

# The Federal Reserve System

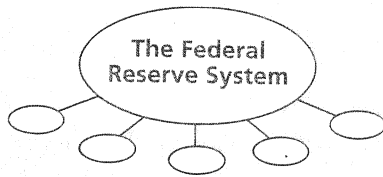
## Study Guide

### Main Idea

The Federal Reserve works to strengthen and stabilize the nation's monetary system.

### Reading Strategy

**Graphic Organizer** As you read this section, complete a graphic organizer similar to the one below by listing the components that make up the Federal Reserve System.



### Key Terms

member bank, bank holding company, Regulation Z, currency, coins

### Objectives

After studying this section, you will be able to:

1. **Describe** the structure of the Federal Reserve System.
2. **Explain** the major regulatory responsibilities of the Fed.

### Applying Economic Concepts

**Truth-in-Lending Laws** Have you or your parents ever bought anything on credit? Read to find out how the Fed influences the type of information you receive from the lender.

## Cover Story

### Design by Sculptor of Vietnam Women's Memorial Selected for Coin

A rendering of Sacagawea by the New Mexico sculptor who created the Vietnam Women's Memorial will appear in millions of Americans' pockets starting in 2000.



Rendering of Sacagawea used for the coin


After sorting through more than 90,000 comments delivered via the Internet, U.S. Mint officials [selected a design by] Glenna Goodacre of Santa Fe. . . . It will depict the Shoshone teenager who accompanied explorers Meriwether Lewis and William Clark to the Pacific Ocean in 1805. . . . Just 16 when she accompanied the explorers, Sacagawea acted as an interpreter and go-between with tribes along the way. . . .

Officials weren't sure Americans would accept the nontraditional look, . . . but Internet responses overwhelmingly favor the mother and child theme and the realistic portrayal.

—CNNInteractive, December 17, 1998

**O**n December 23, 1913, Congress created the Federal Reserve System, or “Fed,” as the central bank of the United States. Today, the Fed provides financial services to the government, regulates financial institutions, maintains the payments system, enforces consumer protection laws, and conducts monetary policy. Even the new Sacagawea dollar coin featured in the cover story is warehoused and distributed by the Fed. Because everyone uses money, and because interest rates affect the overall level of economic activity, the Fed's activities affect us all.

