The Federal Reserve System: Overview Lesson

Because of its thematic importance, this lesson is not framed as an inquiry-driven dilemma, but instead, as a collection of resources that can be used as part of an informational lesson directed by the teacher or made available to students for independent study.

INTRODUCTION

Do financial markets know best? Left alone by the federal government, would the markets benefit the nation's economy and, through self-regulation, the American people as a whole, or would they benefit a narrower group of people? Do the markets care about how well the economy is serving the American people and, if they don't, does the government have an important role to play in achieving outcomes that benefit all Americans? One way to look at U.S. history is that it reflects the efforts of a politically open society to manage concentrations of political and economic power in ways that advance the common good with a minimum of government intervention. The story of the Federal Reserve System (also known as the Federal Reserve Bank, the Federal Reserve, or the Fed) can be told in these terms because the very need for a central bank has always been identified with the needs of private bankers—a group that has represented a concentration of economic power. The debate about Hamilton's First Bank of the United States illustrates this struggle, and this same struggle has continued throughout U.S. history. The controversy surrounding the Second Bank of the United States (the 1819 *McCulloch v. Maryland* U.S. Supreme Court case and President Andrew Jackson's veto of the bank's charter renewal), the various financial panics of the 19th century and accompanying debates about the gold standard versus "free silver," and, right up to the present, the debate about the role of the Federal Reserve during and after the 2008 financial crisis, all illustrate this issue's enduring nature. Recurring debates about national priorities, the proper role and scope of government, and the virtues and limitations of the free market are faces of the struggle to manage concentrations of power, though in detail and tone they reflect the historical peculiarities of the time period.

The role of the Federal Reserve is based on the assumption that a smoothly running economy benefits everyone and that, in order to run smoothly, the economy needs a stable currency, no more than a 4–5% level of unemployment, and the right amount of available credit—not too little and not too much. Keeping things running smoothly is the job of the Federal Reserve, a mostly autonomous, public/private system overseen by Congress. The Federal Reserve sets the nation's monetary policy in part by either increasing or reducing the amount of money in circulation.

> . . . The Fed can influence the money supply by modifying reserve requirements, which is the amount of funds banks must hold against deposits in bank accounts. By lowering the reserve requirements, banks are able loan more money, which increases the overall supply of money in the economy. . . .
>
> . . . If the Fed wants to increase the money supply, it buys government bonds. This supplies the securities dealers who sell the bonds with cash, increasing the overall money supply. Conversely, if the Fed wants to decrease the money supply, it sells bonds from its account, thus taking in cash and removing money from the economic system. (Gallant, 2007)

In theory this encourages banks to loan money at lower interest rates. Making more money available stimulates the economy and encourages economic growth, including employment. When the Federal Reserve pulls back the amount of money in circulation (by increasing the amount of money banks are required to keep in reserve), the opposite occurs. The Federal Reserve also influences the interest rates at which money is loaned by setting the rate for emergency, short-term loans to banks. Lower interest rates put more money in circulation.

The independence of the Federal Reserve is a matter of great importance and, inevitably, a source of controversy because of its power to dial the economy up or down in a way that fundamentally affects everyone's well-being. Is the Federal Reserve a truly independent institution of experts, trying to maintain economic stability through unpredictable business cycles, being careful to maintain a balance between inflation and unemployment and regulating the financial system and money supply to the benefit of all? Or is it subject to the influence and power of the government or private interest groups? Is it, as some (usually conservative) critics have charged, an institution the government can use to inflate away the value of the currency and allow limitless deficit spending ("monetizing" the deficit) in order to expand the scope of the government's power? Or is it, as other critics (usually liberal) have charged, an institution that bankers and corporate interests can use to maintain their own wealth and power at the expense of others?

This lesson is presented as a collection of resources that can be used in multiple places in a U.S. History curriculum. The Federal Reserve Bank that we know today was created in 1913 and has its own foundation story, but this lesson is designed to be used wherever an understanding of how central banking, the money supply, and regulation of the financial system relate to the business cycle and to the differing and often conflicting interests of large bankers ("Wall Street"), small business owners, farmers, salaried employees, and the poor.

LIST OF LESSON RESOURCES

1. A Story of the Federal Reserve, 2006
2. The Federal Reserve at Its Founding
3. The Federal Reserve and the Great Depression
4. The Federal Reserve Today

OVERVIEW

Structure and Function of the Federal Reserve

The Federal Reserve is a public/private institution that regulates the nation's economy by regulating the money supply. Its goal is to manage the money supply by balancing two competing forces—keeping inflation from getting too high if there is too much money in circulation, while ensuring there is enough money and liquidity to keep unemployment at around 4–5%. In September 2010, however, unemployment was 10%. In July 2012 it was 8.2%, and the number was even higher for blacks (14.4%) and teenagers (23.7%). As of November 2015, the unemployment rate had fallen to 5.0%, with higher rates for blacks (9.4%) and teenagers (15.7%) (Bureau of Labor Statistics, 2015).

