assonebb
associazione nazionale
enciclopedia della banca e della borsa

Bankpedia Review Vol. 2 n.2 2012

FEDERAL RESERVE SYSTEM

Federica ALFANI[1]

Abstract

The Federal Reserve System, also known as Federal Reserve (FED), is the central bank of the United States. It was founded when president Woodrow Wilson signed the Federal Reserve Act on 23 December 1913 with the scope of providing the nation with a safer, more flexible and more stable monetary and financial system. Over the years, the FED's role in banking and in the economy has expanded. Today its main objective is to conduct the nation's monetary policy towards full employment, stable prices and long-term interest rate moderation.

The FED System consists of a seven member Board of Governors with headquarters in Washington, D.C., and twelve Reserve Banks located in major cities throughout the United States, which supervise and regulate financial institutions' activities, provide bank services to depository institutions, ensure information exchange and equal treatment of consumers within the bank system. The System also includes several private banks, which are obliged to subscribe a certain amount of resources with the FED.

1. Organizational structure: the Board of Governors

The Board of Governors is the federal agency of the Federal Reserve System and it collaborates with other Systems' bodies. The primary responsibility of the Board members is the formulation of monetary policy. In addition, the Federal Reserve

[1]Federica ALFANI, PhD Candidate in Economics at the University of Rome Tor Vergata and Consultant at the Agricultural and Development Economics Division of the Food and Agriculture Organization of the United Nations (FAO - ESA).

ISSN 2239-8023
DOI 10.14612/ALFANI_2_2012

Board regulates and supervises all the banks that are members of the System and bank holding companies; it coordinates international operations of both member banks and foreign banks into the federal states, it manages international bank services within the country together with the system of payments, ensuring its correct functioning and development; it coordinates the juridical system related to consumer credit.

The Board of Governors is made of seven members that are appointed by the President of the United States and confirmed by the Senate to serve a 14-year term of office. Both the Chairman and Vice-Chairman must be members of the Board or, alternatively, be appointed by the Board and serve their office for four years. The Board meets several times a week. Meetings are conducted in compliance with the Government in the Sunshine Act, and they usually are open to the public. However, if the Board has convened to consider confidential financial information, the sessions are closed to public observation. Furthermore, members of the Board routinely confer with officials of other government agencies, representatives of banking industry groups, officials of the central banks of other countries, members of Congress and academicians.

2. Federal Open Market Committee (FOMC)

The Federal Open Market Committee (FOMC) is one of the main bodies of the FED System. It is composed of the seven members of the Board of Governors and five different Reserve Bank presidents. According to tradition, the FOMC's president and vice-president are the president of the Board of Governors and the president of the Federal Reserve Bank of New York, respectively[2]. The FOMC makes key decisions regarding the conduct of open market operations, being the latter the main

[2]The president of the Federal Reserve Bank of New York serves on a continuous basis, while the presidents of the other Reserve Banks serve one-year terms on a rotating basis beginning on the 1st of January of each year. The rotation is such that each year one member is elected to the Committee by the boards of directors of Reserve Banks in each of the following groups: (1) Boston, Philadelphia, and Richmond; (2) Cleveland and Chicago; (3) Atlanta, St. Louis, and Dallas; and (4) Minneapolis, Kansas City, and San Francisco.

ISSN 2239-8023
DOI 10.14612/ALFANI_2_2012

mechanism in the hands of the FED to regulate and modify the total level of currency and credit within the system. By law, the FOMC must meet at least four times each year in Washington, D.C. and vote on the policy to be carried out during the interval between these meetings. Since 1981, eight regularly scheduled meetings have been held each year at intervals of five to eight weeks. However, if circumstances require consultation or consideration of an action between these regular meetings, members may be called on to participate in a special meeting. Given the confidential nature of the information discussed, attendance at meetings is restricted and limited to Committee members and staff officers, non-member Reserve Bank presidents, the Manager of the System Open Market Account and a small number of Board and Reserve Bank staff. Furthermore, the Board of Governors must keep a record of the actions taken by the FOMC on all questions of policy and, twice a year, submit a written report to the Congress on the state of the economy and the course of monetary policy.

