

Econ 8701

Federal Reserve System

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Historical background

- Established in December 23, 1913
- Purposes:
 - “... to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banks in the United States”*
- Full Employment and Balanced Growth Act of 1978:
 - “... to promote full employment and production ... and reasonable price stability ”*
- This is the so-called “dual mandate”

Organization

- Board of Governors in Washington, DC
- 12 District Banks
- All national banks must be members
- Others can choose to belong or not

Board of Governors

- 7 members
- 14 year terms, staggered every 2 years
- Chairman, Ben Bernanke
- Vice-chairman (Don Kohn) and five governors (only 3 currently)

District Banks

- Technically, owned by member banks
 - earn 6% dividend on their stock
- Board of Directors (9 members)
 - Class A – bankers, elected by member banks
 - Class B – nonbankers, elected by member banks
 - Class C – nonbankers, appointed by Board of Governors
- Appoint the Bank's President and First Vice-President

- ① Supervise banks
 - Bank holding companies
 - State member banks

② Act as fiscal agent for the government

- Act as Treasury's bank
- Sell government bonds
- Record keep Government debt

3 Keep payments system functioning

- Clear checks
- Monopoly provider of currency
- Distribute coin and currency

④ Act as lender of last resort

- Primary credit facility
- Secondary credit facility

- 5 Set monetary policy
 - Done by the Federal Open Market Committee (FOMC)

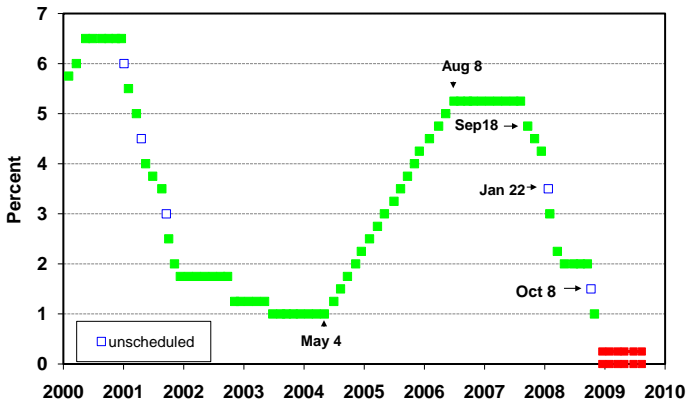
Federal Open Market Committee (FOMC)

- Meets 8 times per year
- 12 voting members
 - 7 Governors
 - President of FRB New York
 - 4 other District Bank presidents (rotating)
- Chairman is BOG Chairman
- All non-voting District Bank presidents attend and participate

- Possible ways to implement monetary policy
 - ① Exchange rate target
 - ② Money supply target
 - ③ Target price level or inflation rate
 - ④ **Interest rate target**

- FOMC sets target for the federal funds rate
 - Federal funds rate – overnight rate at which banks loan reserves to each other
 - must be deposits at Fed
- Affected by **Open Market Operations** carried out by Federal Open Market Desk at FRB New York
- OMOs: Buying or selling government securities
 - Buying injects reserves into banking system, lowering ff rate
 - Selling drains reserves from banking system, raising ff rate

Federal Funds Rate Targets, 2000 to present

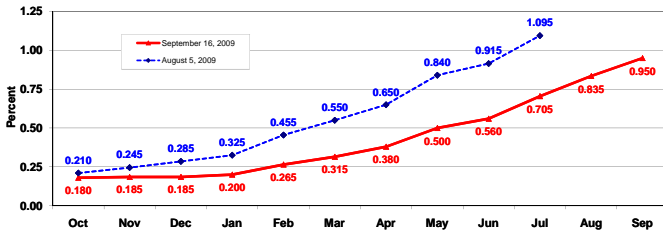


Gauging Market Expectations for Future Policy

- Fed Funds Futures

The contract is cash settled against the average daily fed funds overnight rate, rounded to the nearest one-tenth of one basis point, for the delivery month. The daily fed funds overnight rate is calculated and reported by the Federal Reserve Bank of New York.