Although we speak of "the" Federal Reserve, it is actually a somewhat decentralized system of interrelated parts configured as regional banks. They work together, but they also serve as a system of checks and balances (Suiter & Schug, 2012). At the top of the system is the Board of Governors, located in Washington, D.C., which is made up of seven political appointees who serve staggered 14-year terms. Underneath the Board of Governors is the network of 12 regional Reserve Banks. In addition to their checks and balances role, regional banks are intended to ensure that monetary policy supports the well-being of the people. The final component of the Fed is the Federal Open Market Committee (FOMC), which is composed of the governors and the presidents of five of the regional banks (always including the New York Bank). The FOMC is where the nation's monetary policy is actually made—where interest rates are set and the money supply is regulated. (Note: taxing and spending are part of fiscal policy, which is set by Congress and the President.) (Board of Governors of the Federal Reserve System, 2012)

History of the Federal Reserve

The creation of the Federal Reserve System in 1913 followed a long series of events related to central banking and the monetary policy (Federal Reserve, 2012; ushistory.org, 2012):

1791–1811: The First Bank of the United States was established by Congress in Philadelphia to standardize the currency and help pay Revolutionary War debts. The bank became politically unpopular, especially among farmers, because it was associated with wealthy interests.

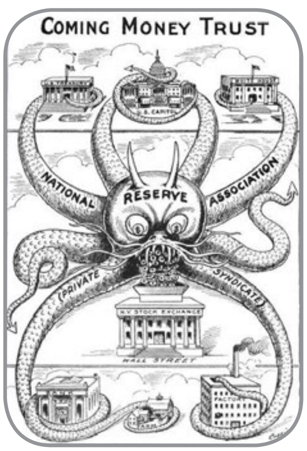
1816–1836: The Second Bank of the United States was established, in part to pay debts from the War of 1812 and to combat inflation, or a general increase in prices for goods and services. President Andrew Jackson did not like the idea of a central bank, and succeeded in blocking the renewal of its charter.

1836–1865: During this era, when there was no central bank, state banks and local, unchartered banks issued their own bank notes, or currency.

1873–1907: The late-nineteenth and early-twentieth centuries saw a number of economic and financial "panics," including the disastrous Panic of 1893 that led to the worst depression up to that point in U.S. history.

1907: Another particularly severe banking panic, caused in part by speculation on Wall Street, led to renewed calls for reform to the nation's banking system. Although fierce debates between conservatives and progressives ensued over the exact nature of the reform, a national consensus emerged that the nation needed a central bank that could provide flexibility to the currency and regulation and stability to the banking system.

1908–1912: Debates persisted between corporate and banking interests, who supported a central bank led by bankers, and progressives such as William Jennings Bryan, who supported a central bank led by the public. A commission led by Senator Nelson Aldrich recommended a banker-controlled bank, but the 1912 election of progressive President Woodrow Wilson effectively killed that plan. Still, the somewhat paradoxical idea of a "decentralized central bank" had significant impact.



See Resource 2 online

December 23, 1913: Based on ideas from Representative Carter Glass and economist H. Parker Willis, and after significant debate, compromise, and revision, Congress ultimately passed and President Wilson signed into law the Federal Reserve Act. Although it has evolved over time and been modified by later laws, the structure of the Federal Reserve System created by the act reflected the basic compromise of a decentralized central bank under a mixture of private and public control.

1914–1919: The Federal Reserve System proved to be useful during World War I, initially by aiding in the trade of goods with Europe and helping to finance the war, and from 1917 onward helping to finance the United States' entry into the war.

1920s: Under the leadership of Benjamin Strong, the Federal Reserve began engaging in "open market operations," or the buying and selling of government securities to influence interest rates and the availability of credit in the financial system.

1929–1933: In October 1929, the stock market crashed, meaning that a tremendous amount of wealth that people thought they held in the value of companies was lost. This event did not directly cause, but was correlated with, the start of the Great Depression, the worst economic depression in U.S. history. Nearly 10,000 banks failed in the first few years of the 1930s, and many debated about the best way to respond to stabilize the financial system, as well as whether the Fed had failed to prevent the crash and depression by allowing too much speculation.

1933–1935: President Franklin Delano Roosevelt and Congress enacted several changes in response to the Great Depression. One of the best known was the Banking Act of 1933, or the Glass-Steagall Act, which required commercial and investment banks to separate, increased the regulatory power of the Fed, and created the Federal Deposit Insurance Corporation (FDIC) to insure savings accounts. President Roosevelt also effectively ended the gold standard by recalling all gold and silver certificates. Over time, other changes were made to help ensure the Fed's independence and ability to achieve its mission, including the creation of the Federal Open Market Committee to set monetary policy and the establishment of 14-year terms for the Board of Governors. Through the 20th century, the Fed's role continued to evolve, including adding promoting full employment to its goals.

See Resource 3 online

1951: When the government faced increased revenue and borrowing needs during the Korean War, the Fed resisted pressure to maintain low interest rates to help fund the conflict, leading to increased independence of monetary and fiscal policies.

1970s–1980s: After a period of rapid inflation through the 1970s, Fed Chairman Paul Volcker took drastic action through the 1980s to reduce inflation. The 1980s also saw significant changes to the banking industry, such as increased interstate banking and interest-bearing accounts, which led to the rise of the modern financial services industry.

1990s: Following a stock market crash on October 19, 1987, the Fed provided liquidity to support the economy and financial system. Under the leadership of Chairman Alan Greenspan, the Fed used monetary policy throughout the 1990s to prevent problems in the financial system from affecting the entire economy. During this period (but not necessarily as a direct result), the economy saw its largest peacetime expansion in history.

1999: The Gramm-Leach-Bliley Act overturned Glass-Steagall and allowed banks to offer a menu of services, including investment banking.

2007–2008: After a housing boom through the 2000s, in which low mortgage rates and the availability of subprime mortgages to borrowers with risky credit records increased homeownership as well as the demand for and price of housing, house prices began to fall, leading some people to owe more on their mortgages than their homes were worth. This led to a downward spiral in the financial system, in which the risks of selling bundled mortgages as securities or investments were revealed. Fears about the true value of assets and the financial health of many institutions spread, culminating in the failure of Lehman Brothers and Washington Mutual, two major financial institutions. Ripple effects, including tightened credit markets, significantly weakened business and consumer confidence, and loss of wealth led to a recession, or period of shrinking economic activity, from 2007 to 2008, with a slow and weak economic recovery following.