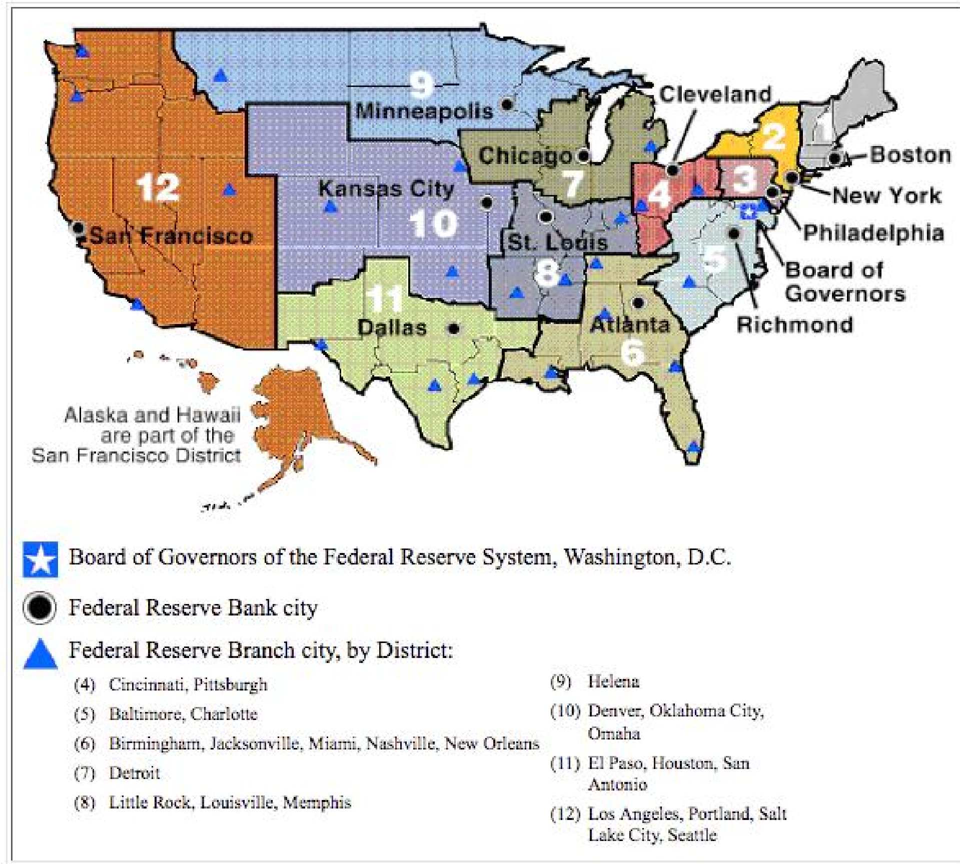
2.1 Federal Reserve Banks

For the purpose of carrying out the FED's daily operations, the nation has been divided into twelve Federal Reserve Districts with Banks in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas and San Francisco. Twenty-five Branches of these Banks serve particular areas within each District. Federal Reserve Banks are in charge of initiating changes in the discount rate and the rate of interest on loans made by Reserve Banks to depository institutions according to the so called "discount window"[3]. The Board of Governors must approve these changes in the discount rate.

[3]All depository institutions that are subject to reserve requirements set by the Federal Reserve – including commercial banks, mutual savings banks, savings and loan associations and credit unions – have access to the "discount window".

ISSN 2239-8023
DOI 10.14612/ALFANI_2_2012

Figure 1 – Locations of Federal Reserve Banks and their Branches.



Source: The Federal Reserve System: Purpose and Functions, System Publication.

