



## Why the Fed Matters

The Federal Reserve (Fed) plays a critical, but largely hidden, role in the day-to-day life of every family in America. When you fill up your gas tank and stock up on groceries for the week, the prices you see are in part shaped by the Fed's policies. When you cut your landlord a rent check each month, the Fed's payment services help ensure your check clears on time. And when you're finally ready to buy your first home, the Fed influences the mortgage rates you're offered and even whether you're likely to have a steady and well-paying job to afford that mortgage. From our most basic daily transactions to our most important financial decisions, the Fed has a tremendous impact on the economic livelihoods of Main Street and Wall Street alike.

Despite its importance, the Fed remains a mystery to many people. As the nation's central bank, the Fed conducts monetary policy, regulates and supervises financial institutions, and processes millions of financial transactions that move through the economy each day. In its capacity as an independent agency, however, it mostly manages these complex responsibilities outside the political sphere and with a low profile. To shed some light, this explainer provides a brief overview of why the Fed exists, what it does, and how it matters for American families.

### Why Do We Have A Central Bank?

Congress established the Federal Reserve System in 1913 in response to a cycle of bank runs that plagued the economy throughout the 19<sup>th</sup> and early 20<sup>th</sup> centuries.<sup>1</sup> These panics led banks around the country to fall like dominoes, in many cases triggering stock market collapse and recession.<sup>2</sup> What the country needed was a way to address money shortages, allow banks to access credit during emergencies, and instill confidence in the financial system. The solution: a central bank.

Though the country experimented with a central bank twice early in its history, many Americans feared that a national bank would be a corrupt tool of government and big-city bankers.<sup>3</sup> Congress addressed these concerns by building a compromise between federal vs. local, and public vs. private, control into the Fed's design.<sup>4</sup> The final result was an unusual agency consisting of a politically appointed "public" board overseeing a constellation of "private" regional banks.

Today, more than 100 years after its founding, the fundamental structure of the Fed remains the same. The Board of Governors (composed of seven members who are appointed by the President and confirmed by the Senate) and twelve Reserve Banks (owned and governed by private banks) work together to make policy and safeguard the banking system.<sup>5</sup>

## What Does The Fed Do?

The Fed is charged with promoting the health and stability of the national economy. It does so by performing a number of different roles, each of which affect family pocketbooks.

### *Monetary Policy*

The Fed's most important responsibility is monetary policymaking. Through monetary policy, the Fed can shape economic growth by influencing the amount of money and credit available in the banking system. Monetary policy is made in the Federal Open Market Committee (FOMC), which is composed of the seven members of the Board of Governors and five of the Reserve Bank presidents, who serve on a rotating basis. The FOMC meets about eight times a year to deliberate and vote on policy in response to economic conditions.<sup>6</sup>

Since 1977, Congress has instructed the FOMC to conduct policy with the goals of achieving stable prices and maximum employment—the “dual mandate.”<sup>7</sup> This can be a tricky balancing act. Economic growth creates jobs, which allows more Americans to find work and earn a living. If the economy grows too quickly, however, prices may rise quickly as well, potentially triggering spikes in inflation.<sup>8</sup> Excess inflation reduces the amount of goods and services one can buy with a dollar, making it more difficult for families to pay their bills and maintain their standard of living.<sup>9</sup> The Fed's challenge is to promote growth that is neither so fast that it sparks inflation, nor so slow that the economy falls into recession.

While the Fed has multiple strategies and tools to pursue these monetary policy goals, it has traditionally focused on changing short-term interest rates; specifically: the federal funds rate. The federal funds rate is the rate at which banks can borrow and lend to each other overnight.<sup>10</sup> Even though this rate does not touch families directly, its effects ripple through the economy, influencing the trajectory of longer-term interest rates, the economic behavior of consumers and businesses, and, ultimately, economic growth.<sup>11</sup> Accordingly, small movements in the federal funds rate can have a big impact on the economic environment families face: from whether businesses are hiring and wages are growing, to how much interest they pay on their credit card bills and how much interest they earn keeping money in a savings account.

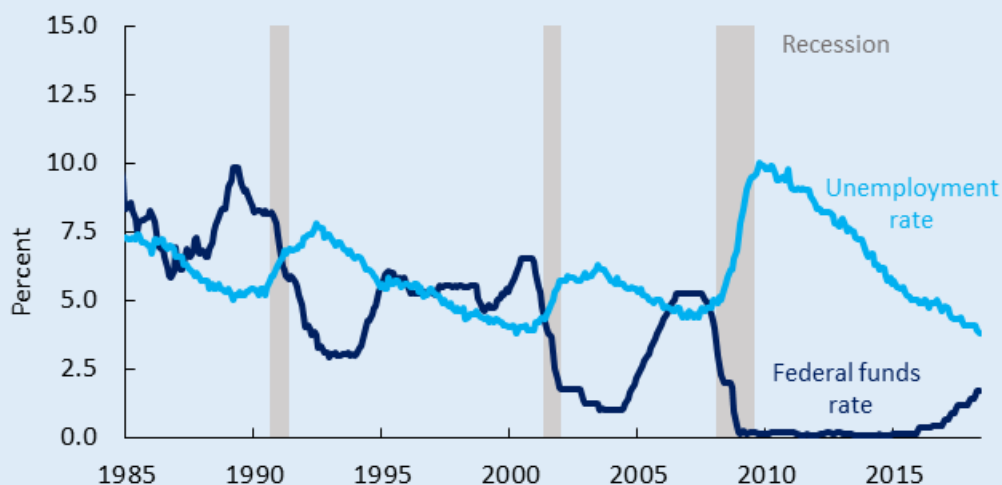
## How the Federal Funds Rate Affects Your Community