See Resource 4 online

The Fed took several actions, some uncustomary (and controversial), to stabilize the financial system and prevent cascading effects. These included large loans to major financial institutions like insurance company American International Group (AIG) to prevent major financial losses from leading to devastating effects throughout the system. The Fed maintained extremely low interest rates to help lower the cost of borrowing and to stimulate the economy, in addition to using uncommon monetary policy tools, such as the purchase of mortgage-backed securities to help keep homes affordable in the wake of the housing market crisis.

2015: For the first time since 2006, the Federal Reserve, citing persistent improvements in the labor market after a slow recovery, engaged in monetary policy activities to raise interest rates. Although inflation remains well below the target rate, Fed leaders expressed concerns that rising prices often lag economic recoveries, as well as that keeping rates at or near zero for an extended period of time encouraged excessive risk and instability in the financial system and left the Fed with limited monetary policy tools to make future adjustments.

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Resource 1 (1 of 2)

A Story of the Federal Reserve, 2006

Federal Reserve Vice Chairman Donald L. Kohn summarized the history of the Federal Reserve in a speech to the American Bar Association in 2006.

Vice Chairman Donald L. Kohn
At the American Bar Association, Banking Law Section, Washington, D.C.
November 3, 2006

The Evolving Role of the Federal Reserve Banks

I am pleased to have the opportunity to speak to this group of lawyers who practice in the banking area. As banking lawyers are well aware, the Federal Reserve embodies a unique legal structure compared with other central banks around the world. Unlike the Bank of England, for example, the Federal Reserve is a not a single entity, but a decentralized system. The essential components are the Board of Governors, a federal government agency, and the twelve regional Federal Reserve Banks, which are structured essentially as private corporations.

This structure has served the nation exceptionally well over the years, In the past decade or so, however, the emergence of nationwide banking systems, significant changes in the nation's payments systems, technological advances, and other developments have prompted changes in the ways in which we meet our responsibilities,

The Existing Structure of the Federal Reserve System

The current structure of the Federal Reserve—the combination of a centralized government agency and regional corporate Reserve Banks—is the product of a carefully crafted political compromise. In the early years of our nation, the First and Second Banks of the United States performed many basic central banking services. These were banks that, while chartered by Congress, were owned and managed by private, nongovernmental interests. Their charters, however, were allowed to expire, and their demise has been attributed to deep-seated opposition in some parts of the country to the centralization and concentration of economic power.

As the nation grew through the nineteenth and early twentieth centuries, it lacked any entity that was constituted to carry out the basic roles of a central bank. However, after a financial panic in 1907 forced a number of banks to close, disrupting the economy, a consensus emerged that the nation needed some form of central bank, and Congress created the National Monetary Commission. The commission, chaired by Rhode Island senator Nelson Aldrich, called for one central institution, with fifteen branches across the country, to issue currency and discount commercial paper. However, thirty-nine of the institution's forty-two-member board of directors would be bankers, which aroused the long-standing fear of some about the concentration of economic power in the hands of a few large banks. Agrarian and progressive interests, led by William Jennings Bryan, favored a central bank under public, rather than banker, control. But the vast majority of the nation's bankers, concerned about government intervention in the banking business, opposed a central bank structure directed by political appointees.

Resource 1 (2 of 2)

A Story of the Federal Reserve, 2006

> The legislation that Congress ultimately adopted in 1913 reflected a hard-fought battle to balance these two competing views and created the hybrid public-private, centralized-decentralized structure that we have today. A centralized governmental Federal Reserve Board, with members appointed by the President and confirmed by the Senate, exercises general oversight over the Federal Reserve System and works with the Reserve Banks to determine policies to fulfill the Federal Reserve's legislative mandates. The Reserve Banks were intended to be "banker's banks" and to carry out the operational functions of a central bank. Additional duties were assigned to them as a result of subsequent developments [but]. . . the Reserve Banks are structured to carry out public policy objectives set in the Federal Reserve Act, not to advance the interests of their shareholders.

Source: Board of Governors of the Federal Reserve System. (2006, November 3). The evolving role of the Federal Reserve banks. Retrieved from http://www.federalreserve.gov/newsevents/speech/kohn20061103a.htm

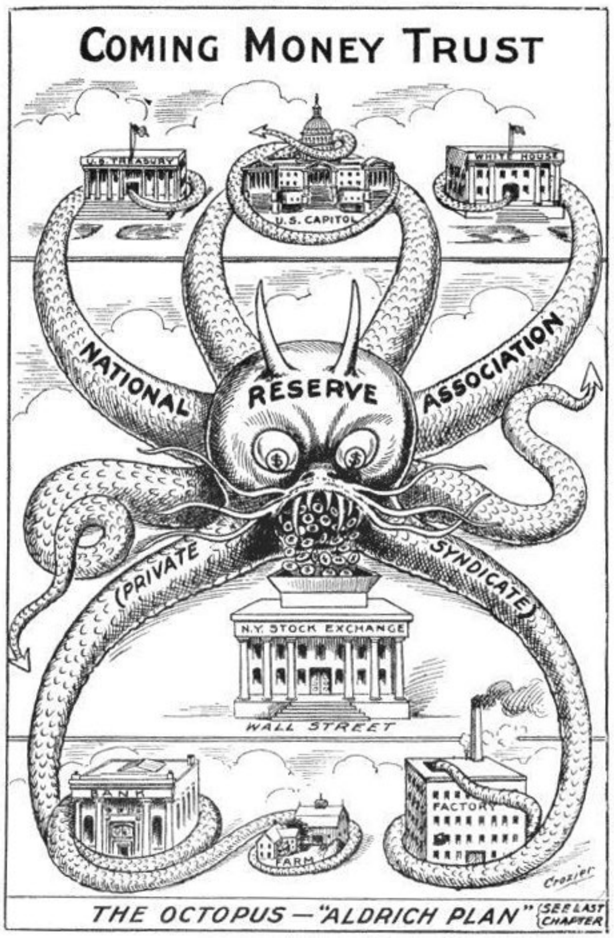
Questions to Consider:

