Importance of the Federal Reserve Bank in the Business and Financial World

ENG 170

Professor Name

Date

Position Paper: Importance of the Federal Reserve Bank in the Business and Financial World

Business is a vast field of study which encompasses other areas of concentration that stimulates arrays of day-to-day issues all over the world. Business can be classified into Economic, Marketing, Business Administration, Business law, Accounting, and so many other fields. Economics on one hand is the study of how scarce resources are used to satisfy unlimited wants. Economics can be sub-divided into Micro and Macro-Economics. Macro-Economics deals with majority of the Micro part of Economics but also the aggregate of all economic issues a specific country. Economic issues may tend topics like fiscal and monetary policies. Without further break-down, the main topic discussed in this essay is the prominence of the Federal Reserve bank in the legislation, execution, and promotion of monetary policies, despite various arguments that the FED does not deserve to exist, and several of its practices require debunking. With the use of its numerous powers such as setting reserve ratios and market rates in terms of borrowing and lending money from the member banks, the Federal Reserve Bank deserves accreditation for its formidable work in ensuring the safety of money supply in the country.

To get the ball rolling, the argument for the importance of the FED deserves some historical analysis, structural representation, and functional depictions. Based on the studies of Roger T. Johnson who wrote the "Historical Beginnings"; an insightful biography and historical report of the various banking systems that existed in the U.S, "For the next quarter century America's banking was a carried on by a myriad of state-chartered banks with no federal regulation." (Johnson 30). These banks were called *state banks.* They issued bank notes which were redeemable for gold. After these banks came the *national banks.* But both banking systems exist today, which divides the U.S banking system into State and National Banks. Later that century, the U.S was in panic of depositors wanting to withdraw their money due to the down-fall of some financial institution which aroused the public. According to Roger T. Johnson, this called for a plan. “Frank A. Vanderlip, president of the National City Bank of New York, appeared before the Senate banking Committee and proposed an entirely new banking and currency plan, which he had prepared at the request of….the committee’s three Democrats. The Vanderlip plan called for the establishment of one Federal Reserve Bank.” (Johnson 32). This new banking system would hold the publics subscribed capital, and those of the government, and national banks.

The Federal Reserve Bank is not just on central bank, but is divided into 12 Federal Reserve Districts around the U.S. These 12 banks represented the cities they were located in and, thus, were named after these cities, for example, the bank in New York, Chicago, Boston, etc. The Federal Reserve Bank is made up of seven members of the Board of Governors who are appointed by the President and confirmed by the Senate to run for a term that ran for 14 years. The President also designated two members of the Board of Governors to be Chairman and Vice-Chairman for a term of four-years who are confirmed by the senate. Members of the Board were chosen from any Federal Reserve District, basically, one per district. The primary objective of the Board is the formulation of monetary policy. These seven Board members are also representatives of the Federal Open Market Committee which comprises of 12 members in total and are allowed to make decisions regarding cost and availability of credit in the economy. The remaining five members of the FOMC are presidents of any of the 12 Reserve Banks. The FOMC’s organization set-up is different from the FRD. Its Chairman is also the Chairman of the Board of Governors and its Vice-Chairman is also the president of the New York Banks, who today is Timothy F. Geithner.

The primary function of the Federal Reserve Bank is to make sure that there is enough money and credit in the banking system required to empower a growing economy. The Board of Governors sets requirements for the reserve and shares the obligations with the Reserve Banks for discount rate policies. According to the text on Macro Economics by William A. McEachern, "The Federal Reserve was also granted other powers: to buy and sell government securities, to extend loans to member banks, to clear checks in the banking system, and to require that member banks hold reserves equal to at least some specified fraction of their deposits." (McEachern 213) These functions constitute the *monetary policy* tools of the Federal Reserve System.

The Federal Reserve does not only deal with monetary policies, but also deals with *regulatory and supervisory responsibilities.* They regulate member banks, holding companies, internationally facilitated banks in the U.S, and agreements on corporations. The Board of Governors set what they call *margin requirements.* These require banks to set a boundary on the use of credits in buying and yielding securities. Furthermore, in *The Federal Reserve System; Purposes & Functions* guide book, "The Federal Reserve plays a vital role in both the nation's retail and wholesale payments system, providing a variety of financial services to depository institutions." (85) This implies that a prominent feature of the Federal Reserve is making sure that there is sufficient cash in the circulation to satisfy the needs of the public through effective wholesaling and retailing. Also, Federal Reserve lends money to banks in need of reserves, which applies to a function that allows them to charge its own interest rate. In addition to the functions stated above, the Federal Reserve also ensures the effective running and operations of the country's large payments system.

Moving to an international hemisphere, the Federal Reserve also has some influence on the international monetary market. Hence, in times of a more flexible exchange rate, one objective of the FRB is to use its foreign currency operations to counter disorderly conditions in exchange markets. With the help of its foreign operations policy, the FED "*…sterilizes* the effects of intervention on Federal Reserve balances through open market operations; otherwise, the intervention could cause the federal funds rate to move away from the target set by the FOMC." (Federal Reserve in the International Sphere 54).

In a nut shell, the Federal Reserve partakes in numerous responsibilities and functions that facilitate its operations. More function include, risk-focused supervision which aids in the supervisory rating system of the economy and in turn helps formulate financial regulatory reports. The FED also takes part in off-site monitoring and accounting policy and disclosures. This calls for the Umbrella Supervision and Coordination. Moreover, the Federal Reserve is prominently known for its Anti-Money-Laundering Programs which helps stimulate business continuity. Lastly, the Federal Reserve carries out various consumer and community related affairs, one of which is the Educating Consumers about Consumer Protection Laws which safeguards consumers against fundamental right impediment.