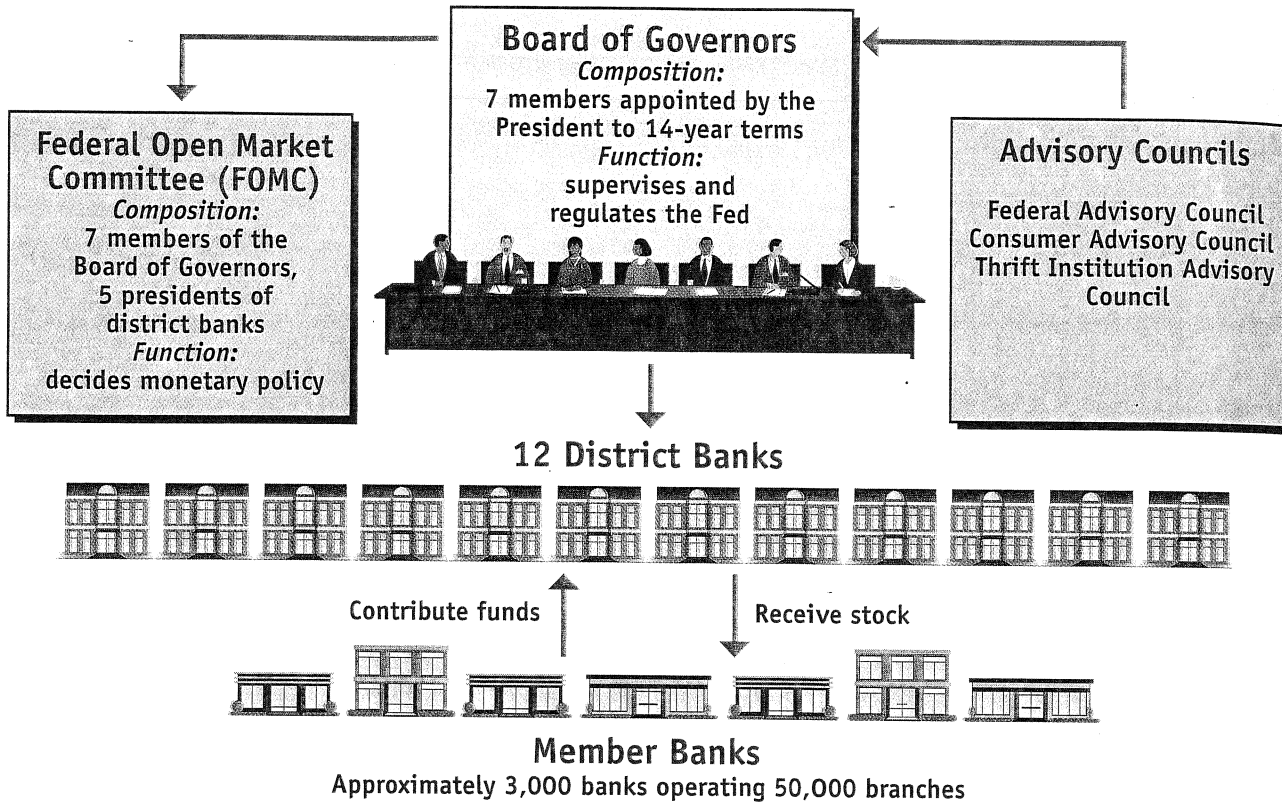
## Structure of the Fed

 **Figure 15.1** outlines the main organizational structure of the Federal Reserve System. The Fed's main components have remained practically unchanged since the Great Depression of the 1930s.

### Private Ownership

One of the unique features of the Fed is that it is privately owned by its **member banks**—commercial banks that are members of, and hold

## Structure of the Federal Reserve System



**Using Charts** The Board of Governors supervises the Federal Reserve System. The FOMC has primary responsibility for monetary policy. The member banks contribute a small amount of funds and receive stock ownership shares in return. Three advisory councils also provide direct advice to the Board on a regular basis. What functions does the Board of Governors perform?

ock in, the Fed. When the Fed was established in 1913, it was organized as a corporation that issued shares of stock, just like any other corporation. Individual banks may or may not belong to the Fed. National banks—those chartered by the national government—*must* belong. Those chartered by state governments have the choice to belong or not.

When privately owned banks joined the Fed, they were required to purchase some of its shares. This made them part owners of the Fed, just as someone might own shares in IBM, Ford Motor, or Microsoft. Only member banks can own shares.

Private individuals can only own shares indirectly by owning shares of stock in a Fed-member bank. Today, Fed membership consists of all national banks and some state banks.

### Board of Governors

In 1935 Congress established a seven-member Board of Governors for the Federal Reserve System. Each member is appointed by the president and approved by the Senate to serve a 14-year term of office. These appointments are staggered, so that one

appointment becomes vacant every two years. As a result, there are always experienced people on the board.

The Board is primarily a regulatory and supervisory agency. It sets general policies for Federal Reserve and member banks to follow, regulates certain operations of state-chartered member banks, and conducts some aspects of monetary policy. It also makes a report each year to Congress and puts out a monthly bulletin that reports on national and international monetary matters.

### Federal Reserve District Banks

When the Fed was established in 1913, it was intended to operate as a system of 12 independent and equally powerful banks. Each reserve bank was responsible for a district, and Federal Reserve notes even carried the name of the district bank on the seal to the left of the portrait. Restructuring minimized, and later eliminated, the Fed's regional nature. The new Fed seal does not incorporate any mention of the district banks.

Today, the 12 Federal Reserve district banks and 25 additional branch banks are strategically located so that they can be near the commercial banks they serve. While each of the 12 banks has its own president and board of directors, the Reserve banks are supervised by the Federal Reserve Board in Washington, D.C. The Federal Reserve banks carry out the same functions for banks and thrift institutions as those institutions carry out for people. The district banks accept the deposits of and make loans to banks and thrift institutions, just as banks perform these functions for the public.

