

## 11.8: The Federal Reserve System

### Learning Objectives

- Explain the structure and key functions of the Federal Reserve



Figure 11.8.1: **Marriner S. Eccles Federal Reserve Headquarters, Washington, DC.** Some of the most influential decisions regarding monetary policy in the United States are made behind these doors.

Money, loans, and banks are all tied together. Money is deposited in bank accounts, which is then loaned to businesses, individuals, and other banks. When the interlocking system of money, loans, and banks works well, economic transactions in goods and labor markets happen smoothly, and savers are connected with borrowers. If the money and banking system does not operate smoothly, the economy can either fall into recession or suffer prolonged inflation.

The government of every country has public policies that support the system of money, loans, and banking. But these policies do not always work perfectly. In this section we will explore how monetary policy works and what may prevent it from working perfectly.

In making decisions about the money supply—that is, the total amount of monetary assets available in an economy at a specific time—a central bank decides whether to raise or lower interest rates and, in this way, to influence macroeconomic policy, whose goal is low unemployment and low inflation. The central bank is also responsible for regulating all or part of the nation’s banking system to protect bank depositors and insure the health of the bank’s finances.

The organization responsible for conducting monetary policy and ensuring that a nation’s financial system operates smoothly is called the **central bank**. Most nations have central banks or currency boards. Some prominent central banks around the world include the European Central Bank, the Bank of Japan, and the Bank of England. In the United States, the central bank is called the **Federal Reserve**—often abbreviated as “the Fed.” This section explains the organization of the U.S. Federal Reserve and identifies the major responsibilities of a central bank.

### Structure/Organization of the Federal Reserve

Unlike most central banks, the Federal Reserve is semi-decentralized, mixing government appointees with representation from private-sector banks. At the national level, it is run by a board of governors, consisting of seven members appointed by the president of the United States and confirmed by the Senate. Appointments are for fourteen-year terms and they are arranged so that one term expires January 31 of every even-numbered year. The purpose of the long and staggered terms is to insulate the board of governors as much as possible from political pressure so that policy decisions can be made based only on their economic merits. In addition, except when filling an unfinished term, each member only serves one term, further insulating decision-making from politics. Policy decisions of the Fed do not require congressional approval, and the president cannot ask for the resignation of a Federal Reserve governor as the president can with cabinet positions.

One member of the Board of Governors is designated as the Chair. For example, from 1987 until early 2006, the Chair was Alan Greenspan. From 2006 until 2014, Ben Bernanke held the post. Janet Yellen, who served as Chair from 2014–2018, was the first woman to hold the post and was generally considered to be the most qualified and perhaps the most successful Fed chair in history. President Trump broke with tradition in not re-appointing Ms. Yellen as chair, nominating instead Federal Reserve Governor Jerome Powell.

## ? Try It

President Trump remarked that he was “greatly impressed” with Yellen but, given her 5’3” height, he felt she was too short to do the job (aside: that she’s been doing exceptionally well for 4 years). In reporting on the situation, Washington Post economic affairs reporter Matt O’Brien quipped “you might say this was the height of a bad decision.”<sup>[1]</sup>

As with most of his interactions with appointments and agencies, Trump’s relationship with Mr. Powell and the Fed has become strained. In a departure from protocol (and good judgement), Trump has repeatedly gone on record trying to bully the Board of Governors and/or undermine monetary policy decisions. One of the more recent headlines, pulled from a CNBC interview with Fed Chair Powell: “The law is clear, Trump can’t fire me.”<sup>[2]</sup> The rebuttal, from conservative commentator Stephen Moore—Trump’s nominee for the Fed—“Trump should fire Fed chair Powell ‘for cause;’ he’s ‘wrecking our economy.’”<sup>[3]</sup>

In response to Trump’s appointment of Moore to be a Fed governor, Republican economist and Harvard professor Greg Mankiw wrote: “[Stephen Moore] does not have the intellectual gravitas for this important job. It is time for senators to do their job. Mr. Moore should not be confirmed.” In a recent Vanity Fair interview, Ms. Yellen stated that she doesn’t believe the President has a grasp of macroeconomic policy and, further, that he doesn’t understand the independent nature of the Federal Reserve or how critical it is in economic terms for American’s to have confidence in the central bank.<sup>[4]</sup>

Regardless of one’s political position, it appears the current Administration will test the effectiveness of the structures put in place to maintain the integrity of economic policy. As well as the confidence of business and consumers in the government and our central bank.

