SESSION 5:
The Federal Reserve System

Session Description

Students will learn about the Federal Reserve System and its role in the economy.

Talking Points

1. The Federal Reserve System (often referred to as "the Fed") is the central bank of the United States. "Central bank" is the generic name given to a country's primary monetary authority. Generally, a nation's central bank is responsible for determining the money supply, supervising and regulating banks, providing banking services for the government, and lending to banks.

2. Congress created the Federal Reserve System in 1913. The Fed must work within the objectives Congress established, yet Congress gave the Federal Reserve autonomy to carry out its responsibilities without political pressure. The Federal Reserve System is a central bank under public control, with many checks and balances.

3. The nation's periodic episodes of banking panics were one of the most serious concerns that led Congress to create the Federal Reserve and establish the following as its responsibility: safe, sound, and competitive practices in the nation's banking system. To accomplish this, Congress included the Fed among those responsible for regulating the banking system and supervising financial institutions.
    a. Regulation refers to the written rules that define acceptable behavior and conduct for financial institutions. Regulations help establish safe, sound banking practices and protect consumers in financial transactions.
    b. The nation's banking system is only as safe and sound as the banks within the system. The Federal Reserve examines banks regularly to identify and contain bank risks.

4. The Fed has three main parts: (1) the Board of Governors, (2) 12 regional Reserve Banks, and (3) the Federal Reserve Open Market Committee (FOMC).

5. The Board of Governors (BOG), also called the Federal Reserve Board, is an agency of the federal government located in Washington, D.C. It is the Fed's centralized component. The BOG consists of seven members who are appointed by the president of the United States and confirmed by the Senate to staggered 14-year terms, which expire every 2 years. Fed governors guide the Federal Reserve's policy actions. Longer, staggered terms ensure the Fed's political independence as a central bank.
    a. The president of the United States appoints two Fed governors to serve 4-year terms as Chair and Vice Chair of the BOG.

   b. The Chair reports to Congress twice a year regarding the Fed's monetary policy objectives, testifies before Congress on numerous other issues, and meets periodically with the Secretary of the Treasury.

6. The structure of the Federal Reserve is complex, yet effective. Reserve Banks operate somewhat independently but under the general oversight of the BOG.

7. Federal Reserve Banks are often called the "bankers' banks" because they provide services to commercial banks similar to the services commercial banks provide to their customers. Federal Reserve Banks authorize or distribute currency and coin to banks, lend money to banks, and process electronic payments.

8. Reserve Banks also serve as fiscal agents for the U.S. government. They maintain accounts for the U.S. Treasury, process government checks, and conduct government securities auctions.

9. Economists at Reserve Banks conduct regional, national, and international research; prepare Reserve Bank presidents for their participation on the FOMC; and distribute information about the economy through publications, speeches, educational workshops, and websites.

10. The FOMC is the Fed's chief body for monetary policy.
    a. By tradition, the Chair of the FOMC is also the Chair of the BOG. The FOMC includes the 7 Fed governors and the 12 District Reserve Bank presidents.
    b. At any time, only 12 of the members vote on policy decisions. These include the 7 members of the BOG, the president of the Federal Reserve Bank of New York, and 4 other Reserve Bank presidents. Although Reserve Bank presidents vote on a rotating basis, all of them attend and participate in deliberations at FOMC meetings even when they are not voting members.
    c. The FOMC typically meets eight times a year in Washington, D.C. If economic conditions require additional meetings, the FOMC can and does meet more often.

11. The Federal Reserve System has a dual mandate from Congress. By law, the Fed must pursue the economic goals of price stability and maximum employment. It does this by managing the nation's system of money and credit—in other words, by conducting monetary policy. The Fed can pursue expansionary and/or contractionary monetary policy.

12. Expansionary policy actions are intended to increase economic activity, and contractionary policy actions are intended to moderate or decrease economic activity.
    a. Expansionary monetary policy refers to actions taken by the Federal Reserve to increase the growth of the money supply and the amount of credit available.

b. Contractionary monetary policy refers to actions taken by the Federal Reserve to decrease the growth of the money supply and the amount of credit available.