- Who is Donald Kohn?
- What do you notice about the way in which he tells the story of the Federal Reserve?
- Kohn was writing in 2006. Would this story have been written differently in 2008? Or 2016?
- How might a critic of the Federal Reserve tell this story? (See Ron Paul quotation in Resource 4.)

Resource 2 (1 of 4)

The Federal Reserve at Its Founding

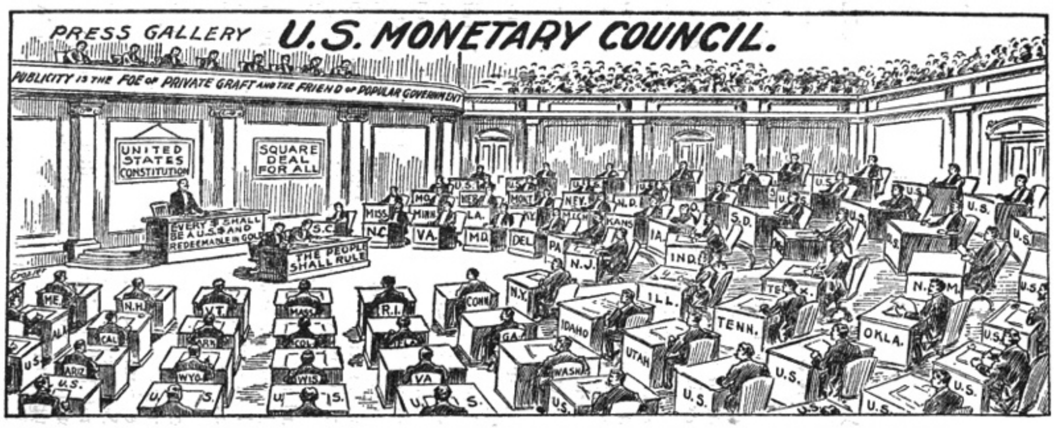
Alfred Owen Crozier on the Aldrich Plan



Source: Crozier, A. O. (1912). U.S. money vs. corporate money, "Aldrich plan," Wall Street confessions! Great bank combine! Cincinnati, OH: Magnet: pp. 1.

Resource 2 (2 of 4)

The Federal Reserve at Its Founding



A DELIBERATIVE PUBLIC INSTITUTION, INSTEAD OF A PRIVATE CORPORATION.

75 members, one representing each of the 48 states and 27 the Federal Government.

It shall regulate the banking system, fix the general discount rate and issue and determine the volume of the public currency, under strict regulations and legal safeguards. It shall establish and maintain the "square deal" between the banks and the public.

Source: Crozier, A. O. (1912). U.S. money vs. corporate money, "Aldrich plan," Wall Street confessions! Great bank combine! Cincinnati, OH: Magnet: pp. 336.

Questions to Consider:

- What do you notice about these two illustrations from a book written by Alfred Owen Crozier in 1912?
- Based on these two illustrations, what can you conclude about Crozier's point of view on the Aldrich plan? Would Crozier be satisfied with the final form of the Federal Reserve?

Resource 2 (3 of 4)

The Federal Reserve at Its Founding

Jacob Gould Schurman speaking at the American Bankers' Association Convention, November 22, 1911

> I believe a thorough and extensive campaign of education will be necessary. . . . The benefits of reform inure to [apply to] the public generally. It is not the bankers but the public who now suffer. And the first lesson to be emphasized in our campaign of education is this: That banking and currency reform is the concern not of bankers, not even of financiers, but of the American public in general.
>
> When panics come and wage earners are thrown out of employment the public must be made to understand that these evils in which all alike are participating are due to a cumbersome, antiquated, and unscientific system of banking and currency, and that they could be eliminated with the reform of that system.

Source: *New York Times*. (1911, November 22). Aldrich answers critics of his plan; denies statement by speaker that Bank of England has a more effective system. Retrieved from http://query.nytimes.com/mem/archive-free/pdf?res=FB0C14FA3E5D16738DDDAA0A94D9415B818DF1D3