## Who Has the Most Immediate Economic Power in the World?



Figure 11.8.2: **Former Chair of the Federal Reserve Board.** Janet L. Yellen was the first woman to hold the position of chair of the Federal Reserve Board of Governors.

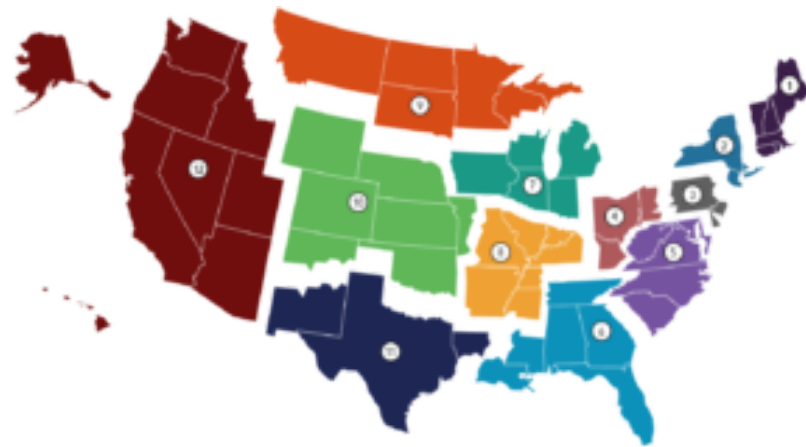
What individual can make the financial market crash or soar just by making a public statement? It’s not Bill Gates or Warren Buffett. It’s not even the president of the United States. The answer is the chair of the Federal Reserve Board of Governors. In early 2014, Janet L. Yellen, shown in Figure 2, became the first woman to hold this post. Yellen has been described in the media as “perhaps the most qualified Fed chair in history.”

With a PhD in economics from Yale University, Yellen has taught macroeconomics at Harvard, the London School of Economics, and most recently at the University of California at Berkeley. From 2004–2010, Yellen was president of the Federal Reserve Bank of San Francisco.

Not an ivory-tower economist, Yellen became one of the few economists who warned about a possible bubble in the housing market, more than two years before the financial crisis occurred. Yellen served on the board of governors of the Federal Reserve twice, most recently as vice chair. She also spent two years as chair of the President’s Council of Economic Advisors. If experience and credentials mean anything, Yellen is likely to be an effective Fed chair.

The Fed chair is first among equals on the board of governors. While he or she has only one vote, the chair controls the agenda, and is the public voice of the Fed, so he or she has more power and influence than one might expect.

The Federal Reserve is more than the board of governors. The Fed also includes twelve regional **Federal Reserve banks**, each of which is responsible for supporting the commercial banks and economy generally in its district. The Federal Reserve districts and the cities where their regional headquarters are located are shown in Figure 3. The commercial banks in each district elect a board of directors for each regional Federal Reserve bank, and that board chooses a president for each regional Federal Reserve district. Thus, the Federal Reserve System includes both federally and private-sector appointed leaders.



Source: <https://www.federalreserve.gov/aboutthefed/federal-reserve-system.htm>

Figure 11.8.1: **The Twelve Federal Reserve Districts.** There are twelve regional Federal Reserve banks, each with its own district.

#### The Federal Reserve Districts and Their Territories

District Number	Head Office Location	Territories Covered
1	Boston, Massachusetts	The state of Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont; and all but Fairfield County in Connecticut.
2	New York, New York	The state of New York; Fairfield County in Connecticut; and 12 counties in northern New Jersey, and serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands.
3	Philadelphia, Pennsylvania	The state of Delaware; nine counties in southern New Jersey; and 48 counties in the eastern two-thirds of Pennsylvania.
4	Cleveland, Ohio	The state of Ohio; 56 counties in eastern Kentucky; 19 counties in western Pennsylvania; and 6 counties in northern West Virginia.
5	Richmond, Virginia.	The states of Maryland, Virginia, North Carolina, and South Carolina; 49 counties constituting most of West Virginia; and the District of Columbia.
6	Atlanta, Georgia	The states of Alabama, Florida, and Georgia; 74 counties in the eastern two-thirds of Tennessee; 38 parishes of southern Louisiana; and 43 counties of southern Mississippi.
7	Chicago, Illinois	The state of Iowa; 68 counties of northern Indiana; 50 counties of northern Illinois; 68 counties of southern Michigan; and 46 counties of southern Wisconsin.
8	St. Louis, Missouri	The states of Minnesota, Montana, North Dakota, and South Dakota; the Upper Peninsula of Michigan; and 26 counties in northern Wisconsin.

