THE IMPORTANCE OF THE FEDERAL RESERVE

A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman
Joint Economic Committee
United States Congress

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Joint Economic Committee
G-01 Dirksen Building
Washington, DC 20510
Phone: 202-224-5171
Fax: 202-224-0240

Internet Address:
http://www.house.gov/jec/

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EXECUTIVE SUMMARY

The Federal Reserve — our Central Bank — is one of the country's most powerful economic institutions. The Federal Reserve is relevant for Congress not only because the Constitution gives monetary powers to Congress but also because Congress created the Fed and, therefore, has critically important responsibilities for Federal Reserve oversight.

This paper provides a brief overview of what Members of Congress should know about the Federal Reserve. It is intended to lay the groundwork for several subsequent papers surrounding issues related to congressional oversight of Federal Reserve monetary policy and the goal of price stability.

Congressional oversight of the Federal Reserve and monetary policy is important because:

- Monetary policy can dominate fiscal policy in certain circumstances.
- Inflation is determined by monetary policy.
- The Federal Reserve influences interest rates.
- The Federal Reserve stabilizes the financial system.

This paper briefly summarizes the structure and operating procedures of the Federal Reserve and comments on the significance of congressional oversight.

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INTRODUCTION

Although the Federal Reserve—our Central Bank (or monetary authority)—is one of the country's most powerful economic institutions, it is also one of the most misunderstood. For Congress, the Federal Reserve is relevant because (1) the U.S. Constitution (Article I, Section 8) explicitly gives Congress the power over money and the regulation of its value and (2) this responsibility was delegated by Congress to the Federal Reserve; the Federal Reserve was created by an act of Congress. Accordingly, Congress has important responsibilities for overseeing the Federal Reserve and monetary policy.

This paper provides a brief overview of what (and why) Congress should know about the Federal Reserve. A broad-brush overview, it is intended to lay the groundwork for several subsequent papers addressing issues related to congressional oversight of Federal Reserve monetary policy and the goal of price stability.

OUR CENTRAL BANK: THE FEDERAL RESERVE

As the Nation's Central Bank, the Federal Reserve is granted special privileges and so assumes the responsibilities and characteristics of such a bank. It monopolizes the issuance of paper money, serves as banker for both the government and commercial banks, and acts as lender of last resort. The latter, in turn, calls for bank regulatory responsibilities. Since Federal Reserve operations work to centralize reserves (Federal Reserve notes and deposits form a large portion of bank reserves), they entail responsibility for reserve management and hence monetary policy. Two critically important macroeconomic functions of the Central Bank, therefore, are the maintenance and achievement of price and financial system stability (i.e., stable monetary policy and the provision of lender-of-last-resort services).

WHY FEDERAL RESERVE FUNCTIONS ARE IMPORTANT

The importance of congressional oversight of the Federal Reserve cannot be overemphasized. These functions are important, for example, because they imply that the Federal Reserve controls and hence is responsible for the management of total spending or aggregate demand as well as inflation. In carrying out its monetary policy management (via manipulating reserves), the Federal Reserve influences interest rates—especially short-term rates—as well as foreign exchange rates and other financial market prices. And in times of financial crisis, the Federal Reserve's lender-of-last-resort function stabilizes the entire financial system. The significance of these important considerations is briefly summarized in turn.

- **Management of Aggregate Demand: Monetary Policy Dominates Fiscal Policy.**

Most economists recognize that total spending or aggregate demand is determined more by monetary policy than by fiscal policy. In other words, if Congress passes tax or spending legislation intended to affect total spending or aggregate demand, these effects can be fully offset or outweighed by changes in monetary policy. Indeed, accurate counter-cyclical fiscal policy—altering budget deficits to manage economic activity or aggregate demand—is now seen as neither possible nor desirable. Economists no longer agree on even the direction of the economic effects of changing budget deficits,[1] yet all agree that changes in monetary policy do have predictable and potent effects on aggregate demand and economic activity.

This implies that changes in monetary policy are often a major factor in movements of the business cycle; many booms and recessions are directly related to changes in monetary policy. Conversely, stable economic activity is often the result of appropriate, stable monetary policy. For example, in recent years the Federal Reserve deserves credit for instituting a restrained, non-inflationary policy, which not only has helped to stabilize the economic cycle but has helped to stabilize most financial markets as well.

- **Inflation is Determined by Monetary Policy.**

Federal Reserve monetary policy is also the key determinant of inflation. It is well known that, among other economic effects, inflation can adversely affect savings, distort investment decisions, and be used by government to enhance its tax revenue and reduce its real debt. Inflation works to distort the signals of the price system, the signaling mechanism of a free market economy. Partly for this reason, recent research has shown that higher inflation is associated with lower economic growth. Accordingly, the only lasting contribution monetary policy can make toward fostering long-term economic growth is to promote price stability. Consequently, there is a growing consensus among experts that price stability should be the key objective of monetary policy. Congress can, of course, mandate this objective to the Federal Reserve.

- **Interest Rates Are Influenced by the Federal Reserve.**

The Federal Reserve also influences interest rates which affect key interest-rate sensitive sectors of the economy such as housing, autos, and investment. More specifically, the Federal Reserve influences interest rates by manipulating reserves. Short-term rates are more directly influenced by Federal policy because its reserve operations involve purchases and sales of short-term government securities which influence bank reserves. Nonetheless, long-term rates are also influenced by monetary policy. Among other influences, for example, long-term rates are affected by changes in

[1] Some economists believe increases in budget deficits stimulate aggregate demand whereas others have argued deficit reduction will stimulate economic activity because of its effects on interest rates.

inflationary expectations as well as expectations of Fed policy. Nonetheless, the only way monetary policy can sustain lower long-term rates is to promote price stability, thereby removing the influence of both inflationary expectations as well as uncertainty premiums. Certainly, Congress has reason to ensure the provision of lower long-term rates in this way.

