Lecture Notes on

MONEY, BANKING, AND FINANCIAL MARKETS

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Chapter 14: Structure of the Federal Reserve System

1. Origins of the Federal Reserve System
2. Federal Reserve Banks
3. Member Banks
4. Board of Governors of the Federal Reserve System
5. Federal Open Market Committee

Our analysis of the money supply process led us to two important conclusions:

First, that the Federal Reserve exercises fairly tight control over the monetary base.

And second, that while in theory, fluctuations in the total money supply can reflect either a change in the monetary base or a change in the money multiplier, in practice, changes in the monetary base account for most of the changes in the money supply.

Together, these facts tell us that the Federal Reserve is the key player in the money supply process.

But who controls the Fed, and who decides what its actions will be?

In other words, how is monetary policy actually formulated in the US economy?

These are the questions addressed in Mishkin's Chapter 14, which will serve as our introduction to the sixth and final part of this course, on the Federal Reserve System and the conduct of monetary policy.

As we first learned in our introduction to the money supply process, the Federal Reserve has a complicated structure, consisting of 12 Federal Reserve Banks and the Board of Governors in Washington, DC.

It turns out that this complicated structure is largely the result of the circumstances under which the Federal Reserve System was created. Thus, Chapter 14 begins with a discussion about the origins of the Federal Reserve System.

Then, the chapter goes on to discuss the separate roles played within the System by the Federal Reserve Banks, the member banks, the Board of Governors, and the Federal Open Market Committee.

1 Origins of the Federal Reserve System

The Federal Reserve System was created by the Federal Reserve Act of 1913, with an eye towards maintaining the same sort of decentralized power and system of checks and balances emphasized in the US Constitution.

In practice, this meant:

- Division of power between the Board of Governors in Washington and the Federal Reserve Banks in 12 other cities.
- Division of power between the Federal Government, the banking industry, non-bank business interests, and the public.

As a result, within the Federal Reserve System, the Federal Reserve Banks, the member banks, the Board of Governors, and the Federal Open Market Committee all play separate and important roles.

2 Federal Reserve Banks

There are 12 Federal Reserve Districts, each with a main Federal Reserve Bank and a number of Federal Reserve Bank branches.

Exact locations are shown in Mishkin's Figure 2 (p.338).

Some details:

- The largest Federal Reserve Banks in terms of assets are: New York (2nd district), Chicago (7th district), and San Francisco (12th district).
- The Federal Reserve Bank of New York is the largest and most important, reflecting the role of New York as the financial center of the US and, possibly, the world.
- The Federal Reserve Bank of Boston is headquarters for the 1st district.

Each Federal Reserve Bank is a legally separate corporation that is owned by the commercial banks in its district—called the member banks.

These member banks hold stock in the Federal Reserve Bank, which pays a 6% annual dividend.

The member banks are not allowed to sell their shares of stock in the Reserve Bank.

Each Federal Reserve Bank has 9 directors, classified into three categories:

3 Class A Directors = bankers, elected by member banks.

3 Class B Directors = other business leaders in industry, commerce, and agriculture, also elected by member banks.

3 Class C Directors = representatives of the non-bank public, appointed by the Board of Governors.

Monetary policy functions of the Federal Reserve Banks:

The directors of each bank recommend a setting for the discount rate—the interest rate charged on discount loans—which is then approved by the Board of Governors.

Make discount loans to depository institutions in their districts.

At any given time, five Bank presidents have a vote on the Federal Open Market Committee. The president of the New York Fed always has a vote; the other Reserve Bank presidents rotate, with annual terms as voting members. The presidents who do not vote still attend meetings and participate in debates and discussions.

The New York Fed runs the Open Market Desk, where open market operations are conducted at the request of the Federal Open Market Committee.

The directors of each bank select one banker from their district to serve on the Federal Advisory Council, which provides the Board of Governors with information about conditions in the banking industry and in the economy as a whole and which advises the Board of Governors on the possible effects of new banking regulations.