13. The Fed has four main tools to achieve its monetary policy goals:
    a. Open market operations
        i. Open market operations refers to the Fed buying and selling government securities from its portfolio. It is the most frequently used monetary policy tool by far.
        ii. Buying and selling securities affects an important interest rate called the federal funds rate. The federal funds rate is the interest rate that banks charge one another for overnight loans. It is an important rate because it influences other interest rates in the economy. For example, if the federal funds rate rises, home loan rates and car loan rates will likely rise as well. The FOMC establishes a target for the federal funds rate and then uses open market operations to move the rate toward that target.
        iii. The term "open market" means that market forces and not the Fed itself decide with which securities dealers the Fed will buy and sell government securities—that is, various securities dealers compete against each other in the government securities market based on price.
        iv. The Fed's purchase of government securities is referred to as expansionary monetary policy and its sale of government securities as contractionary monetary policy.
            1. Expansionary monetary policy
                a. Purchases of government securities increase bank reserves, making more funds available for lending. This action puts downward pressure on the federal funds rate. Policymakers call this easing, or expansionary monetary policy.
                b. When the Fed buys government securities through securities dealers in the bond market, the money it pays the dealers is ultimately deposited into the bank accounts of the banks, businesses, and individuals for whom the dealers sold the securities.
                c. Those deposits become part of the funds in commercial bank accounts and thus part of the funds that commercial banks have available to lend.
                d. Because banks want to lend money, to attract borrowers they decrease interest rates, including the rate they charge each other for overnight loans (the federal funds rate).
            2. Contractionary monetary policy
                a. Sales of government securities reduce bank reserves. Less money available for lending tends to raise the federal funds rate. Policymakers call this tightening, or contractionary monetary policy.

b. When the Fed sells government securities, buyers pay from their bank accounts, which reduces the amount of funds held in bank accounts.

c. Because there is less money in bank accounts, banks have less money available to lend.

d. When banks have less money to lend, the price of lending that money—the interest rate—goes up, and that includes the federal funds rate.

b. The discount rate

i. The discount rate is the interest rate Reserve Banks charge commercial banks for short-term loans. The discount rate influences other interest rates. Federal Reserve lending at the discount rate complements open market operations in achieving the target federal funds rate and serves as a backup source of liquidity for commercial banks. Reserve Banks and the BOG make changes to the discount rate.

ii. Lowering the discount rate is expansionary monetary policy because lower interest rates encourage lending and spending by consumers and businesses.

iii. Raising the discount rate is contractionary monetary policy because higher interest rates discourage lending and spending by consumers and businesses.

c. Reserve requirements

i. A reserve requirement is the portion of deposits the Fed requires banks to hold in cash, either in their vaults or on deposit at a Federal Reserve Bank. The BOG has sole authority over changes to reserve requirements. The Fed rarely changes reserve requirements.

ii. A decrease in reserve requirements is expansionary monetary policy because it increases the funds available in the banking system to lend to consumers and businesses.

iii. An increase in reserve requirements is contractionary monetary policy because it reduces the funds available in the banking system to lend to consumers and businesses.

d. Interest on reserves

i. The Fed has fairly recently added a tool, interest on reserves. Interest on reserves is interest paid by the Federal Reserve on required and excess reserves held by banks at Federal Reserve Banks.

ii. While many central banks around the world have paid interest on reserves for some time, the Fed did not implement this policy until 2008.

iii. Banks can choose to either hold their reserves, including excess reserves, on deposit at a Federal Reserve Bank and earn interest or use their excess reserves to make loans to businesses and individuals and charge interest.

iv. The Federal Reserve can influence banks' decisions to hold excess reserves at the Fed or lend to customers by increasing or decreasing the interest rate paid on excess reserves.

v. Raising interest rates on reserves is contractionary monetary policy. Reducing interest rates on reserves is expansionary monetary policy.

Session 5: Standards and Benchmarks

Missouri Personal Finance Competencies

Money Management

9. Analyze the role of the Federal Reserve in controlling the money supply.

National Standards for Financial Literacy

Standard 3: Saving, Grade 8 Benchmarks

3. Interest rates paid on savings and charged on loans, like all prices, are determined in a market.

Standard 3: Saving, Grade 12 Benchmarks

6. Government agencies supervise and regulate financial institutions to help protect the safety, soundness, and legal compliance of the nation's banking and financial system.

Standard 4: Using Credit, Grade 8 Benchmarks

6. Interest rates on loans fluctuate based on changes in the market for loans.

Standard 5: Financial Investing, Grade 12 Benchmarks

4. Buyers and sellers in financial markets determine prices of financial assets and therefore influence the rates of return on those assets.
13. The Securities and Exchange Commission (SEC), the Federal Reserve, and other government agencies regulate financial markets.

Common Core State Standards

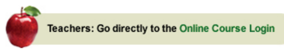
- CCSS.ELA-Literacy.RH.9-10.1 Cite specific textual evidence to support analysis of primary and secondary sources, attending to such features as the date and origin of the information.
- CCSS.ELA-Literacy.RH.9-10.2 Determine the central ideas or information of a primary or secondary source; provide an accurate summary of how key events or ideas develop over the course of the text.
- CCSS.ELA-Literacy.RH.9-10.4 Determine the meaning of words and phrases as they are used in a text, including vocabulary describing political, social, or economic aspects of history/social science.
- CCSS.ELA-Literacy.SL.9-10.1 Initiate and participate effectively in a range of collaborative discussions (one-on-one, in groups, and teacher-led) with diverse partners on grades 9-10 topics, texts, and issues, building on others' ideas and expressing their own clearly and persuasively.

