



FEDERAL RESERVE BANK *of* ST. LOUIS

CENTRAL to AMERICA'S ECONOMY™

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In Plain English

Hi, I'm Buck, your personal tour guide to the Federal Reserve. I'm here to introduce you to one of the most complex but effective institutions in the United States. But don't worry — I'll explain it all in plain English! Just beside me is a road map of where we're going. Together, we'll walk through the Federal Reserve System — literally. And along the way, I'll show you just what goes on around here and why it's important. By the end of this tour, you, too, will be able to explain the Federal Reserve — in plain English!

As you can see, there's a lot going on around the Fed. But keep in mind that the whole is really just the sum of the parts. Basically, the Federal Reserve is made up of three parts:

- * the Board of Governors — that's the building on the far left;
- * the Reserve Banks — the 12 buildings along the right; and
- * the Federal Open Market Committee.

The complex design of these three parts is actually tied to how the Fed was created in the first place. To understand the structure better, let's first step back about a hundred years.

You've probably heard of the bank failures that occurred during the late 1800s and early 1900s. Back then, the failure of one bank often had a domino effect, in which customers of other banks rushed to withdraw funds from their own banks. These banking panics wreaked

havoc, even on financially sound banks, and sometimes paved the way to serious widespread economic recessions.

When Congress wrote the Federal Reserve Act in 1913, one objective of the Fed was to help banks acquire emergency cash reserves to meet such panic withdrawals so that the shortage of funds at one bank didn't disrupt the entire banking system. This function would go a long way in establishing confidence in the banking system and more stability in the economy overall.

Another goal of the Fed was to improve the efficiency of the national payment system by making it easier for payments — mostly checks — to be exchanged through different parts of the country. To achieve these goals, the Fed, then and now, combined centralized national authority through the Board of Governors (remember that on the map?) with a healthy dose of regional independence through the Reserve banks. A third entity, the Federal Open Market Committee, brings together the expertise of the first two in setting the nation's monetary policy.

OK, that was a mouthful. Let me see if I can make better sense of it. Let's take a walk through some of the places that make up the Fed, where you can see firsthand what exactly we do.

I'm here now in Washington, D.C. Behind me is the Board of Governors, which is a U.S. government agency. The Board has seven members, called governors, who are appointed by the U.S. president and confirmed by the U.S. Senate. One thing the governors do is write the regulations that make commercial banks financially sound and that make the nation economically strong. It's the governors' jobs, along with economists and support staff, to study trends in the economy and to help forecast the country's future economic direction. The

governors also oversee those 12 Reserve banks I showed you earlier. Probably the governors' most important responsibility, however, is participating on the Federal Open Market Committee, or FOMC.

Speaking of the FOMC, the meeting room is right next door. Let's take a peek inside; I think a meeting is just wrapping up. Looks like we're right on time. Straight ahead is the FOMC, the Fed's chief body for monetary policymaking. Here, the seven governors from the Board of Governors meet with the presidents of the 12 Reserve banks about eight times a year to discuss the current state of the economy and how to promote steady and sustainable economic growth. While everyone here participates in the discussion, only the voting members actually vote on any actions that the FOMC can take to influence monetary policy. Oh, and when I say "voting members," I mean the seven Board governors plus the president of the Federal Reserve Bank of New York and four other Reserve bank presidents who serve on a rotating basis.

As we've just seen, each FOMC meeting ends with a vote on actions that will affect the country's money supply — not how much is printed, but how much money banks have to lend — which, in turn, affects the amount of money consumers and businesses have to spend. We'll talk about this more in a minute. Before we do, though, let's follow this Reserve bank president back to the office to see what goes on there. Buckle up — we're headed west.

In all, there are 12 districts in the Federal Reserve, and each is served by a regional Reserve bank. Many also have one or more branches. As we'll see, Reserve banks have three main responsibilities: providing financial services, contributing to monetary policy and supervising commercial banks in their regions. Now, don't worry if you didn't catch that the

first time through; we'll take a look at each of these activities one by one. First, let's head to the financial services area and see why a Reserve bank is often called the *banker's bank*.

This floor is busy 'round the clock, which shouldn't surprise you. This is where the Fed's task of providing a safe and efficient method for transferring money throughout the banking system takes place. Every day, banks deposit billions of dollars at the Fed — in cash, checks, wire transfers or some other form of electronic payment — for many of the same reasons we consumers use a bank.