9	Minneapolis, Minnesota.	The states of Minnesota, Montana, North Dakota, and South Dakota; the Upper Peninsula of Michigan; and 26 counties in northern Wisconsin.
10	Kansas City, Missouri	The states of Colorado, Kansas, Nebraska, Oklahoma, and Wyoming; 43 counties in western Missouri; and 14 counties in northern New Mexico.
11	Dallas, Texas	The state of Texas; 26 parishes in northern Louisiana; and 18 counties in southern New Mexico
12	San Francisco, California	The states of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington, and serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands

## What Does a Central Bank Do?

The Federal Reserve, like most central banks, is designed to perform the following three important functions:

1. To conduct monetary policy
2. To promote stability of the financial system
3. To provide banking services to commercial banks and other depository institutions, and to provide banking services to the federal government

The Federal Reserve provides many of the same services to banks as banks provide to their customers. For example, all commercial banks have an account at the Fed where they deposit reserves, and they can obtain loans from the Fed through the “discount window,” which will be discussed in the next reading. The Fed is also responsible for check processing. When you write a check to buy groceries, for example, the grocery store deposits the check in its bank account. Then, the physical check (or an image of that actual check) is returned to your bank, after which funds are transferred from your bank account to the account of the grocery store. The Fed is responsible for how these transactions are handled once the check leaves the cash register and is deposited into the store’s bank account. Does that mean that your check to the grocery store goes all the way to Washington, DC.? No. Instead the regulations that govern how banks handle checks, deposits, withdrawals are regulated by The Federal Reserve Act. This act is the reason that a bank must start paying you interest on a savings deposit the day it is received. It’s also the reason that if you deposit a large check, your bank may tell you that the funds will not be available for three to five business days.

On a more mundane level, the Federal Reserve ensures that enough currency and coins are circulating through the financial system to meet public demands. For example, each year the Fed increases the amount of currency available in banks around the Christmas shopping season and reduces it again in January.

Finally, the Fed is responsible for assuring that banks are in compliance with a wide variety of consumer protection laws. For example, banks are forbidden from discriminating on the basis of age, race, sex, or marital status. Banks are also required to publicly disclose information about the loans they make for buying houses and how those loans are distributed geographically, as well as by sex and race of the loan applicants.

### ? Practice Question

<https://assessments.lumenlearning.co...essments/14323>

1. O'Brien, Matt. "Trump Thought Yellen Was Too Short to Be Fed Chair. That's Not How Any of This Works." The Washington Post. December 03, 2018. Accessed May 22, 2019. [www.washingtonpost.com/business/2018/12/03/trump-thought-yellen-was-too-short-be-fed-chair-thats-not-how-any-this-works/](http://www.washingtonpost.com/business/2018/12/03/trump-thought-yellen-was-too-short-be-fed-chair-thats-not-how-any-this-works/). ↵

2. Cox, Jeff. "Fed Chair Powell: 'The Law Is Clear,' Trump Can't Fire Me." CNBC. March 11, 2019. Accessed May 22, 2019. <https://www.cnbc.com/2019/03/11/fed-chair-powell-the-law-is-clear-trump-cant-fire-me.html>. ↵
3. Schwartz, Ian. "Stephen Moore: Trump Should Fire Fed Chair Powell 'For Cause,' He's 'Wrecking Our Economy'." RealClearPolitics. December 24, 2018. Accessed May 22, 2019. [www.realclearpolitics.com/video/2018/12/24/stephen\\_moore\\_trump\\_should\\_fire\\_fed\\_chair\\_powell\\_for\\_cause\\_hes\\_wrecking\\_our\\_economy.html](http://www.realclearpolitics.com/video/2018/12/24/stephen_moore_trump_should_fire_fed_chair_powell_for_cause_hes_wrecking_our_economy.html). ↵
4. Levin, Bess. "Janet Yellen: Trump Is an Even Bigger Idiot Than He Looks." The Hive. February 25, 2019. Accessed May 22, 2019. <https://www.vanityfair.com/news/2019/02/janet-yellen-donald-trump-interview>. ↵

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