### Federal Open Market Committee

The Federal Open Market Committee (FOMC) makes decisions about the growth of the money supply and the level of interest rates. It has 12 voting members: seven members from the Board of

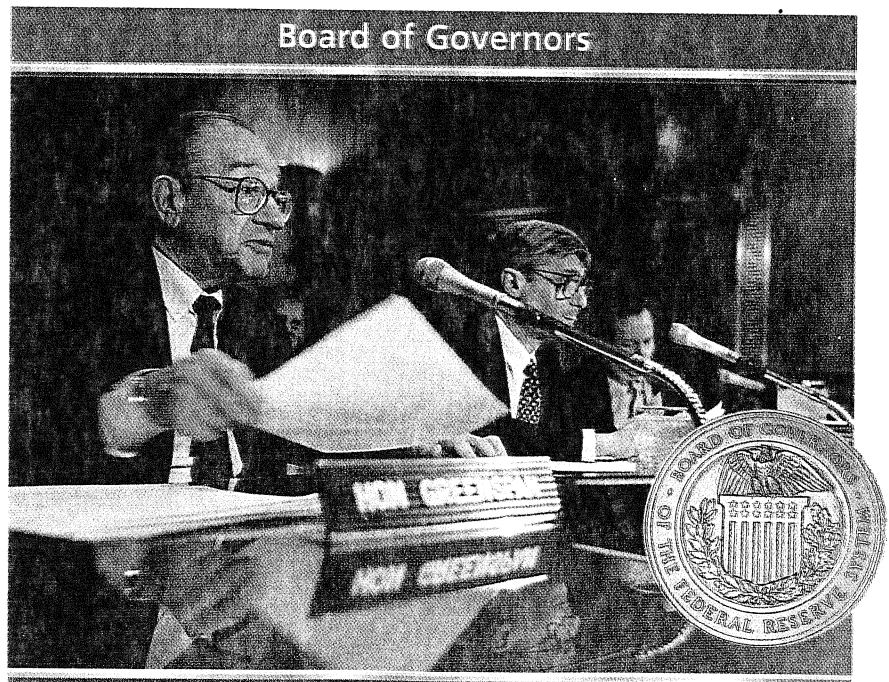
Governors, the president of the New York district Fed, and four district Federal Reserve bank presidents who serve one-year rotating terms. The remaining seven Reserve bank presidents participate in the committee on a non-voting basis.

The committee meets eight times a year in Washington, D.C., to review the country's economy and to make decisions about the cost and availability of credit. Most decisions are made in private but are announced almost immediately. The FOMC is the Fed's primary monetary policy-making body.

### Advisory Committees

The Fed has three advisory committees that advise the Board of Governors directly. The first is the Federal Advisory Council, which consists of representatives from each of the 12 district banks. It provides advice to the Federal Reserve on matters concerning the overall health of the economy.

The second committee is the Consumer Advisory Council. The council's 30 members meet with the Board three times a year on consumer credit laws.




**Responsibilities** The Board of Governors supervises the entire Federal Reserve System. **What are the duties of the Board of Governors?**

Members include educators, consumer legal specialists, and representatives from consumer and financial industry groups.

The third advisory group is the Thrift Institutions Advisory Council. On the council are representatives from savings and loan associations, savings banks, and credit unions. It meets with the Board three times a year to advise on matters pertaining to the thrift industry.

## Regulatory Responsibilities

 The Federal Reserve System has a broad range of responsibilities ranging from member bank supervision to enforcing consumer legislation.

## State Member Banks

All depository institutions—including commercial banks, savings banks, savings institutions, and credit unions—must maintain reserves against their customers' deposits. The Fed is responsible for monitoring the reserves of its state-chartered member banks, while other federal agencies monitor the reserves of nonmember banks and other depository institutions.