In addition, Reserve banks offer payment services to all financial institutions in the United States, no matter what their size or location. For example, that fast-paced clicking sound you hear is a high-speed machine that sorts thousands of paper checks every minute and puts them into bundles to be rerouted to financial institutions. We've got machines like this that sort currency, too. And over there, through the glass, you can see the computers that transfer money electronically from one bank to another. Companies offer these services as well, but the Fed is a primary player in the business.

By the way, even though the Fed competes with other businesses in the financial services it provides, the Fed stays in the marketplace primarily to promote competition, innovation and overall efficiency.

Besides serving commercial banks, Reserve banks also serve as banks for the U.S. government. We maintain accounts for the U.S. Treasury, process government checks and assist the Treasury in issuing and redeeming securities. There's plenty more information about this on our website.

It's getting noisy on this floor. Let's go visit the research department, where it's a little quieter.

As you might guess, one of the most important jobs of the Fed is to keep our economy healthy. We do this by managing the nation's money supply, or what teachers call *conducting monetary policy*. This isn't easy to explain, but let me start by telling you what the economists do. Economists at Reserve banks are all experts in different aspects of our national economy. These economists pursue their own research interests and contribute to a broad exchange of ideas across the Federal Reserve System. If you hang out in this department for a while, you'll notice that economists often hold firmly to their individual opinions and are known to debate their points of view with one another. Despite their varying perspectives, most economists agree, though, that the economy performs well when inflation is low and stable. As a result, low inflation is a long-term goal of the Fed.

So, what do the economists do with their research? A lot of publishing and a lot of public speaking before all types of audiences. But their most important job is to prepare the Reserve bank president for the FOMC meetings we poked our heads in on earlier.

At the FOMC meetings, members together set a target interest rate, called the *federal funds rate*, which is the interest rate on overnight loans between banks. This rate influences other interest rates, like those for mortgage loans, and greatly affects the direction of the economy. To hit the fed funds rate target, the FOMC issues a directive to the New York Fed's Domestic Trading Desk, which will then buy or sell U.S. government securities on the open market. You're going to have to trust me on this one, but ultimately, this action of buying or selling securities affects how much money banks have available to lend to you and your family or business and, thus, either increases, decreases or maintains the growth of the money supply in the banking system.

Speaking of the banking system, let's tag along with this bank examiner, heading out to a commercial bank. To see what these guys do, you have to hit the road.

As you might recall, Congress created the Federal Reserve to foster safe, sound and competitive practices in the nation's banking system. To accomplish this, the Fed both regulates the banking system and supervises certain types of financial institutions. In case you're wondering, these types include state-chartered member banks; bank holding companies, which are the companies that own banks; and international organizations that do banking business in the United States. There are other types of banks that are supervised by other regulators.

So, what's the difference between regulation and supervision? Bank regulation refers to the written rules that define what is acceptable behavior for financial institutions. The Board of Governors in Washington, D.C., takes care of this responsibility. Supervision refers to the enforcement of these rules, which is carried out by staff at the 12 Reserve banks.

Fed examiners, like those here, visit commercial banks and look over the bank's financial statements to evaluate the quality of assets, internal controls and ability to manage risk. Now, why do you care? Because you've got money in this bank. The examiner's job is to make sure your money is safe and sound. Examiners also review a bank's performance in complying with federal and state laws. At the end of an on-site review, Fed examiners issue the bank a rating that reflects whether the institution is in good shape or whether it has weaknesses that require corrective action and close monitoring.

One of the most important ways that the Fed ensures safety and soundness of the banking system is by helping banks respond to all kinds of crises. One way the Fed does this is by making short-term loans to banks through its discount window. This not only helps

individual banks and their customers but also ensures that a shortage of funds at one institution does not disrupt the flow of money and credit in the entire banking system.

Well, here we are, at the end of our journey. I guess you could say, “The Buck stops here!” As promised, I’ve introduced you to the three big stops on the Fed tour: the Board of Governors, the FOMC and one of the 12 Reserve banks. I’ve also described our three main responsibilities: providing financial services, conducting monetary policy and supervising banks. I hope my “plain English” style has helped you make sense of the complex yet effective design of the Federal Reserve System and how we contribute to a healthy economy. And, hey, if you’re ever near a Reserve bank, don’t forget to stop in and say “hi.” With all this savvy knowledge under your belt, I just may recruit you to give the next tour. Oh, and in the meantime, don’t forget to visit our website for bonus features about the Federal Reserve. There, you’ll find interactive games and other tools to learn about the Fed, including the publication *In Plain English*, available in both a web and PDF format. Just go to www.federalreserveeducation.org, and tell them Buck sent you.