If the American economy is contracting or growing too slowly, the FOMC can give it a boost by lowering its target for the federal funds rate. Lowering the funds rate makes it cheaper for banks to lend money to each other overnight. Banks can then pass on some of these savings to their customers by offering lower interest rates on longer-term loans, making it less expensive for consumers and businesses to borrow money, too.

By reducing the cost of borrowing, lower interest rates encourage consumer spending, business expansion, and job creation. When rates are low, you may decide to finally buy that new car you need. Your local coffee shop will find it cheaper to access credit to open a new location and hire new workers. Your city government may also decide to take advantage of cheaper credit to invest in much-needed road repairs. All of this activity helps the economy grow.

If, on the other hand, the FOMC is worried that the economy is “overheating,” it will increase the target federal funds rate. A higher funds rate will lead to higher interest rates for consumers and businesses, discouraging borrowing and spending. You may decide to hold off on making a big purchase, while businesses cut back on new hiring. Governments may also have to pay more to service their debts, potentially reducing spending on public programs. The slowdown in economic activity slows the pace of economic growth, as well as the rate of inflation.

### Federal Funds Rate Falls During Economic Downturns



Sources: Federal Reserve Board of Governors; Bureau of Labor Statistics; NBER  
Note: Effective federal funds rate is not seasonally adjusted; unemployment rate is seasonally adjusted. Gray bars denote recessions.

The Great Recession demonstrated the limits of the federal funds rate as a tool of monetary policy, however. In response to the bubbling financial crisis, the FOMC began a series of sharp cuts to its target for the funds rate in the fall of 2007.<sup>12</sup> By the end of 2008, the rate was lowered to nearly zero, a level unprecedented in modern history.<sup>13</sup> This created a serious challenge for the

Fed. With the funds rate effectively at zero, there was no room to cut interest rates further in hopes of fighting the recession.

To overcome this problem, the Fed turned to a set of untraditional tools, including large-scale purchases of bonds and mortgage debt.<sup>14</sup> This policy of “quantitative easing” provided a way to stimulate the economy without relying on the federal funds rate. Between 2009 and 2014, the Fed bought trillions of dollars in bonds, injecting new money into the economy while increasing the size of the Fed’s balance sheet five-fold from before the crisis.<sup>15</sup> This unconventional form of monetary policy helped the Fed spur an economic recovery and allowed it to begin raising the federal funds rate in 2015 for the first time in nearly a decade.<sup>16</sup>

### *Regulation, Supervision, and Financial System Oversight*

The Fed also regulates and supervises financial institutions to foster a financial system that is safe for both banks and consumers. This involves implementing Congress’ regulatory legislation, monitoring bank compliance, and penalizing banks that are not following the rules. Over the last decade, the Fed has taken more than 1,400 enforcement actions against banks and bankers, including levying fines and prohibiting predatory activities.<sup>17</sup>

Following the Great Recession, Congress expanded the Fed’s regulatory responsibilities to include the stability of the financial system more broadly.<sup>18</sup> As a result, the Fed is now also tasked with identifying and mitigating system-wide dangers, such as growing debt levels or excessive risk-taking, that threaten to bring about the next crisis.

### *Payments and Financial Services*

Beyond monetary and regulatory policy, the Fed performs other important functions that are easy to take for granted. True to its roots, the Fed continues to serve as a “bankers’ bank,” lending money and providing other services to banks around the country. It also manages the federal government’s official bank account. In addition, the Fed helps ensure that consumers are able to pay—and be paid—as smoothly as possible. This includes monitoring the quality of the bills and coins in circulation, processing paper checks, and facilitating electronic payments, including the direct deposit of your tax refunds and Social Security checks.<sup>19</sup>

## **What Is Fed “Independence?”**

Congress designed the Fed to be an independent agency within government. In practice, this means that while the Fed is ultimately accountable to Congress, it should make its policy decisions free from political pressure or interference. Independence enhances the Fed’s credibility, allowing it to communicate more effectively to financial markets and ensure its policies have the desired effect.