- **The Federal Reserve is the Lender of Last Resort.**

During financial crises, provision of lender-of-last-resort services can stabilize the financial system. The Central Bank, being the ultimate supplier of system-wide reserves, can satisfy sharp increases in reserve or liquidity demand, thereby preventing systemic liquidity shortages and stabilizing the financial system. Failure to provide this function as, for example, occurred in the Great Depression of the 1930s, can be disastrous. On the other hand, liquidity provision prevented any serious financial system fallout from the sharp 1987 stock market crash and 1989 stock market decline. The Federal Reserve (and by inference the Congress) has responsibility to ensure that lender-of-last-resort safeguards are adequate and in place in case of unforseen financial shocks.

STRUCTURE[2]

The Federal Reserve's organizational structure is unusual, some would say even Byzantine. It is a Federal system made up of (1) a central government agency, the Board of Governors in Washington, D.C., (2) 12 regional banks located in major U.S. cities, and (3) a monetary policy decision-making unit, the Federal Open Market Committee (FOMC), composed of representatives from both the Board and banks.

- **The Board of Governors (BOG).**

The BOG was established as a Federal agency. It is composed of seven Governors appointed by the President of the United States and confirmed by the Senate to staggered 14-year terms. A Chairman (and Vice Chairman) are also appointed by the President and confirmed by the Senate, for four-year terms. The Board of Governors and its staff of about 1,700 are located in Washington, D.C.

- **Twelve Federal Reserve Banks.**

Twelve Federal Reserve Banks serve as the operating arm of the Federal Reserve system; they perform a number of functions such as operating a nationwide payment system, supervising certain financial institutions, distributing the nation's currency and coin, and serving as a banker for commercial banks and the U.S. Treasury. Each bank has a President nominated by its board of directors and approved by the Board of Governors. The New York Bank is clearly " the first among

[2]For a more detailed description, see *The Federal Reserve System Purposes and Functions*, Eighth Edition, 1994.

equals" since it not only sits in the world's financial center but serves as the Federal Open Market Committee's operating arm, conducting open market operations and foreign exchange intervention. Congress chartered these banks and, consequently, has oversight responsibilities for them.

- **Federal Open Market Committee.**

The FOMC, the Federal Reserve's key monetary policy decision-making unit, formally meets eight times a year in Washington, D.C.[3] It oversees open-market operations, the principal tool of monetary policy which influences short-term interest rates and determines reserve and monetary growth. It also directs foreign exchange market operations of the Federal Reserve System. The FOMC is made up of the seven Board Members and five of the 12 Reserve Bank presidents.[4] These presidents bring "grass roots" information to the meetings and, historically, have had relatively conservative voting records due in part to their insulation from political pressures. Notably, the structure described here was designed by Congress and therefore can be changed by Congress.

POLICY OPERATIONS

The Federal Reserve conducts monetary policy principally using open-market operations (purchases/sales of securities) to alter bank reserves and influence short-term interest rates, but it also can employ the discount rate and changes in reserve requirements as policy tools. In so doing, the Federal Reserve uses the Fed funds rate as its key policy instrument. Movements in this rate (relative to other rates) in turn influence a wide array of financial and economic variables with differing time lags. These movements, for example, influence financial market variables (such as other interest rates, foreign exchange rates, commodity prices, and yield spreads), monetary and credit aggregates, measures of economic and business activity, and eventually broad measures of inflation. Because of the long time lags involved between adjustments to Federal Reserve instruments and ultimate policy goals, monetary policy makers look for those variables that are both reliably influenced by Fed policy moves and in turn predictably related to subsequent movements in policy goals; i.e., they look for reliable intermediate guides to policy.

Over the years, controversies about monetary policy have often related to debates over which variables best serve as intermediate policy guides or targets. In the past, for example, Keynesian economists prescribed target variables such as unemployment or interest rates whereas monetarist economists prescribed monetary aggregates as targets. Both of these types of targets, however, have proven unreliable. Currently, the Federal Reserve has no single explicit intermediate policy target. Rather, it uses an eclectic approach, but undoubtedly has paid more attention to movements in financial market variables than previously was the case.

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[3]Other meetings can be held by telephone when needed.

[4]The New York Federal Reserve Bank president is a permanent member whereas others attend, but vote on a rotating basis.

CONGRESSIONAL OVERSIGHT OF MONETARY POLICY

Detailed knowledge of the intricacies and fine points of monetary policy operations, however, is not necessary for successful congressional oversight. Rather, the keys for Congress are to clearly establish a viable objective for the Federal Reserve and to ensure the Central Bank is fully accountable for achieving this goal. This can be fostered by establishing appropriate incentives for monetary policy makers as well as mandating enhanced reporting and disclosure requirements related to progress in achieving stated objectives. Oversight, therefore, should promote policy transparency which can help to promote the credibility of a given monetary policy.

Notably, congressional oversight of the Federal Reserve need not imply increased political influence on monetary policy, especially if explicit, objective policy goals such as price stability are established for the Central Bank. Such oversight can actually work to minimize political influence by ensuring Executive Branch sway over monetary policy reflecting their appointments to the Board of Governors is kept in check.

This report was written by the Joint Economic Committee's Chief Macroeconomist, Dr. Robert Keleher.