    - CCSS.ELA-Literacy.SL.9-10.1D Respond thoughtfully to diverse perspectives, summarize points of agreement and disagreement, and, when warranted, qualify or justify their own views and understanding and make new connections in light of the evidence and reasoning presented.

- CCSS.ELA-Literacy.L.9-10.6 Acquire and use accurately general academic and domain-specific words and phrases, sufficient for reading, writing, speaking, and listening at the college and career readiness level; demonstrate independence in gathering vocabulary knowledge when considering a word or phrase important to comprehension or expression.
- CCSS.ELA-Literacy.RH.11-12.1 Cite specific textual evidence to support analysis of primary and secondary sources, connecting insights gained from specific details to an understanding of the text as a whole.
- CCSS.ELA-Literacy.RH.11-12.2 Determine the central ideas or information of a primary or secondary source; provide an accurate summary that makes clear the relationships among the key details and ideas.
- CCSS.ELA-Literacy.SL.11-12.1 Initiate and participate effectively in a range of collaborative discussions (one-on-one, in groups, and teacher-led) with diverse partners on grades 11-12 topics, texts, and issues, building on others' ideas and expressing their own clearly and persuasively.
    - CCSS.ELA-Literacy.SL.11-12.1D Respond thoughtfully to diverse perspectives; synthesize comments, claims, and evidence made on all sides of an issue; resolve contradictions when possible; and determine what additional information or research is required to deepen the investigation or complete the task.
- CCSS.ELA-Literacy.L.11-12.6 Acquire and use accurately general academic and domain-specific words and phrases, sufficient for reading, writing, speaking, and listening at the college and career readiness level; demonstrate independence in gathering vocabulary knowledge when considering a word or phrase important to comprehension or expression.

Session 5: Resources

1. Print lesson with PowerPoint: The Fed's Toolbox; http://www.stlouisfed.org/education_resources/the-feds-toolbox/

2. Online course: In Plain English
    a. Go to www.stlouisfed.org.
    b. Choose "Education Resources."
    c. Choose 

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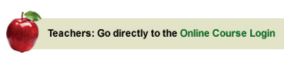
    d. Create an account or, if you already have an account, log in.
    e. Register your class for the "In Plain English" course.

3. Complete one of the following, either the print lesson or the online course:
    a. Print lesson with PowerPoint and whiteboard resources: The Great Depression Curriculum Unit, Lesson 6: Could It Happen Again?; http://www.stlouisfed.org/education_resources/great-depression-curriculum-unit/
    b. Online course: The Great Depression Curriculum Unit, Lesson 6: Could It Happen Again?
        i. Go to www.stlouisfed.org.
        ii. Choose "Education Resources."
        iii. Choose 

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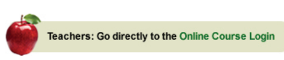
        iv. Create an account or, if you already have an account, log in.
        v. Register your class for the "The Great Depression Curriculum Unit, Lesson 6: Could It Happen Again?" course.

4. Online course: Monetary Policy
    a. Go to www.stlouisfed.org.
    b. Choose "Education Resources."
    c. Choose 

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    d. Create an account or, if you already have an account, log in.
    e. Register your class for the "Monetary Policy" course.

5. Online Video Q&A (Short videos followed by a few multiple-choice questions)
    a. In Plain English (13:52)
        i. Go to www.stlouisfed.org.
        ii. Choose "Education Resources."

   iii. Choose Teachers: Go directly to the Online Course Login .

   iv. Create an account or, if you already have an account, log in.

   v. Register your class for the "In Plain English" video.

b. Classroom Economist: How Can Monetary Policy Affect the Economy? (4:27)

   i. Go to www.stlouisfed.org.

   ii. Choose "Education Resources."

   iii. Choose Teachers: Go directly to the Online Course Login .

   iv. Create an account or, if you already have an account, log in.

   v. Register your class for the "Classroom Economist: How Can Monetary Policy Affect the Economy?" video.

c. Classroom Economist: Why Monetary Policy Is Important for Everybody (3:23)

   i. Go to www.stlouisfed.org.

   ii. Choose "Education Resources."

   iii. Choose Teachers: Go directly to the Online Course Login .

   iv. Create an account or, if you already have an account, log in.

   v. Register your class for the "Classroom Economist: Why Monetary Policy Is Important for Everybody" video.