6.8: The Federal Reserve System

Figure 6.8.1: Hallway of Federal Reserve Bank of San Francisco

The Federal Reserve System (the Fed) is the central bank of the United States. It was created in 1913, following a series of banking crises that led to the desire for some central control on the stability of the banking sector. Since then the Fed has evolved into one of the most powerful economic body in the world. Today the major goals of the Federal Reserve System include full employment, stable prices, and moderate long-term interest rates.

Functions of the Federal Reserve System

Managing the nation's money supply through Conducting Monetary Policy is one of the primary responsibilities of the Fed. There are three main tools of monetary policy: open market operations, the discount rate, and the reserve requirements.

Open market operations is the most commonly used tool, in which the Fed purchases and sells U.S. government and federal agency securities, such as Treasury bills. As a recent example of using open market operations to implement expansionary monetary policy, the Federal Reserve purchased unprecedented amount of Treasury securities following the 2008 financial crisis to stimulate the U.S. economy. As a result, the Fed's holdings of Treasury notes increased dramatically during the following years.

Figure 6.8.2: US Treasury securities held by the Federal Reserve Source: https://fred.stlouisfed.org/series/TREAST

As an alternative approach to manage money supply, the Fed can simply change the discount rate it charges on the loans made to commercial banks. By lowering the discount rate, commercial banks would find the loans from the Fed more affordable and hence borrow more, which leads to an increase in money supply to the economy. A third alternative is to change the reserve requirement. Each commercial bank is required to hold some proportion of assets from being invested in such assets as loans and mortgages. When the Fed lowers the required reserve ratio, commercial banks free up additional capital which can be potentially made into loans and mortgages.

The Federal Reserve supervises and regulates the activities of banks and other financial institutions. To effectively implement its supervisory and regulatory function, the Federal Reserve System is divided into 12 districts. Each district has one main Federal Reserve Bank which examines the activities of member banks located in their own district. The figure below shows the geographic boundaries of the 12 districts.

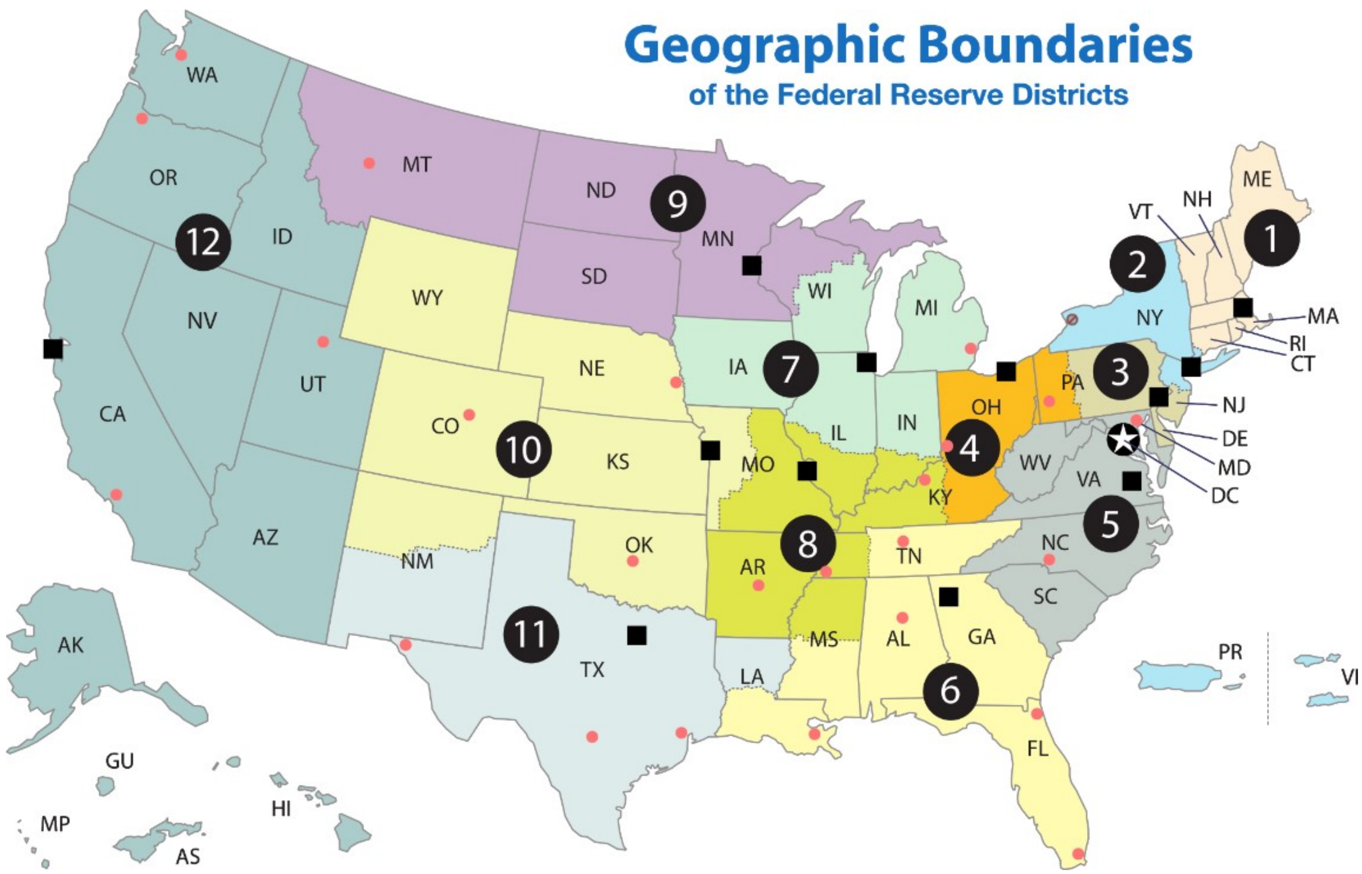

Figure 6.8.3: Geographic boundaries of the Federal Reserve Districts Source: https://en.Wikipedia.org/wiki/Federal_Reserve_System

Other functions of the Federal Reserve include:

- Collecting and replacing damaged currency from circulation.
- Check clearing. The Fed transfers funds from one bank to another as checks clear through the system.
- Serving as the commercial bank for the U.S. Department of Treasury.
- Providing research in the banking sector and economy as a whole.