CBOT FFR Futures
September 16, 2009



Meeting date
 Funds target

Meeting date	Sep 23	Nov 4	Jan 27	Mar 16	Apr 28	Jun 23	Aug 10
0.00	0.28	0.26					
0.25	0.72	0.74	0.94	0.48	0.00		
0.50			0.06	0.52	1.00	0.18	
0.75						0.82	
1.00							0.28
1.25							0.72

However, appears FOMC has been following a different policy since September 2008

- Some have referred to it as “Quantitative Easing”

Conventional Monetary Policy

- Typical Fed balance sheet, 12/7/07 (\$billions)

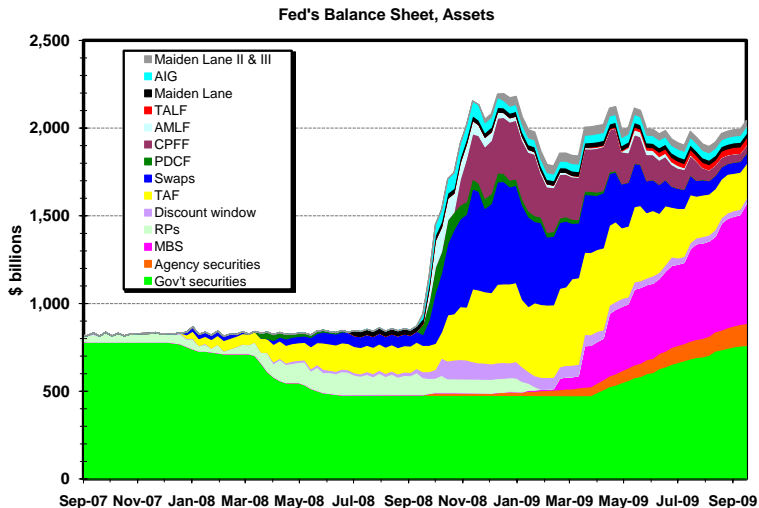
Assets	Liabilities
Government Securities \$819.0	Federal Reserve Notes \$785.7
Discount Window \$4.7	Bank Reserves \$17.6
Foreign currencies \$39.0	Other \$51.2
Other \$28.3	Capital \$36.5
Total \$891.2	Total \$891.2

Conventional Monetary Policy

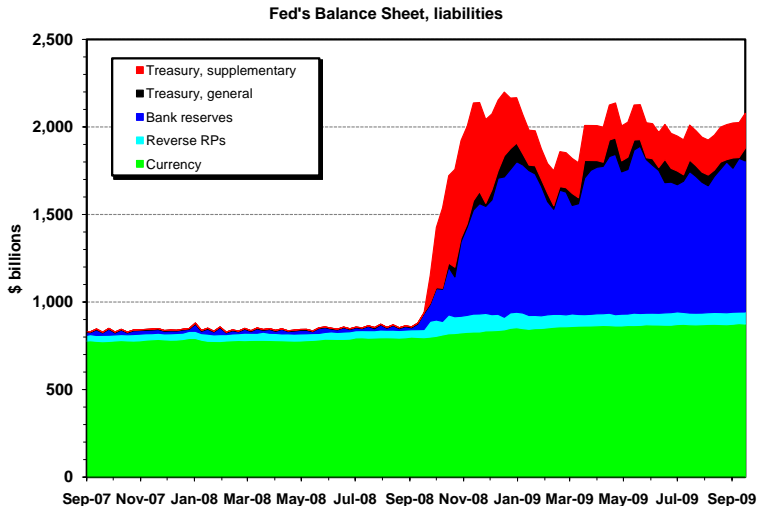
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Evidence That Policy Has Changed



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Details of new policy

- Term Auction Facility (TAF)
- Expansion of swaps
- Provide liquidity directly to key credit markets under Section 13(3)

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System . . . may authorize any Federal reserve bank . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange

Details of new policy

- Specific 13.3 programs:
 - Primary Dealer Credit Facility (PDCF)
 - Money Market Investing Funding Facility (MMIFF)
 - ABCP Money Market Fund Liquidity Facility (AMLF)
 - Commercial Paper Funding Facility (CPFF)
 - Term Asset-Backed Securities Loan Facility (TALF)
- All except TALF are running off

The future

- Currently committed to purchase \$1.25 trillion of MBS and \$200 billion of Agency securities
- Have purchased \$685 of MBS and \$125 of Agency
so \$640 billion left to purchase
- Since little other left to run off could boost total balance sheet to \$2.7 trillion
and reserves to \$1.4 trillion

The future

- Implication: To get banks to hold these additional reserves either
 - ① **Have to increase interest on reserves**
 - or
 - ② **Will a once-and-for-all increase in price level or deflation**