ISSN 2239-8023
DOI 10.14612/ALFANI_2_2012

2.2 Board of Directors

The Federal Reserve System also includes the Board of Governors, whose responsibilities were established by the Federal Reserve Act of 1913, ranging from the supervision of the Reserve Bank to making recommendations on monetary policy. In particular, each of the Reserve Banks is supervised by a board of nine directors who are familiar with economic and credit conditions in the district, while each of the twenty-five Reserve Bank Branches has a board of five or seven directors.

Reserve Banks' boards of directors are divided into three classes – A, B and C – of three persons each. Class A directors represent the member commercial banks in the District, while class B and C directors represent consumers with due consideration to the interests of agriculture, commerce, industry, services, labour and consumers. Class A and B members are appointed by District Banks, while the Board of Governors appoints class C members.

The Board of Directors appoints the Reserve Bank presidents and the first vice-presidents, subject to approval by the Board of Governors. Directors are in charge of reviewing their Reserve Bank's budget and expenditures and set every two weeks the discount rate paid by depository institutions when borrowing from the Reserve Banks. This last activity is subject to approval by the Board of Governors due to the fact that, by raising or lowering the rate, the System can influence the cost and availability of money and credit.

Federal Reserve System's bodies are integrated by commissions that advice the Board of Governors on several issues. Among these commissions are the Federal Advisory Council, which gives recommendations to the Board about its responsibilities, the Consumer Advisory Council, which deals with consumers' financial services, and the **Thrift Institutions** Advisory Council, which provides information about economic institutions' needs and problems.

ISSN 2239-8023
DOI 10.14612/ALFANI_2_2012

3. Monetary policy instruments

The Federal Reserve Act of 1913 calls on the Federal Reserve System to set the nation's monetary policy in order to promote the objectives of maximum employment, stable prices and moderate long-term interest rates. In particular, the FED should ensure the right amount of reserves able to promote liquidity and credit expansion in line with the objectives of price stability and sustainable economic growth. The main monetary policy instruments the FED has consist of the determination of monetary demand and the definition of the discount rate, through the activity of the Board of Governors together with the Federal Banks, and the realization of open-market operations through the Federal Open Market Committee. By means of these instruments, the FED can influence the demand and supply for balances at the Federal Reserve Banks, thus controlling the federal funds rate[4].

4. Monitoring and controlling

The Federal Reserve System monitors and controls the activity of several financial institutions with the objective of ensuring their stability, the financial markets' solidity and an equal and fair treatment of customers in financial transactions. In particular, the FED's monitoring activity includes the audit and supervision of banks on their conformity with laws and regulations. In case of non-fulfillment, the FED's Surveillance Authority takes both formal and informal actions aimed to resolve the problem. The controlling activity concerns the emanation of specific regulations and

[4]The federal funds rate is the interest rate at which private depository institutions lend balances (federal funds) to other depository institutions at the Federal Reserve, usually overnight. A change in the federal funds rate can set off a chain of events that will affect other short-term interest rates, longer-term interest rates, the foreign exchange value of the dollar, stock prices and other variables such as employment, household, and business spending decisions and goods price level.

ISSN 2239-8023
DOI 10.14612/ALFANI_2_2012

guidelines aimed to regulate activities, operations and acquisitions of different banking organizations.

Bibliography

Bauer P. W., Hancock D. (1993), *The Efficiency of the Federal Reserve in Providing Check Processing Services*, Journal of Banking and Finance. No. 17, pp. 287-311.

Broz J. L. (1997), *The International Origins of the Federal Reserve System*, Cornell University Press.

Mullins E. C. (1952), *Secrets of the Federal Reserve*, John McLaughlin.

Wicker E. (1966). *Federal Reserve Monetary Policy, 1917-33*. Ohio State University Press.

Board of Governors of the Federal Reserve System (2003), *The Federal Reserve System: Purposes and Functions*, System Publication.

ISSN 2239-8023
DOI 10.14612/ALFANI_2_2012