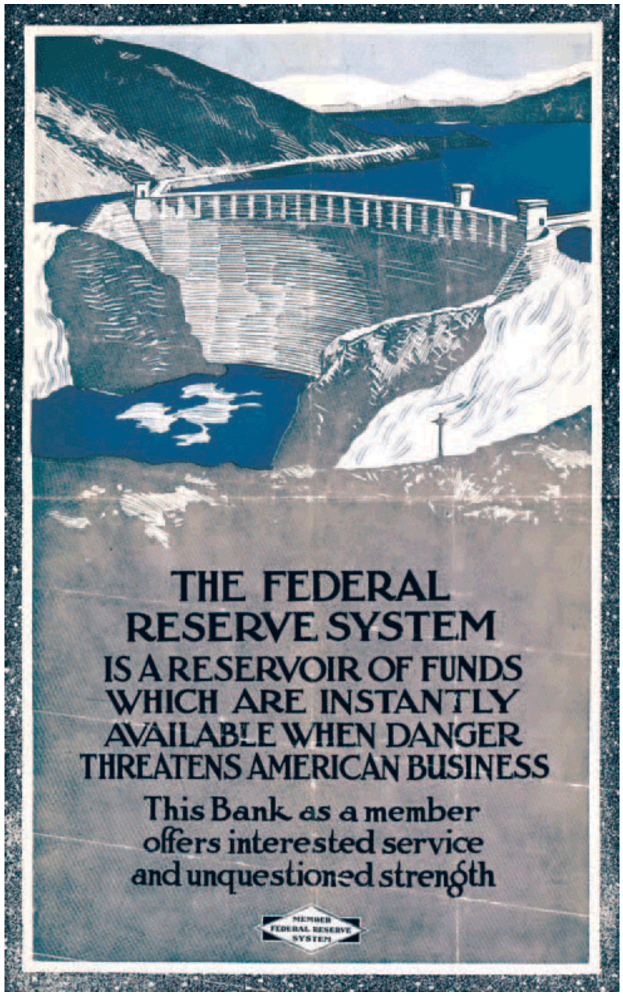
Questions to Consider:

- Who was Jacob Schurman?
- What else would you want to know to evaluate these remarks made at the American Bankers' Association Convention?

Resource 2 (4 of 4)

The Federal Reserve at Its Founding

Mid-1920s Poster Displayed in Member Banks of the Federal Reserve System



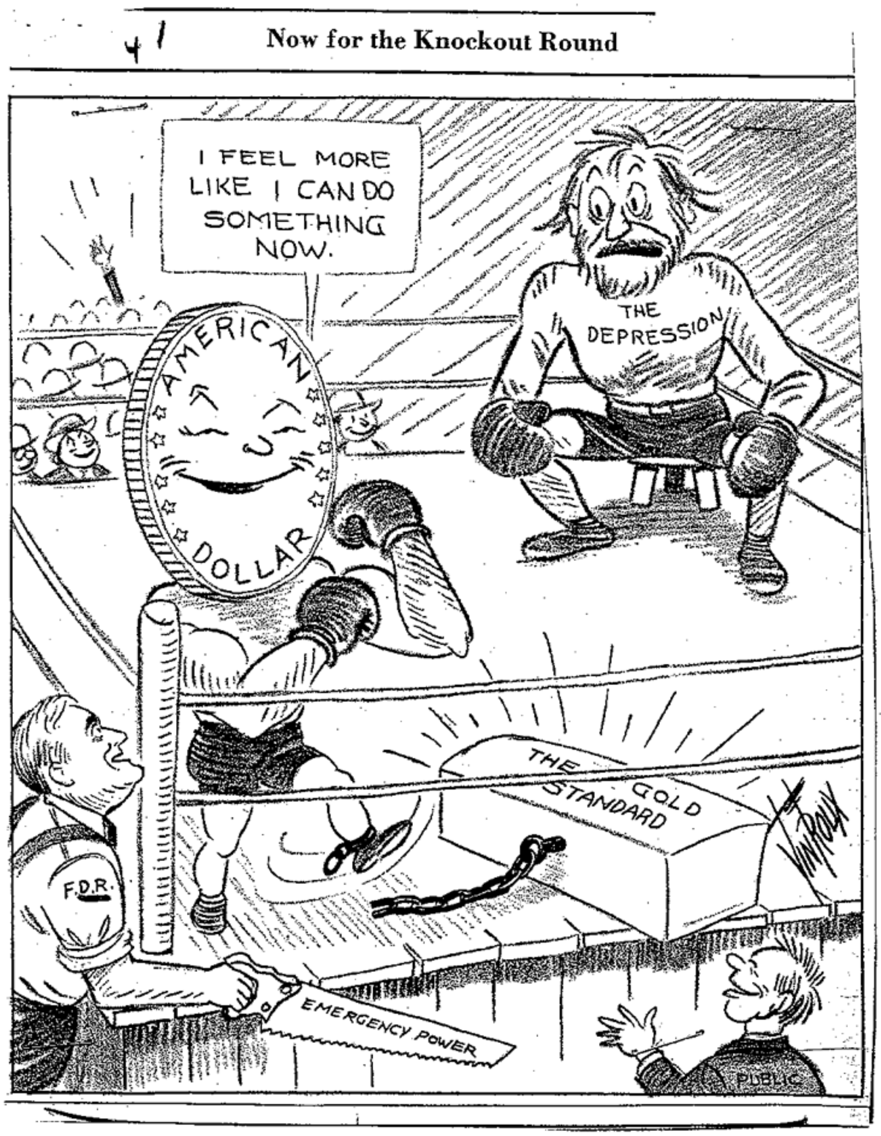
Source: New York Fed Research Library. (2011, May 20). Historical echoes: Communication before the blog. Retrieved from http://libertystreeteconomics.newyorkfed.org/2011/05/historical-echoes-communication-before-the-blog.html

Questions to Consider:

- What do you notice about this poster and the date it was exhibited?
- What information might Jacob Schurman want the Federal Reserve to emphasize to explain and defend its current role in the economy?

Resource 3 (1 of 5)

The Federal Reserve and the Great Depression



by Kendall Vintroux, April 23, 1933. *The Charleston (W.Va.) Gazette*

Questions to Consider:

- What do you notice about this cartoon?
- What story does it tell about the Great Depression and the role of the Federal Reserve?

