

EconEdLink: Where Did All the Money Go? - Clue Sheet #3b

The Federal Reserve Board

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The Federal Reserve Act was signed into law by Woodrow Wilson on December 23, 1913. The stated purposes of the act were "to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means to rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." While certainly a dry statement of purpose, there is arguably no more important institution to the well functioning of the U.S., and even global, economy than the Federal Reserve Board.

U.S. policymakers established the Fed in an effort to stave off the periodic financial panics that plagued the nation from its inception. The Panic of 1907 was particularly severe, as the fragmented and unregulated banking system was unable to keep up with the rapidly expanding industrial U.S. economy of that time. That panic convinced Congress to establish the National Monetary Commission, which put forth proposals to create an institution that would counter these kinds of financial disruptions. The Fed was to be the lender of last resort, a role it continues to play today as evidenced by its recent actions during last year's Asian economic and financial crisis.

The Fed had a somewhat inauspicious start. The 1929 stock market crash and the Great Depression that followed are in part the result of the Fed's policy actions. The Fed tightened monetary policy in the period leading up to the 1929 crash with the stated objective to cool off what policymakers deemed to be an overvalued and speculative market. When stock prices plunged, the Fed failed to step in to restore confidence and financial stability. The resulting rash of banking and corporate bankruptcies and failures was key to the deflation and economic depression that followed.

With the aid of further legislation expanding and clarifying the Fed's objectives, greater and more refined tools for managing monetary policy, and nearly a century of experience, the Fed has become increasingly successful in managing the nation's economic performance. The Fed is now charged with multiple goals, including maintaining economic growth in line with the economy's potential, low unemployment and stable prices. The Fed works to accomplish these tasks through its continuing role as a lender of last resort, open market operations and through its regulation of a large part of the banking system.

While the Fed's role as lender of last resort is perhaps its most important function, it is called upon only infrequently. Its efforts to maintain full employment and price stability through open market operations are much more common and closely followed. Fed policymakers currently target the federal funds rate, the interest rate that the reserves banks are required to hold on their deposits, by buying and selling U.S. government (mainly Treasury) securities. The funds rate, in turn, significantly influences other shortterm interest rates, and to a lesser degree, long-term interest rates. Changing interest rates in turn have significant impacts on the economy's growth and ultimately inflation.

The Fed's responsibilities in regulating much of the nation's banking system can also have significant economic impacts. Banks ultimately determine who gets credit and under what terms. Even if the Fed is tightening monetary policy in an effort to slow the economy, it may be unsuccessful if banks are aggressively extending credit to households and businesses by lowering loan standards and/or not passing through to borrowers some of their own higher costs. In this case, the Fed can pressure banks to tighten their lending standards or face their heightened scrutiny.

It is fitting that the 20th century is ending with the Fed seemingly at the top of its influence and success. The U.S. economy is, for all intents and purposes, at full employment, growing at close to its potential and with stable prices. Living standards have never been higher and they are growing quickly. This has occurred despite significant global hurdles, and while the result of many factors, none is more important than the establishment of the U.S. Federal Reserve Board. It is the single most important event of the 20th century American economy.

Answer the following questions:

1. What was the main reason the Federal Reserve Board was established?

It was established to keep bank panics from happening and to keep the economy more stable than it had been by centralizing the monetary and banking systems.

2. What is meant when the Federal Reserve is called "the lender of last resort?"

Banks can borrow money from the Federal Reserve for a short period of time if they have a lack of cash reserves.

3. What actions did the Federal Reserve take leading up to the stock market crash of 1929?

The Federal Reserve tightened up the supply of money leading to the crash to "cool off" a speculative and overvalued market.

4. Why is the Fed criticized that made the economic downturn worse?

As stock prices tumbled, the Fed took a hands off approach and failed to take action to stop the decline. Bank failures and business bankruptcies that followed further undermined people's confidence which then led to a recession turning into the Great Depression.