One of the major issues surrounding the FED is the issue of liquidation in this time of financial crisis and the impeding recovery of the national deficit in the U.S. A lot of financial and banking officers, who are not in support of this recent liquidation act of 2007, exclaimed that this monetary policy was a jolt to the economy and decreases the integrity of the FED towards effectively handling the economy. This liquidation act included the changes in the primary credit discount facilities to shorten the uncertainty concerning the availability and cost of funds available to the institutions in charge of deposits. (Fleming 2) Hence, it is the FED's responsibility to change interest rates in order to improve the financial state of the economy. The FED not only provided liquidation to depository institutions, but also dealers, and other market participants. In relations to this liquidation act, many critics suggested that this monetary policy administered by the FED might, in the long run, prove ineffective and costly. Thus, Michael J. Fleming, co-writer on the *Income Effects of Federal Reserve Facilities,* stated that "Many studies have found that the facilities were effective in promoting financial stability during the crisis. In addition, because the facilities were designed according to well-understood lender-of-last-resort principles—the Fed's loans were well collateralized and generally priced at a premium to the cost of funds—they also earned considerable income." (Fleming 1) Therefore, the FED serves as a prominent factor in the decision making of monetary policies in the economy, despite critical assertions.

Fund liquidation is not the only aspect criticized by a majority of the banking personnel. Inflation brings about serious conflict in banking and financing. Inflation is the increase in the economy's price level, and in return diminishes certain other things, like lenders willingness to deposit money, and their sporadic attempt to cash in on all their deposits. This, therefore, causes economic downturn which, consequentially, calls for financial bailout, for example, the financial crisis in 2007. According to the New York Times newspaper online, "…liberal Democrats have accused the Federal Reserve of caving in to demands by banks for huge bailouts, for failing to protect consumers against dangerous financial products and for being too secretive about its emergency rescue programs." (April 27, 2012) Even the Republicans criticize the regulations made by the FED. Historically, the FED was also criticized in this same manner, but Gerald Epstein suggests that various comments towards the FED were unjustified and non-academic in logic. He asserts that:

> Viewed in terms of our analysis, most of the mystery evaporates about two controversial issues in the later financial history of the Depression:

> the final disastrous run ono the banks that led to the Bank Holiday of early 1933 and all the subsequent worries withing the system about iinflation after 1935. Both of these are almost unintelligible in terms of the standard historiography. That the Federal Reserve System largely sat on its hands as the entire American financial structure collapsed seems unbelievable. (Epstein 982)

These few lines explain the unjustified attempts by critics to downplay the FED, hence, instill doubts in the minds of people in the economy to question the effectiveness of the FED.

Recalling the objectives of the FED, firstly, the FED exist primarily to promote monetary policy through open-markets, that is, buying government bonds and securities, secondly, influencing the discount rate of the economy to lend money, and lastly, to influence the reserve ratios for how much of deposits should be held as reserves. Nevertheless, there are numerous oppositions towards the methods of execution of the functions of the FED. Some critics argue in terms of the ineffectiveness of the management of the FED by its Board of Governors, some bring out points that relate directly to the centralized nature of this institution. In reference to Marc Labonte's article on the *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, "Critics of the Federal Reserve have long argued for more oversight, transparency, and disclosure. Criticism intensified following the extensive assistance provided by the FED during the financial crisis." (Labonte 14) This means that people depict a sense of concern towards the FED and want to be more involved in the policy making system to re-assure their trust. Hence, the need for re-assurance proclaims the need to perceive the FED as predictable, rather than a body of systems that could go bad without fair warning.

Critically analyzing the functions and responsibilities of the Federal Reserve in relations to its ancestors and their individual flaws, I believe that the enactment of the FED was one of the brightest bills the U.S. has ever passed. The Federal Reserve Banks take on monetary and supervisory responsibilities. In short, they are the legislators of the monetary policies and the implementers of those same policies. This police-like institution more than meets the objectives for which it was established for, hence, despite several scandals, the Federal Reserve System that has existed since 1913 provides financial and monetary protection for the whole economy. Hence, considering comments and suggestions by critics, through fund liquidation acts and changes in interest rates, it is more than welcoming to accept the fact that the FED provides more benefit to the economy than it is erroneous.

<u>Work Cited</u>

Johnson, Roger T. "Historical Beginnings: The Federal Reserve." *Public and Community Affairs Department* (2010). Print.

McEachern, William A. *Econ Macro 2*. Mason, OH: South-Western Cengage Learning, 2010. Print.

Federal Reserve in the International Sphere *The Federal Reserve System; Purposes & Functions* guide book. Print.

Epstein, Gerald, and Thomas Ferguson. "1. Monetary Policy, Loan Liquidation, and Industrial Conflict: The Federal Reserve and the Open Market Operations of 1932." *The Journal of Economic History* 44.4 (1984): 957-83. Print.

Malling, Jay. “Federal Reserve (The Fed).” *New York Times* April 27, 2012 late ed. : Al. Print.

Fleming, Michael J., and Nicholas J. Klagge. "Income Effects of Federal Reserve." *Current Issues in Economics and Finance* 17.1 (2011). Print.

Labonte, Marc. “Monetary Policy and the Federal Reserve: Current Policy and Conditions.” *Congressional Reserve Service* (2012). Print.