Resource 3 (2 of 5)

The Federal Reserve and the Great Depression

The Sower (after Millet)

by Gregor Duncan, April 1934, *Life*

Questions to Consider:

- What do you notice about this cartoon?
- What fiscal policy does it depict?
- How might this complement or contradict the monetary policy recommended by former chairman of the Federal Reserve Ben Bernanke (next reading)?

Resource 3 (3 of 5)

The Federal Reserve and the Great Depression

Remarks by Governor Ben S. Bernanke

At the H. Parker Willis Lecture in Economic Policy, Washington and Lee University, Lexington, Virginia
March 2, 2004

Money, Gold, and the Great Depression

. . . I was a professor myself before coming to the Federal Reserve Board. One topic of particular interest to me as a researcher was the performance of the Federal Reserve in its early days, particularly the part played by the young U.S. central bank in the Great Depression of the 1930s. . . .

The number of people with personal memory of the Great Depression is fast shrinking with the years, and to most of us the Depression is conveyed by grainy, black-and-white images of men in hats and long coats standing in bread lines. However, although the Depression was long ago—October this year will mark the seventy-fifth anniversary of the famous 1929 stock market crash—its influence is still very much with us. In particular, the experience of the Depression helped forge a consensus that the government bears the important responsibility of trying to stabilize the economy and the financial system, as well as of assisting people affected by economic downturns. Dozens of our most important government agencies and programs, ranging from social security (to assist the elderly and disabled) to federal deposit insurance (to eliminate banking panics) to the Securities and Exchange Commission (to regulate financial activities) were created in the 1930s, each a legacy of the Depression.

. . .

What caused the Depression? This question is a difficult one, but answering it is important if we are to draw the right lessons from the experience for economic policy. Solving the puzzle of the Depression is also crucial to the field of economics itself because of the light the solution would shed on our basic understanding of how the economy works.

. . .

While the fact that money, prices, and output all declined rapidly in the early years of the Depression is undeniable, the interpretation of that fact has been the subject of much controversy. Indeed, historically, much of the debate on the causes of the Great Depression has centered on the role of monetary factors, including both monetary policy and other influences on the national money supply, such as the condition of the banking system. Views have changed over time. During the Depression itself, and in several decades following, most economists argued that monetary factors were not an important cause of the Depression. For example, many observers pointed to the fact that nominal interest rates were close to zero during much of the Depression, concluding that monetary policy had been about as easy as possible yet had produced no tangible benefits to the economy. The attempt to use monetary policy to extricate an economy from a deep depression was often compared to “pushing on a string.”

Resource 3 (4 of 5)

The Federal Reserve and the Great Depression

During the first decades after the Depression, most economists looked to developments on the real side of the economy for explanations, rather than to monetary factors. Some argued, for example, that overinvestment and overbuilding had taken place during the ebullient 1920s, leading to a crash when the returns on those investments proved to be less than expected. Another once-popular theory was that a chronic problem of "under-consumption"—the inability of households to purchase enough goods and services to utilize the economy's productive capacity—had precipitated the slump.

. . .

The economy was only just emerging from a recession, commodity prices were declining sharply, and there was little hint of inflation. Why then did the Federal Reserve raise interest rates in 1928? The principal reason was the Fed's ongoing concern about speculation on Wall Street. . . .

The market crash of October 1929 showed, if anyone doubted it, that a concerted effort by the Fed can bring down stock prices. But the cost of this "victory" was very high.

. . .

new research found that a complete understanding of the Depression requires attention to the operation of the international gold standard, the international monetary system of the time.

. . . the gold standard is a monetary system in which each participating country defines its monetary unit in terms of a certain amount of gold. The setting of each currency's value in terms of gold defines a system of fixed exchange rates, in which the relative value of (say) the U.S. dollar and the British pound are fixed at a rate determined by the relative gold content of each currency. To maintain the gold standard, central banks had to promise to exchange actual gold for their paper currencies at the legal rate.

. . .

The finding that leaving the gold standard was the key to recovery from the Great Depression was certainly confirmed by the U.S. experience. One of the first actions of President Roosevelt was to eliminate the constraint on U.S. monetary policy created by the gold standard, first by allowing the dollar to float and then by resetting its value at a significantly lower level. The new President also addressed another major source of monetary contraction, the ongoing banking crisis. Within days of his inauguration, Roosevelt declared a "bank holiday," shutting down all the banks in the country. Banks were allowed to reopen only when certified to be in sound financial condition. Roosevelt pursued other measures to stabilize the banking system as well, such as the creation of a deposit insurance program. With the gold standard constraint removed and the banking system stabilized, the money supply and the price level began to rise. Between Roosevelt's coming to power in 1933 and the recession of 1937–38, the economy grew strongly.

. . .

Resource 3 (5 of 5)

The Federal Reserve and the Great Depression

Some important lessons emerge from the story. One lesson is that ideas are critical. The gold standard orthodoxy. . . led policymakers astray, with disastrous consequences. . . . Another lesson is that central banks and other governmental agencies have an important responsibility to maintain financial stability. . . . Finally, perhaps the most important lesson of all is that price stability should be a key objective of monetary policy. By allowing persistent declines in the money supply and in the price level, the Federal Reserve of the late 1920s and 1930s greatly destabilized the U.S. economy and, through the workings of the gold standard, the economies of many other nations as well.

Source: Federal Reserve Board. (2004, March 2). Remarks by governor Ben S. Bernanke. Retrieved from http://www.federalreserve.gov/boarddocs/speeches/2004/200403022/default.htm

Questions to Consider:

- Who is Ben Bernanke?
- What more would you need to know to evaluate his view of the Great Depression and its causes?
- Consider the date of this selection. What significance does Bernanke's view of the Great Depression have for the role the Federal Reserve in response to the financial crisis of 2008?

