speculative activity is apt to replace productive efforts, inventory and other excesses leading to recession may develop, and balance of payments problems will probably arise. Serious balance of payments problems in turn may make it impossible to pursue as expansionary monetary and fiscal policies as may be needed domestically. A sound balance of payments position, high levels of employment, and stable prices, however, produce the best possible environment for sustainable economic growth. Because of these interrelationships, the System considers all its goals to be equally important.

STRUCTURE OF THE SYSTEM



The structure of the System closely resembles that of a triangle. At the apex is the Board of Governors, farther down are the 12 Federal Reserve Banks and their 24 branches. Forming the base of this triangle are the nearly 6,000 commercial banks that are "members" of the System. There are also several committees that play important roles in System operations.

The Member Banks. Federal Reserve member banks hold about 80 percent of all commercial bank deposits, although only about 40 percent of all commercial banks belong to the System. National banks must be members, and state-chartered banks may join if they meet certain requirements. The member banks of each district are the stockholders of the Reserve Bank serving their district.

The Reserve Banks. The Reserve Banks

constitute the next level of the pyramid. Each of the 12 Reserve Banks serves a certain district of the country, and all but two Reserve Banks have branches that cover particular parts of their districts. Cities with head offices of Reserve Banks are Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

The corporate structure of the Reserve Banks resembles that of commercial banks, but there are important differences. First, the Banks are not profit-motivated. Instead, policy is based purely upon the System's estimates of the needs of the economy. Since the System acquires large quantities of income-producing Government securities in the process of implementing monetary policy, Reserve Banks do earn substantial

THE FEDERAL RESERVE SYSTEM

BOUNDARIES OF FEDERAL RESERVE DISTRICTS AND THEIR BRANCH TERRITORIES



Legend

- Boundaries of Federal Reserve Districts — Boundaries of Federal Reserve Branch Territories
- ⊕ Board of Governors of the Federal Reserve System
- ⊙ Federal Reserve Bank Cities • Federal Reserve Branch Cities



The office of the Board of Governors in Washington.

profits. During 1970, for example, their combined earnings totaled \$3.9 billion. Second, the member bank stockholders do not have all the rights of ordinary stockholders. For example, their dividends are limited by law to six percent, they elect only six of the nine directors of each Bank, and they would share in the assets of the Banks only to the extent of the par value of their stock if the Reserve Banks were ever liquidated. Third, "investment" decisions are under the control of the Federal Open Market Committee rather than the boards of directors of the Banks. Finally, the Board of Governors exercises over the Reserve Banks many of the supervisory powers customarily held by directors of private corporations.

Reserve Bank directors have several monetary policy duties, however, in addition to their regular responsibilities in overseeing Bank operations. First, they establish, subject to the approval of the Board of Governors, the discount rates the Reserve Banks charge on loans to member banks. Second, they elect five of the Reserve Bank presidents to serve as members of the Federal Open Market Committee. Third, they provide System officials with considerable "grass roots" information on business conditions.

Board of Governors. The Board of Governors in Washington is composed of seven members appointed for 14-year terms by the President of the United States with the advice and consent of the Senate. Board members may not be reappointed if they have served a full term, and each must come from a different Federal Reserve District. The chairman and vice chairman of the Board are appointed from among the members by the President for

four-year terms and may be reappointed.

The Board's duties include supervising state member banks, overseeing the operations of Reserve Banks, approving changes in the discount rate, setting reserve requirements for member banks, establishing margin requirements on specified stocks and bonds, setting maximum interest rates payable on time and savings deposits of member banks, and serving as members of the Federal Open Market Committee.

The Federal Open Market Committee. The Federal Open Market Committee is the System's most important policymaking body since it determines the extent to which the System buys and sells Government securities and bankers' acceptances. It also has charge of the System's operations in foreign exchange markets. Members include not only the seven members of the Board of Governors but also five Reserve Bank presidents, one of whom is the President of the New York Reserve Bank. The other presidents serve one-year terms on a rotating basis. Both domestic and foreign operations are conducted by the New York Reserve Bank as agent for the Committee.

Other Committees. Other important committees include the Conference of Presidents, the Conference of Chairmen, the Conference of First Vice Presidents, and the Federal Advisory Council. The first three—as their names imply—meet periodically to discuss problems of mutual interest to the Reserve Banks. The Federal Advisory Council is a 12-man committee of bankers, which meets several times a year to advise the Board of Governors on matters of current interest.