While reserves were originally a matter of prudent banking practice, they fulfill two key roles

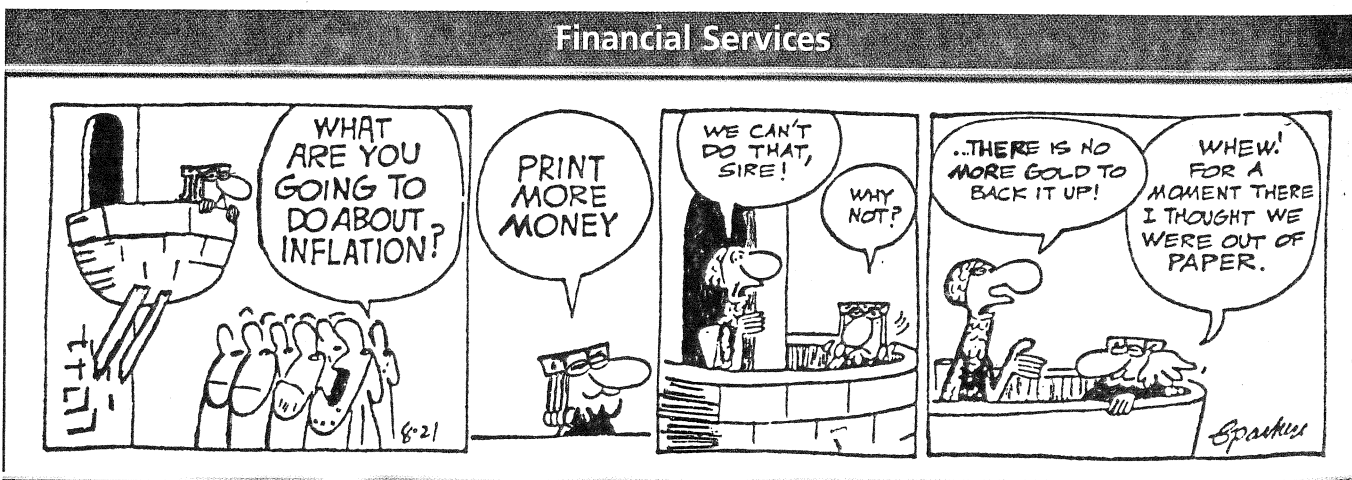
today. First, the banks use reserves to clear checks. Second, the Fed uses reserves to control the size of the money supply.

## Bank Holding Companies

The Fed also has broad legislative authority over **bank holding companies**—corporations that own one or more banks. Holding companies, unlike banks, do not accept deposits or make loans. When individuals buy stock in a bank today, they generally purchase the stock of the holding company, which in turn owns one or more individual banks.

This arrangement may seem unusual, but it can be traced to the many restrictions placed on banks after many of them failed during the Great Depression. At the time, bankers tried to sidestep the restrictions by setting up holding companies that would not be subject to banking laws because they were not banks in the traditional sense. Later, Congress gave the Fed the power to regulate the activities of the holding companies so that they could not evade restrictions.

Today about 5,900 holding companies control approximately 6,300 commercial banks. In many cases, the holding company structure has resulted in even more regulation and supervision. For example, the FDIC may inspect and regulate three nonmember state banks that a single holding company owns, while the Fed regulates the holding company itself.



**Managed Money** Because nations no longer back their money with gold, they rely on central banks, like the Fed, to manage the amount of money in circulation. *What financial services does the Fed provide to the government?*

## International Operations

Foreign banks have a large presence in the economy. Banks from about 55 different countries operate about 250 branches and agencies in the United States. In addition, foreign banks own shares of many large United States banks. In all, foreign banks control about 20 percent of all banking assets in the United States.

The Fed has broad authority to supervise and regulate these foreign banks. Branches and agencies of these banks are examined annually, and the Fed even has the power to terminate the domestic operations of foreign banks.


In addition, the Fed authorizes and supervises the international operations of United States member banks and holding companies. Currently, Fed member banks operate about 800 branches in foreign countries.

## Member Bank Mergers

A merger of two or more banks requires the approval of the appropriate federal banking authority. If the surviving bank is a state member bank, the Fed must approve the merger.