Resource 4 (1 of 7)

The Federal Reserve Today

The Fed's Battle Rages On

by Sage Stossel, www.sagestossel.com

Questions to Consider:

- What do you notice about this cartoon and its depiction of the Federal Reserve?
- This cartoon was drawn in 2008, at the beginning of the financial crisis. What type of cartoon might Stossel draw today?

Resource 4 (2 of 7)

The Federal Reserve Today

Representative Ron Paul (R., Texas)

> Everybody thinks about money and almost everybody wants more. We use money without thinking much about its nature and function. Few of us ask where it comes from, who controls it, why it has value, or why it loses value from time to time.
>
> In the same way, most people accept the Federal Reserve as an indispensable institution—the manager of the nation's money stock—that the United States cannot function without, and so they don't question it. . . .
>
> It's my own view that ending the Fed would address the most vexing problems of politics of our time. It would bring an end to dollar depreciation. It would take away from the government the means to fund its endless wars. . . . The national wealth would no longer be hostage to the whims of a handful of appointed bureaucrats whose interests are equally divided between serving the banking cartel and serving the most powerful politicians in Washington.
>
> **Source:** Paul, R. (2009). *End the fed*. New York, NY: Grand Central: 1–8.

Questions to Consider:

- What more do you need to know about Ron Paul to put his view of the Federal Reserve in context—both in terms of the political debates of 2009 and Ron Paul's views on other issues?
- In what way do Ron Paul's concerns about the Federal Reserve parallel concerns expressed at the time of its foundation?
- Is the connection Paul draws between the Federal Reserve and the ability of the nation to wage wars a reasonable one?
- What more would you want to know in order to decide if you agree with Ron Paul?

Resource 4 (3 of 7)

The Federal Reserve Today

Ethan S. Harris, Former Fed Economist

After more than twenty years as a Fed economist and as a Fed watcher, I am still amazed by the misconceptions and mythology that surround the Fed. . . . The Fed is not an omnipotent manager of the economy, but is more like a tugboat steering an oil tanker in rough waters. . . . Moreover, the Fed really has only one tool for managing the economy—changing the funds rate—hence it cannot fight inflation, stimulate growth, and manage capital markets all at the same time. It must pick its battles.

. . . There are good reasons to keep the Fed independent of the political process—monetary policy is best left to "econocrats" worried about their legacy in history, not politicians worried about the next election. Fortunately, today the Fed is as strong and independent as it has ever been. Increased independence has gone hand in hand with more transparency in the way the Fed communicates with the public. Transparency and independence are self-reinforcing: if the Fed is left to do its job, then it should communicate more clearly about what it is doing; if the Fed is clearer about its actions, then the public will trust it more.

Source: Harris, E. S. (2008). *Ben Bernanke's Fed: The Federal Reserve after Greenspan*. Cambridge, MA: Harvard Business School Press, 11–12.

Questions to Consider:

- What more would you want to know about Ethan Harris to evaluate his view of the role and responsibility of the Federal Reserve?
- What significance do you attach to the date of the publication of the book from which this selection is taken? What can you surmise from the book's title?

Resource 4 (4 of 7)

The Federal Reserve Today

From *The Economist*

The Federal Reserve
Right man, rough job

Ben Bernanke's renomination as Fed chairman is good news. But his hardest work lies ahead

Aug 27th 2009 | from the print edition

HAVING endured weeks of criticism over his plans to reform American health care, Barack Obama urgently needs some friendly headlines. That helps to explain why, on August 25th, the president nominated Ben Bernanke to a second term as chairman of the Federal Reserve, even though Mr Bernanke's first one does not expire until next January. The decision was widely hailed on Wall Street and in Washington, DC. With few exceptions, politicians and economists lined up to praise Mr Bernanke and to laud Mr Obama for keeping him.

The decision was a good one, for two important reasons. The first, on which most commentators have dwelt, is that Mr Bernanke has done a sterling job of dealing with the worst financial crisis since the 1930s. Some of the breathless praise about how this former student of the Depression saved the world from a repeat is overdone. It ignores the fact that Mr Bernanke was complicit in creating the loose monetary conditions which fuelled the financial frenzy in the first place. As a governor of the Fed earlier this decade, he was even more convinced than Alan Greenspan that central banks had no business raising interest rates to head off asset bubbles. Reappointing Mr Bernanke might thus appear akin to paying a plumber all over again for repairing pipes that he fitted after they have flooded your home. Nor, once the crisis struck, was he the only central banker to prove handy with monetary plunger and wrench. The leaders of several other rich-world central banks have also acted boldly.

Nonetheless, Mr Bernanke's academic research gave him an acute appreciation of the risks posed by dysfunctional financial markets. His willingness to experiment with unconventional monetary-policy devices allowed the Fed to counter financial collapse even as America's politicians were paralysed. And his mild, diplomatic manner brought much-needed calm amid the crisis.

The second reason why the renomination makes sense has less to do with Mr Bernanke's strengths than with the dangers of ditching him. The likely alternatives were not obviously superior to the incumbent. Given the broad consensus that he has handled the crisis well, replacing him, especially with an obvious Democrat, would have whiffed of politicisation. True or not, that perception would have damaged the Fed and thus the economy. America's central bank is already in its most parlous political position in generations, under fire from the left for failing to prevent financiers' excesses and from the right for swelling its balance-sheet and overstepping its remit. It is caught up in a furious debate over financial regulation, and has little popular support. According to one poll, Americans think less of the Fed than of the Internal Revenue Service. In this environment, the merest hint of a partisan decision could have been disastrous.