SERVICE FUNCTIONS

Coupons being clipped on municipal securities held in safekeeping for a member bank.



Like the central banks of most other countries, the System provides a number of important services to the Treasury and the public.

Fiscal Agency Functions. One of the most important of these is acting as fiscal agent for the U. S. Treasury. The Reserve Banks service the Treasury's checking accounts; assist in the sale, transfer, and redemption of Government securities; pay interest coupons; and assist the Treasury and other Government agencies in many other ways. Reserve Banks receive no compensation for redeeming coupons and handling the Treasury's checking accounts, but they are reimbursed for most other fiscal agency functions.

Collection of Checks and Noncash Items. The System also operates a nationwide "clearinghouse" for checks, drafts, and similar items. Member banks route these items to Reserve Banks, which in turn send them to the proper places for collection. Settlement is accomplished by means of entries to the accounts member banks maintain with the Reserve Banks.

Wire Transfer of Funds. The System maintains a communications center at Culpeper, Virginia that is staffed and operated by the Federal Reserve Bank of Richmond for transferring funds by wire from one part of the country to another. The communications system is actually composed of several computers designed to transmit messages in a very rapid fashion over special telephone lines. For example, if a national concern headquartered in New York wishes to transfer funds to its Chicago office, it can have its bank request the transfer through the System communications facilities. The New York Reserve Bank will deduct the funds from the bal-



With machines such as these, the Federal Reserve Banks can quickly transfer funds from one part of the country to another.

The Federal Reserve Banks use machines like these in collecting more than eight billion checks every year.





Coins being counted at the Federal Reserve Bank of Richmond.



A truckload of new currency being transferred to a vault at the Federal Reserve Bank of Richmond.

ance of the New York commercial bank, and the Chicago Reserve Bank will add the funds to the reserve balance of the firm's bank in Chicago, which will credit the account of the firm. The Reserve Banks will then settle by means of an entry on the books of the Interdistrict Settlement Fund—a System clearing agency in Washington.

Supplying Coin and Currency. The Federal Reserve Banks provide a vital part of the machinery through which most coin and currency moves into and out of circulation. As the public demands more cash from commercial banks, the banks draw

down their balances at the Federal Reserve in exchange for additional cash. Similarly, when cash flows in from the public, the banks deposit the funds in their accounts with the Reserve Banks.

Note Issue. Look in your billfold and chances are that you will find a bill bearing a green seal. This is a Federal Reserve note—the most common type of currency in circulation today. These notes, which are issued by the 12 Reserve Banks, must be backed 100 percent by collateral consisting of Government securities, gold certificates, or other special types of assets.

INFLUENCE ON ECONOMIC ACTIVITY

System policy affects the economy primarily through influencing interest rates, the availability of credit, and the money supply (cash plus private demand deposits) and, through them, the volume of spending. The initial impact of policy is usually felt by the commercial banking system, but it spreads quickly throughout the entire financial structure of the nation and, often, throughout the international economy as well.

Key Role of Commercial Banks. Commercial banks play a vital role in this whole process because they are the only private institutions that can "create" money. Other private financial institutions act merely as intermediaries in channeling on to borrowers or others money entrusted to them by depositors, stockholders, and others. It is not so with commercial banks, whose actions can actually increase or decrease the volume of money in existence.

Here is how the process works. Suppose that the System purchases some Government securities from a New York bond house and credits the proceeds to the "reserve account" that the dealer's bank maintains with the Reserve Bank. The dealer's bank will then have excess reserve funds and will normally put the funds to work by making loans or investments. If it makes loans, it will simply credit the checking accounts of the borrowers. If it purchases investments, deposits will also rise when the funds used in payment are deposited by the seller. In both cases new money, in the form of additional demand deposits (checking accounts), will be "created."

But the process does not stop here. As these deposit holders spend their newly acquired funds, the deposits will move to other banks. These banks will have to set aside part of their new funds as "reserves" to back their new deposits but will be able to lend approximately the remainder. These loans will create additional new deposits, which will move at least in part to other banks that in turn can expand loans and deposits in the same manner. The process can go on until deposits become so large that all the funds injected into the banking system are used as reserves to support the new deposits. By the time the process stops, demand deposits will usually have risen by several times the amount of the reserves created by the System's original action. Conversely, a decline in member bank reserves can bring about a multiple contraction in the money supply.