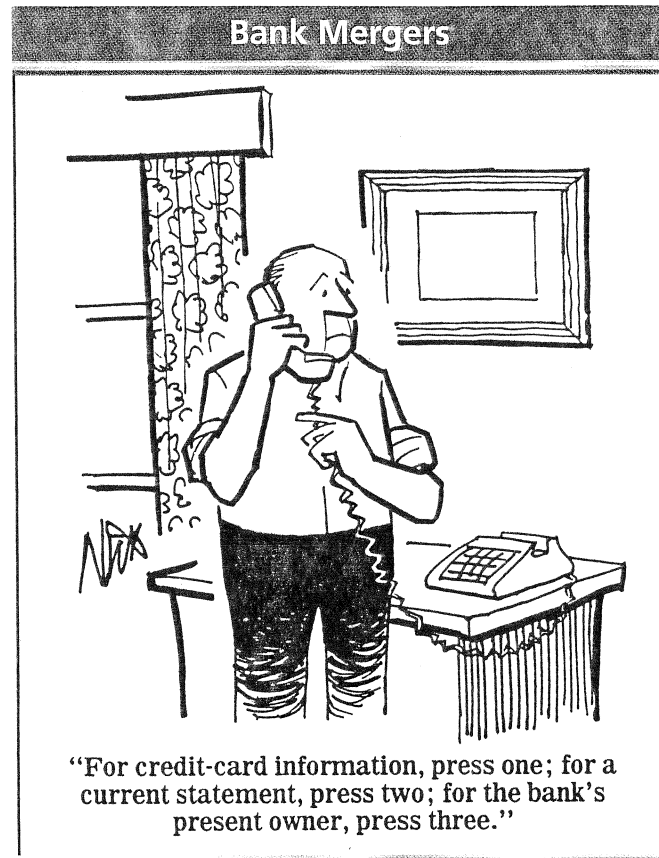
Other banking authorities approve other mergers. If two national banks merge, the Comptroller of the Currency, a Treasury Department official, must approve the merger. If two nonmember state banks merge, the FDIC must approve the merger.

## Other Federal Reserve Services

 The Federal Reserve has other responsibilities as well. These include clearing checks, enforcing consumer legislation, maintaining currency and coins, and providing financial services to the government.

One major service the Fed performs is that of clearing checks, a process that makes extensive use of the reserves in the banking system. In general, the deposits that member banks keep with the Fed are shifted from one bank to another, depending on the way checks are written on the member banks.

**Figure 15.2** illustrates the check-clearing process. The person in the example writes a \$5 check. As the check is processed through the banking system,



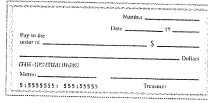
**The Fed’s Role** Mergers are a fact of economic life. *What is the Federal Reserve’s role in bank mergers?*

funds are moved from one member bank’s account to another until the check returns to the issuer. The money is then removed from the issuer’s checking account.

The Fed clears millions of checks at any given time by using the latest high-speed check-sorting equipment available. In some cases banks gather information from a check when it is deposited, and then transfer the information to computer files. These files are sent to the Fed, which uses the information to adjust member banks’ accounts. In this way, the member bank’s balance can be adjusted without the check having to go through the entire system.

The Fed is also responsible for some consumer legislation, primarily the federal Truth in Lending Act that requires sellers to make complete and accurate disclosures to people who buy on credit. Under **Regulation Z**, the Fed has the authority to

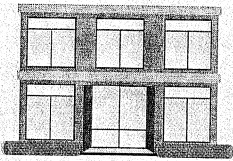
## Clearing a Check



Anna	
DDA <del>\$100</del>	
95	

The check is returned to Anna.

### Bank X

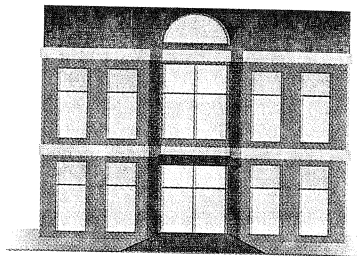


Bank X then returns Anna's check to her at the end of the month, along with any others she wrote during the same period. When Anna gets the canceled checks, she balances her checkbook to make sure her records agree with the bank's.

Bank X learns of Anna's check only when it arrives from the Fed. The bank then makes up for the loss of the \$5 in its MBR account by reducing Anna's DDA by \$5.

