Session Six: Why The Fed Works

In addition to direct control over Interest Rates, the Fed influences the money supply by raising or lowering the “Reserve Requirement” and the “Margin Requirement”, as well as through what is known as “Moral Suasion”. The Reserve Requirement is the percentage of deposits a bank must keep liquid in it’s own account; increases will tend to slow borrowing, and decreases will tend to have the opposite effect. The Fed has not used this particular tool in some time. The Margin Requirement is the amount real money a investor must put up when buying securities on Margin; increases will slow investor margin orders, and decreases will do the reverse. This tool has also not been used in many years. Finally, moral suasion in the form of public statements by the Fed, especially by the Fed chairman, can have a substantial effect on economic activity. For example, if the Fed releases a report predicting economic growth in the near future, this may spur otherwise hesitant investors to action.

Besides setting Monetary Policy, the Fed also provides a clearinghouse for all checks that pass through the domestic banking system, manages the circulation of currency, regulates the activities of member banks, and handles the day-to-day banking requirements of the US Government. For practical purposes, many of these responsibilities are delegated to regional banks. But perhaps the most important responsibility of the Fed beyond setting Monetary Policy is in serving as the lender of last resort.

Banks can borrow money from what is known as the Fed’s “Discount Window” at the Discount Rate. The Fed typically sets this rate (which is not determined by supply and demand—there’s that mixed market again) 0.5% below the Federal Funds rate. While borrowing from the Fed is cheap, banks are hesitant to go this route, because it signals that the bank in question is in trouble, discouraging other banks from lending to them. However, borrowing from the Fed can stave off bankruptcy or other crises. To cite one recent example, after the September 2001 terrorist atrocities, Fed loans helped temporarily stabilize member banks.

Through its spokespeople such as former chairpersons Paul Volcker and Alan Greenspan, and current chairperson Ben Bernanke, the Fed is the single most powerful institution in the US domestic economy. It is a constant dynamic trying to keep inflation low, markets stable and rates in proportion to the current environment. As shown by the panic of 2008, these efforts are not always successful.