The Importance of Money in the Economy. Money plays a unique role in the economy in that nothing else is generally acceptable in payment for goods and services. Other assets such as time deposits, savings and loan shares, and short-term Treasury securities possess many of the attributes of money, but they cannot be spent until they have been converted into cash or demand deposits.

The volume of expenditures determines the level of economic activity. Rising expenditures require either more money or a pickup in velocity—the rate at which money is spent. Since the average dollar is spent many times in the course of a year, increases or decreases in the supply of

Commercial banks play a unique role in the American economy.



Rising business activity requires more money or a more intensive use of existing money.

money can result in shifts in spending that have tremendous impacts upon prices and the overall level of economic activity.

How Reserves Fit into the Picture. To a large extent, changes in the volume of member bank reserves determine the amount of money banks can "create." Several other factors—the amount by which time deposits rise, the behavior of Government deposits at commercial banks, the amount of cash withdrawn from banks, and so on—play important roles, but reserves usually play the most important single part.

Consequently, by increasing or decreasing the volume of reserves the System can influence the money supply, the availability of credit, interest rates, and, through these, the level of economic activity and prices. By stepping up the rate of increase in member bank reserves, the System can stimulate the domestic economy, and by slowing down the rate of increase or by actually letting reserves fall, the System can reduce the rate of increase in total domestic spending.

In the process of affecting reserves, it also can influence both directly and indirectly international trade and capital movements. By helping prevent inflation while encouraging healthy growth and high employment, the System can make a major contribution to a successful foreign trade position. By helping to keep interest rates in reasonable alignment with foreign rates and by taking certain other actions, System policy can also ease balance of payments problems arising from international capital movements.

MONETARY

POLICY

TOOLS

The System utilizes several important policy tools to affect the level of economic activity. Basically, controls fall into two categories: general and selective. General controls—the discount rate, reserve requirements, and open market operations—are aimed at the overall availability of money and credit and the general level of interest rates. Selective controls regulate particular types of credit. At the present the System's only strictly selective control is the changing of margin requirements on certain stocks and bonds. In addition to these tools, the System has two others that are partly general and partly selective. One is the setting of maximum interest rates payable on time and savings deposits of member banks. The other is the buying and selling of foreign currencies in the foreign exchange market.

The Discount Rate. Probably no other policy tool is as well known or as poorly understood as the discount rate—the rate charged member banks on their loans from the Reserve Banks. Changes in the discount rate are initiated by the boards of directors of the individual Reserve Banks, but the Board of Governors must approve all changes. This coordination, plus the fact that the boards of directors of all the Reserve Banks have much the same information available to them, generally results in roughly simultaneous changes at all Reserve Banks. Small differences in timing do occur, but the first change is the important one since “the market” assumes that other Reserve Banks will soon come into line. Changes in the discount rate have several important effects on credit conditions and hence on the economy. A hike in the rate, for example, makes it more costly for banks to borrow at the

A group of System economists and statisticians discussing monetary policy.



The President and the Board of Directors of the Federal Reserve Bank of Richmond.

Reserve Banks. The higher cost may encourage them to sell short-term securities rather than use the discount privilege. Such sales lower the prices of short-term securities and raise short-term interest rates. In addition, the higher cost of funds may force banks to screen loan applications more carefully and to slow the growth in their loan portfolios. Conversely, a reduction in the rate reduces bankers' incentives to sell short-term securities as a substitute for borrowing at the discount window. As a result prices of short-term securities tend to be higher, and interest rates on these securities correspondingly lower, than would otherwise be the case.

But apart from this, changes in the discount rate can have important psychological effects on the attitudes of both lenders and borrowers. These psychological effects react on market expectations patterns and often influence both the timing of borrowers' demands for funds and the willingness of lenders to lend. If, for ex-

ample, the market interprets an increase in the rate as the beginning of a sustained program to tighten credit, the tightening effects can be quite dramatic. Lenders will tend to cut back commitments, waiting for more attractive rates, and some borrowers will try to complete their borrowing before the expected higher rates materialize. A reduction in the rate, on the other hand, may produce precisely the opposite effect.

These expectational effects sometimes occur before an actual change in the discount rate takes place. This is the case when the market develops a strong feeling that general credit conditions will soon dictate a change in the discount rate. As a rule, the discount rate is kept "in line" with the market, and when substantial differentials develop between the discount rate and market rates market participants may anticipate a change in the discount rate. When the change is fully anticipated—or in market parlance, "discounted"—the announcement of the actual change

System purchases and sales in the open market are made by telephone from this "trading desk" at the New York Federal Reserve Bank.