Other functions performed by the Federal Reserve Banks:

Clear checks.

Withdraw damaged currency from circulation and replace it with new currency.

Act as liaisons between local business communities and the Federal Reserve System.

Help regulate banks.

3 Member Banks

Member banks = commercial banks that own (hold stock in) the Federal Reserve Banks.

National banks = commercial banks chartered (licensed) by the Federal Government, through the Office of the Comptroller of the Currency.

State banks = commercial banks chartered by their State Governments.

All national banks are required to be members of the Federal Reserve System.

State banks are not required to be members, but can join if they want to.

Before 1980, only member banks were required to hold reserves as vault cash or deposits at the Federal Reserve Banks. These reserves do not pay interest. Many states allowed nonmember banks to hold reserves in the form of interest-earning securities. As a result, many state banks chose not to become members and, as interest rates rose during the 1970s, many state banks who were members decided to leave the Federal Reserve System.

The Depository Institutions Deregulation and Monetary Control Act of 1980 required all depository institutions to the same reserve requirements, and required all depository institutions to hold reserves as vault cash or deposits at the Fed. In return, the Fed agreed to allow all depository institutions to obtain discount loans on an equal basis and gave all depository institutions access to its check-clearing services.

At the end of 2002, there were about 8,000 commercial banks in the United States.

About 3,000 of these are members of the Federal Reserve System.

About 2,000 of these are national banks that are required to join.

About 1,000 are state banks that have chosen to join.

4 Board of Governors of the Federal Reserve System

Often called the Federal Reserve Board.

Consists of seven Governors, led by Chairman Alan Greenspan.

Headquartered in Washington DC.

Each governor is appointed by the US President and confirmed by the US Senate for a nonrenewable 14-year term.

Not more than one governor can come from each Federal Reserve District.

The governor who is chosen as chairman serves as chairman for a 4-year term, which can be renewed.

All seven governors are voting members of the Federal Open Market Committee.

The Board of Governors sets reserve requirements, within limits established by the US Congress.

The Board of Governors also sets bank regulations.

And the Board of Governors selects from among the 12 Reserve Bank's recommendations to set the discount rate.

Finally, the US Congress has given the Board of Governors authority over certain regulations that are unrelated to monetary policy but do have important effects on the financial system as a whole.

For example, the Board of Governors sets margin requirements: the limit on how much investors can borrow in order to purchase securities.

5 Federal Open Market Committee (FOMC)

The Federal Open Market Committee (FOMC) meets eight times per year.

The FOMC consists of:

All 7 members of the Board of Governors.

The president of the New York Fed and four other Reserve Bank presidents.

The seven Reserve Bank presidents who do not vote are technically not on the FOMC, but they still attend the meetings and participate in the discussions.

Two other facts:

The Chairman of the Board of Governors also presides as Chairman of the FOMC.

The Governors as a group have 7 of the 12 votes—and hence a majority of the votes—on the FOMC.

The FOMC's principal role is to make decisions regarding the conduct of open market operations.

Thus, the FOMC controls the monetary base, and thereby exerts the most powerful influence on the money supply as a whole.

Within the Federal Reserve System, the FOMC plays the most important role in formulating monetary policy.

Three key documents are prepared before each FOMC meeting:

Green Book = Contains forecasts for the US economy prepared by staff economists within the Research and Statistics Division at the Federal Reserve Board.

Blue Book = Contains an outline of different monetary policy options prepared by staff economists within the Monetary Affairs Division at the Federal Reserve Board.

Beige Book = Contains a description of economic activity within each of the 12 Federal Reserve districts. Prepared by staff economists at each of the 12 Reserve Banks.

Only the beige book is released to the public.

6 Conclusion

The structure and functions of the Federal Reserve System are summarized nicely in Mishkin's Figure 1 (p.337).

Mishkin, Figure 1 (p.337)