Session 2: The Federal Reserve System

The primary engine for stabilizing the economy is the Federal Reserve System, or "Fed". The Fed itself is often misunderstood, and there is a lot of misinformation about its powers and actions. Everyone seems to agree that it is important and powerful, but how and why remains somewhat obscure.

The Federal Reserve System, created in 1913, is the central bank for the United States. The primary responsibility of the Fed is the regulation of the money supply (including all currency in circulation and the deposits and reserves held by banks). The amount of money in circulation in turn influences the rate of borrowing. When more money is available, it is easier to borrow money; when less money is available, the reverse is true. The rate of borrowing in turn has a significant effect on the rate of growth. Hence, the Fed regulates economic growth without regulating economic growth. More precisely, the Fed regulates the money supply, and leaves the regulation of the rate of borrowing, and therefore economic growth, to the forces of supply and demand ("The Invisible Hand" of Free Market Economics). Before 1913, there was no real centralized control over the money supply, and bank "panics" and other minor financial crises were frequent. The Fed was designed to stabilize the banking system—a job it does admirably, and with considerable finesse.

If the Fed believes the rate of growth is too rapid, it will reduce, or "tighten", the money supply; if growth is stagnating, the Fed will increase, or "loosen" the money supply. To prevent the Fed from falling prey to partisan politics, it is distanced from the government—in it's day-to-day business, the Fed operates independently of any governmental authority.

The Fed is not a single institution. There are 12 Federal Reserve Banks in major cities and 25 additional branches in smaller cities, led by a seven-member "Board of Governors" headed by a Chairman, and a twelve-member Federal Open Market Committee (FOMC). Individual banks are also part of the Federal

Reserve System—membership is required for all national banks, and state banks may also join. Members of the board of Governors are appointed by the President of the United States—the only direct political control the Fed is subject to.