System regulations specify the cash down payments that must be made in purchasing or carrying specified stocks and bonds.





The room where foreign exchange operations are conducted at the New York Reserve Bank.

may have little or no perceptible effect on credit markets.

Open Market Operations. Open market operations are the most useful of the System's policy tools. Each purchase or sale directly affects the volume of member bank reserves and, in the process, the economy as a whole. Purchases increase reserves and "ease" credit since the System pays for the securities by crediting the reserve account of the seller's bank. Conversely, sales reduce reserves and "tighten" credit since the System collects

by charging the reserve account of the seller's bank.

Operations are either "dynamic" or "defensive." Dynamic operations are those taken actually to increase or decrease the volume of reserves in order to ease or tighten credit. Defensive operations are those taken merely to offset the effects of other factors influencing reserves. For example, the System sometimes sells securities to offset increases in reserves resulting from an inflow of cash into commercial banks. On the surface, such sales appear

to be tightening moves, but actually they may be part of an easier money package if the System does not sell enough securities to offset the entire increase in reserves resulting from the cash inflow. Consequently, it is impossible to know the significance of a purchase or a sale unless one knows how other factors are affecting reserves.

Reserve Requirements. The System's most powerful tool is the Board's power to change reserve requirements—the percentage of reserves that banks must hold back of deposits. Changes in requirements either increase or decrease the volume of excess reserves by changing the volume of reserves required against existing deposits. A reduction, for example, increases excess reserves and stimulates the economy while an increase has roughly opposite effects.

Margin Requirements. Changes in margin requirements are the changes in the percentages of cash down payments the Board requires purchasers of securities to make when they borrow to buy specified securities. There are three separate regulations—Regulation T, which covers credit extended by brokers and dealers; Regulation U, which governs loans made by commercial banks; and Regulation G, which applies to credit granted by others. An increase in margin requirements tends to discourage speculation on borrowed credit, and a decrease tends to encourage security purchases.

Regulation Q. The Board can also use its ability to set interest rate ceilings on member bank time and savings deposits as a means of influencing economic activity. Such ceilings must be set in consultation with the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board. The ceilings are set forth in the Board's Regulation Q.

There are various ways in which Regulation Q can be used. If the Board wishes to slow down the rate of expansion in bank credit, for example, it can leave the ceilings unchanged while other interest rates are rising. Conversely, it can speed up bank credit expansion by raising the ceilings. In the process it will probably also affect the relative levels of short- and long-term interest rates.

Foreign Exchange Operations. As a means of fostering improved international liquidity and offsetting temporary disruptive international capital flows, the System also engages fairly frequently in the purchase and sale of foreign currencies—British pounds, German marks, Swiss francs, and the like. Foreign balances are generally acquired either in the market or through “swaps” with foreign central banks that credit the account of the System on their books in exchange for a like dollar credit on the books of the Federal Reserve.

The System can use such foreign exchange to acquire surplus dollars held by foreigners before they are converted into gold, to prevent speculation against the dollar, and to assist foreigners in fighting inflationary inflows of capital funds. Such actions, of course, yield no permanent solution to balance of payments deficits, but they do provide a convenient respite during which a permanent solution can be sought.

Since foreign exchange operations have important effects upon foreign currencies as well as upon our own, they naturally must be undertaken in close cooperation with foreign monetary authorities. Because of similar Treasury responsibilities in this area, they are also closely coordinated with Treasury actions, most of which are actually conducted by the New York Federal Reserve Bank as agent for the Treasury.

THE POLICYMAKING PROCESS

Coordination among the several policy tools is maintained largely through the Federal Open Market Committee—the most important System policy forum. There both Board and Bank representatives meet regularly about every four weeks, or more often if necessary, to establish policy. In attendance are not only the Board members and the five presidents currently on the Committee but also the other seven presidents, the managers of the System's open market and foreign accounts and one

The Federal Open Market Committee and some of its staff.



of their assistants, some senior Board staff members, and one of the senior economists from each Bank. Thus, not only the policy-makers but also their chief advisers and those who implement policy for the Committee are always apprised currently as to System policy objectives.