Bank X	
MBR <del>\$10</del>	Anna's DDA <del>\$100</del>
5	95

Bank X has its MBR reduced, and receives Anna's check.

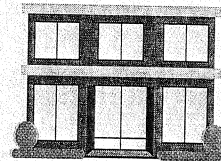


District Federal Reserve System Bank	
MBR Bank X <del>\$10</del>	
5	
MBR Bank Y <del>\$10</del>	
15	

Nathan	
DDA <del>\$100</del>	
105	

Nathan deposits the check.

### Bank Y



Nathan, who banks at Bank Y, now has the check. If he decides to cash it, he will have \$5 in currency in addition to his DDA of \$100. If he decides to make a deposit, his DDA will rise to \$105. Either way, Bank Y ends up with the check written by Anna.

Because the check is drawn on Bank X, Bank Y gets payment for it by sending the check to the district Federal Reserve Bank. The Fed then processes the check by transferring \$5 from Bank X's MBR account to Bank Y's MBR account. The Fed then sends Anna's check to Bank X.

Bank Y	
MBR <del>\$10</del>	Nathan's DDA <del>\$100</del>
15	105

Bank Y sends the check to the Fed district bank for payment.

extend truth-in-lending disclosures to millions of individuals who purchase or borrow from corporations, retail stores, automobile dealers, banks, and lending institutions.

If you buy furniture or a car on credit, for example, you will discover that the seller must explain several items before you make the purchase. These items include the size of the down payment, the number and size of the monthly payments, and the total amount of interest over the life of the loan.

Today's **currency**, the paper component of the money supply, is made up of Federal Reserve notes—fiat paper money issued by Federal Reserve banks and printed at the Bureau of Engraving and Printing. This currency, issued in amounts of \$1, \$2, \$5, \$10, \$20, \$50, and \$100, is distributed to the Fed district banks for storage.

The Bureau of the Mint produces **coins**—metallic forms of money—such as pennies, nickels, dimes, quarters, and the new Sacagawea dollar coin. After the coins are minted, they are shipped to the Fed district banks for storage. When member banks need additional coins or currency, they contact the Fed to fulfill their needs.

When banks come across coins or currency that are mutilated or cannot be used for other reasons, they return it to the Fed for replacement. The Fed then destroys the old money so that it cannot be put back into circulation.

## Did you know?

**Commercial Banks** Commercial banks are the largest financial institutions in the country and are the main sources for exchanging money. The first commercial bank in the United States was founded in 1781 in Philadelphia. Today, commercial banks hold about two-thirds of the nation's money deposits.

One of the Fed's important functions involves the financial services it provides to the federal government and its agencies. For example, the Fed conducts nationwide auctions of Treasury bills, bonds, and notes. It also issues, services, and redeems these securities on behalf of the Treasury. In the process, it maintains the equivalent of numerous demand deposit accounts for the Treasury and clears all checks drawn on those accounts. Other accounts are used to process the tens of millions of dollars of U.S. savings bonds that are sold and redeemed annually.

The Fed also maintains accounts for the IRS, which holds federal taxes paid by individuals and businesses. In fact, any check written to the United States Treasury is deposited in the Fed. Any federal agency check, such as a monthly Social Security payment, comes from accounts held at the Fed. In essence, the Fed serves as the federal government's bank.

## Section 1 Assessment

### Checking for Understanding

- 1. Main Idea** What is the purpose of the Federal Reserve?
- 2. Key Terms** Define member bank, bank holding company, Regulation Z, currency, coins.
- 3. Describe** the structure of the Fed.
- 4. List** eight areas in which the Fed has responsibility.

### Applying Economic Concepts

- 5. Truth-in-Lending Laws** Visit any local store that sells goods on credit—appliances, cars, or furniture, for example. Ask the owner or

manager about the type of information that the store is required to disclose when the sale is made. Obtain copies of the disclosure forms and share them with your classmates.

### Critical Thinking

- 6. Synthesizing Information** One of the responsibilities of the Fed is to approve or disapprove mergers between state member banks. Explain how the mergers of two such banks would be classified according to the discussion of mergers in Chapter 3.



Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2*.