Resource 4 (5 of 7)

The Federal Reserve Today

Mr Bernanke's reappointment has defused that danger. But far more perilous times lie ahead. For both substantively and politically, the tasks over the next four years may be harder than handling the crisis itself. There will be no quick return to business as usual for the Fed or any other central bank. The Fed's monetary stance must be loose enough for long enough to prevent the economy sinking into a deflationary quagmire, but must be tightened quickly enough to stop inflation soaring. With short-term rates close to zero, this monetary balancing-act must be performed with untested equipment—particularly the swelling and shrinking of the Fed's balance-sheet—and against a backdrop of steeply rising government debt .

A question of backbone

Politically, the difficulties will if anything be greater. Mr Bernanke must steer the debate over regulatory reform so that the Fed is not left with implausibly broad responsibilities and insufficient tools with which to carry them out. He must explain the logic behind its monetary decisions but stand firm against pressure to influence them. Given that America's economy is likely to face weak growth and high unemployment for a long time, that will not be easy. For example, the housing industry will cry out if the Fed starts to sell its mortgage-backed securities. And there will be howls from Congress, and maybe the White House too, if interest rates rise when joblessness is still high and the deficit huge.

Mr Bernanke has earned his reappointment by showing that he is a bold and creative crisis-manager. In his second term he will need just as much technical competence as he has shown in his first, and even more political backbone.

Source: *The Economist*. (2009). Right man, rough job. Retrieved from http://www.economist.com/node/14303777

Questions to Consider:

- What more would you need to know about *The Economist* to evaluate this version of the role the Federal Reserve played in responding to the economic crisis of 2008?
- This article was written just one year after the financial crisis of 2008. Is this version of events still relevant?
- What can you surmise about the role of the chairman of the Federal Reserve in U.S. politics and global economics?
- What else would you need to know to decide if you agree with the point of view expressed by this article?

Resource 4 (6 of 7)

The Federal Reserve Today

New Leadership, New Challenges

As of February 3, 2014, after being nominated by President Barack Obama and confirmed by the Senate, Janet Yellen replaced Ben Bernanke as chair of the Federal Reserve. Dr. Yellen is the first female head of the Federal Reserve, and similar to her predecessor is known for an academic approach to monetary policy, rooted in her research as an economist. She entered the office at a critical juncture, when the economy was slowly showing signs of recovery but was potentially threatened by instability in the financial system, particularly due to ongoing economic and financial turmoil in Europe and Asia. Consider the following excerpt from an article by Ylan Q. Mui, originally appearing in *The Washington Post*, and the issues it raises regarding a change in Fed leadership, making monetary policy decisions to manage an economic recovery without returning to recession, and responding to public pressure while attempting to keep the Fed insulated from short-term politics.

From *The Washington Post*

Fed chair Janet Yellen is learning the importance of politics in economics
By Ylan Q. Mui, December 4, 2015

Janet L. Yellen stepped into the top job at the Federal Reserve last year with more experience than anybody who has led the central bank in its 100-year history. But she is finding that success demands not just economic expertise, but a political prowess she is still learning to master.

As the Fed prepares to tackle the controversial task of unwinding years of support for the economy, Yellen has grappled with fractious colleagues and dissent within one of the world's most influential financial institutions. Outside the Fed, liberal lawmakers and some of the world's top economists are urging her not to move too fast, for fear that the economy is weaker than it seems. She has also clashed, sometimes acrimoniously, with conservatives trying to rein in her power, while several Republican presidential candidates have slammed her record on the campaign trail.

The Fed will meet in less than two weeks to decide whether to finally raise interest rates. Many analysts say the vote has been clinched by Friday's strong jobs report, which showed that the economy last month added 211,000 jobs and that the unemployment rate stayed at 5 percent.

The decision will be Yellen's biggest test. She declined to comment for this article, but documents and interviews with more than 20 associates reveal how Yellen is trying to navigate this challenging moment. Her goal is to forge consensus within the Fed while being responsive to Capitol Hill's critiques—all without hampering the policies that she says has helped keep the U.S. economy on course.

. . .

Resource 4 (7 of 7)

The Federal Reserve Today

Yellen wanted to wait. The wild swings in global financial markets over the summer were potentially bad omens for China's economy—which in turn could drag down America, she feared. But her colleagues were not as worried. A slim majority of the 17 people who make up the central bank's top brass was willing to start pulling back the Fed's support for the recovery in September.

. . .

Source: Mui, Y. Q. Fed chair Janet Yellen is learning the importance of politics in economics. *The Washington Post*. Retrieved from https://www.washingtonpost.com/business/economy/yellen-learning-the-games-politicians-play/2015/12/04/83bb492a-83ce-11e5-9afb-0c971f713d0c_story.html

Questions to Consider:

- What more would you want to know about the author and *The Washington Post* to evaluate this take on Yellen?
- Does anything in this article change your perspective on the role of the Federal Reserve, and specifically the role of the chair, in light of a change in leadership and changing economic circumstances?
- What more would you like to know about the political pressures the Fed faces in order to take a position on whether the Federal Reserve should be subject to additional governmental oversight?
- The Federal Open Market Committee, the leadership body in the Federal Reserve most directly responsible for setting monetary policy, voted to implement the change contemplated in this article by modestly raising interest rates by 0.25 percentage points on December 16, 2015. Based on your understanding of the article, what are some of the benefits and the risks of this move? What more would you want to know in order to evaluate whether you agree with the FOMC's decision?