Committee meetings fall into three parts—a discussion of recent policy actions by the managers of the accounts, a rundown on current economic developments by the Committee staff, and finally a discussion

and a vote by members of the Committee. Discussion is quite free, and there is often considerable diversity of opinion. In addition to discussing open market policy, presidents typically state their views concerning discount rate policy so that the Board—which must ultimately approve such moves—and the other presidents will know in advance what actions the presidents plan to recommend to their boards.

Between meetings, Board members and presidents keep in daily touch with the New York Bank by means of phone calls, wires, and memoranda. If necessary, telephone meetings of the entire Committee may be called on very short notice, and any member is free to object at any time to the manner in which the instructions of the Committee are being followed. In addition to these daily contacts, numerous memoranda are exchanged at less frequent intervals to provide maximum information to the various policymakers.



System policymakers keep in daily contact with each other by means of telephone calls, wires, and memoranda.

MONETARY POLICY: LIMITATIONS, ADVANTAGES

Limitations. Formulating monetary policy is a very difficult task, and there are definite limitations as to what policy can do. Real economic stability requires not only wise monetary policy but also (1) sound fiscal actions—the manner in which the Government taxes, spends, and manages its debt—and (2) sufficient competition throughout the economy so that individual prices are free to move down as well as up. Obviously, trouble can develop in all three areas, so it is difficult to achieve perfect stability for any sustained period of time.

But even if fiscal policy were always perfectly prudent and competition strong enough to prevent monopolistic price increases, there would still be limitations to what monetary policy could do. First, the problem of forecasting would still exist since wise monetary policy—and, indeed, sound discretionary stabilizing policy of any type—requires good forecasts. Errors of judgment can be minimized through experience and careful analysis, but they can never be eliminated completely. Second, even under the best conditions, there are important “slippages” in the financial mechanism. For example, commercial banks may not readily contract or expand earning assets in response to System nudging, thus negating some of the action. In addition, even if they do respond promptly, shifts in the velocity of money may partly offset changes in the money supply. Both kinds of slippage complicate the task of the money authorities, but their importance can easily be overrated.

Advantages. Despite its imperfections, monetary policy has several advantages over the two alternative types of stabilizers—fiscal policy and direct controls such as price controls and rationing.

First, it is highly impersonal. Monetary policy itself interferes very little with the freedom of the market, although market imperfections sometimes intensify the effects of policy upon particular sectors of the economy. A tight monetary policy cuts down the rate at which *total spending* can rise, but it does not dictate which *particular* expenditures must be slowed down or reduced. The expenditures cut are the ones to which spenders attach the lowest priorities. Similarly, a policy of "ease" stimulates total outlays, but the market directs which form the added expenditures will take. Even the policy actions themselves are impersonal. For example, no Government security dealer is told that he must buy or sell Government securities when the "Fed" is in the market. He does so because the System "buys at the market." Direct controls obviously dictate what can and cannot be done, and even fiscal policy stimulates or restricts *particular* sectors of the economy. In so doing, both give a different "mix" of goods and services than would the free market of its own accord.

Second, monetary policy is more flexible than most stabilizers. It is not completely flexible, of course, since it—like virtually all stabilizers—involves some lags. But it is unusually flexible. The Open Market Committee meets at least every four weeks, reaches a decision that day, and begins to implement its decision immediately. In contrast, discretionary fiscal policy actions necessarily involve considerable delays

since any large moves must be debated by Congress. And certainly few would want to eliminate that debate. The so-called automatic stabilizers—primarily Federal income taxes and unemployment compensation payments—that tend to create budget surpluses during booms and deficits in recessions may, however, act more quickly than monetary policy.

Finally, and perhaps most important, Congress has carefully insulated the Federal Reserve against day-to-day political pressures so that it is free to act in the best interests of the country's economy. Congress wisely spread the policymaking machinery throughout the System to avoid undue concentration of power; it made the System responsible to Congress rather than to the Executive Branch; it provided for 14-year terms for Board members and made them ineligible for reappointment after they have served a full term; and it staggered their terms of office. The System has, of course, only such powers as Congress has given it and can lose those powers if it does not exercise good stewardship. Its powers are broad, however, and Congress has so far chosen to permit the System to base its policy actions almost entirely upon economic considerations. Such can never be the case with fiscal policy or direct controls, which, in our sort of democracy, must necessarily be partly influenced by noneconomic factors.

PHOTO CREDITS

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