### *Sources of Independence*

The Fed’s independence is reinforced through a variety of unique institutional features. Notably, unlike agencies in the Executive Branch—and even other independent agencies, like the Central Intelligence Agency—the Fed does not rely on Congress for funding.<sup>20</sup> Instead, it funds its own operations through income earned via fees and interest-bearing investments.<sup>21</sup>

Appointments to the Fed are also structured to curtail political influence. Although elected officials appoint the Board of Governors, governors serve long (14-year) terms that are staggered to prevent a presidential administration from having too much say over the Board's composition.<sup>22</sup> The Reserve Bank presidents, moreover, are not selected with any direct input from politicians.<sup>23</sup>

Congress chose to limit its control over the Fed and entrust monetary policy to independent experts to guarantee that policy is made in the long-term best interest of the country. As discussed above, manipulating interest rates allows the Fed to influence the economy: lower rates generally encourage economic growth, but interest rates that are too low may spur dangerous inflation and financial instability. The Fed's founders wisely recognized that political pressure might lead the Fed to prioritize low interest rates in order to deliver temporary bursts of economic growth—even if doing so creates inflation and harms the economy in the long run. Internationally, studies have shown that central banks with higher degrees of political independence deliver lower and more stable inflation without sacrificing long-term growth.<sup>24</sup>

### *Independent but Not Unaccountable*

Despite its independence, the Fed remains accountable to Congress and the public. Importantly, Congress establishes the Fed's policy goals, just as it did with the dual mandate.<sup>25</sup> So while the Fed has freedom to choose the instruments by which it conducts monetary policy, it must pursue the objectives Congress defines for it. Congress also conducts oversight of the Fed's activities and can reform its structure to meet new challenges. The Fed has also taken its own steps to become more transparent to the public, including publishing transcripts of FOMC meetings and holding press conferences to discuss its policy decisions.<sup>26</sup>

## **Threats to Fed Independence Today**

For millennials paying down their student loans, young families looking to purchase their first home, and senior citizens waiting on their Social Security checks, the Fed plays an essential role in structuring economic life. An independent and well-functioning Fed is critical to the stability of the economy and the livelihoods of families across the country—even if there is disagreement over its policies. Moreover, as the Great Recession slowly recedes from our rearview mirrors, fighting the next crisis will require the Fed's competence and credibility.

The Fed faces a series of threats, however. Americans' trust in public institutions has fallen to historic lows.<sup>27</sup> Over the last several years, congressional Republicans have also pushed to exert greater political control over monetary policymaking, potentially threatening the Fed's ability to make policy in the country's long-term best interest. Even more concerning, President Trump has openly demonstrated a flagrant disregard for the Fed's independence—consistent with his track record of attacking other independent agencies across government.<sup>28</sup> There is little reason to assume the Fed will escape the kinds of attacks other independent institutions are weathering.

These developments underscore the fragility of Fed independence, and the importance of what's at stake. If the Fed is to remain a stabilizing force in the economy and the lives of American families, Congress must vigilantly protect its independence.

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[https://www.federalreservehistory.org/essays/banking\\_panics\\_of\\_the\\_gilded\\_age](https://www.federalreservehistory.org/essays/banking_panics_of_the_gilded_age)
- <sup>3</sup> <https://www.philadelphiafed.org/publications/annual-report/2009/first-and-second-banks>
- <sup>4</sup> *Ibid*
- <sup>5</sup> <https://www.federalreserveeducation.org/about-the-fed/structure-and-functions>
- <sup>6</sup> <https://www.federalreserveeducation.org/about-the-fed/structure-and-functions/monetary-policy>
- <sup>7</sup> [https://www.richmondfed.org/publications/research/economic\\_brief/2011/eb\\_11-12](https://www.richmondfed.org/publications/research/economic_brief/2011/eb_11-12)
- <sup>8</sup> <https://www.brookings.edu/testimonies/the-federal-reserve-balancing-multiple-mandates/>
- <sup>9</sup> <https://www.investopedia.com/terms/p/purchasingpower.asp>
- <sup>10</sup> <https://www.federalreserve.gov/monetarypolicy/openmarket.htm>
- <sup>11</sup> See for example: <https://www.thebalance.com/fed-funds-rate-definition-impact-and-how-it-works-3306122>
- <sup>12</sup> <https://research.stlouisfed.org/pageone-economics/uploads/newsletter/2011/201104.pdf>
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- <sup>21</sup> [https://www.federalreserve.gov/faqs/about\\_12799.htm](https://www.federalreserve.gov/faqs/about_12799.htm)
- <sup>22</sup> *Ibid*
- <sup>23</sup> <https://www.federalreserve.gov/faqs/how-is-a-federal-reserve-bank-president-selected.htm>
- <sup>24</sup> <https://www.federalreserve.gov/newsevents/testimony/kohn20090709a.htm>
- <sup>25</sup> <https://www.federalreserve.gov/faqs/what-economic-goals-does-federal-reserve-look-to-achieve-through-monetary-policy.htm>
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- <sup>28</sup> <https://www.politico.com/story/2018/05/09/trump-federal-reserve-independence-523275> ;  
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