Fed Focus: Fresno—Partners With Business
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The Role of the Federal Reserve in the Economy

I. Good morning. It's a pleasure to be with you today.

A. I'd like to try to answer some of the questions that I often hear people ask:

1. What's the Fed's role in the economy?

2. How does it function?

3. What can it do for the economy?

II. I'll begin by describing the Fed's role in a nutshell:

A. As the nation's central bank, the Fed basically does three things:

1. It works to keep the banking, financial, and payments systems safe, sound, and stable.

2. It also provides financial services to the government and the public.

3. Finally--and very importantly--the Fed's conduct of monetary policy contributes to the long-run health of the economy by promoting maximum sustainable employment and stable prices.

B. Since its founding in 1913, it has evolved with some special characteristics:

1. public and private

2. national and regional

3. subject to congressional oversight, but "independent" and insulated from day to day political pressures.

4. These characteristics create important checks and balances for conduct of policy and operations.

C. Structure embodies public/private, national/regional, independent characteristics

1. BOG in Washington: 7 members with staggered 14-year terms; appointed by President with consent of Senate; Chairman preeminent.

2. 12 Reserve Banks cover all 50 states

a. Reserve Banks are each incorporated

b. and have own boards of directors,

(1) made up of bankers, businesspeople, and the general public.

3. SF Fed--Twelfth District

a. Headquarters plus four branches cover largest geographic territory—nine westernmost states

b. nearly one-fifth total US population and employment

c. and almost one-sixth of total U.S. banking assets.

D. Reserve banks provide banking services, bank supervision and regulation, and discount window.

1. Banking services

a. check processing and collection

(1) SF handles about eight million checks per day

b. electronic wire payments system (Fedwire)

(1) SF handles $122 billion per day;

(2) other electronic payments services (ACH)

c. banker for U.S. Treasury

(1) handles payments for Treasury through account at Fed

(2) sells Treasury securities and keeps track of ownership

through book entry system

(3) provides fit coin and currency

2. Supervision and Regulation

   a. state-chartered member banks

   b. bank holding companies

   c. consumer protection and securities lending regulations

3. Discount Window

   a. provides temporary funds against collateral to depository institutions

III. Monetary policymaking also reflects national/regional, public/private, independent characteristics.

A. Conducted by FOMC

1. 12 members: 7 Governors plus 5 Reserve Bank presidents on a rotating basis.

2. All Reserve Bank presidents attend FOMC meetings and participate fully in discussions,

   a. providing independent perspective on national policy and regional information.

B. The tools the Fed uses to conduct policy are

1. open market operations--federal funds rate

2. discount rate.

3. With these tools, the Fed can affect credit conditions in the economy, which affect people’s demand for goods and services, and ultimately economic performance.

C. The Fed uses these tools to achieve both short-run and long-run goals.

1. For example, a short-run goal would be to deal with a recession;

    a. in that case, the Fed may ease up on interest rates,

    b. and that would help stimulate the economy and promote a recovery.

2. But in the long-run, the goal is low inflation, because monetary policy is the main determinant of inflation in the long run.

    a. This is true not only for the Fed, but also for central banks around the world.

    b. Keeping inflation low is the best way a central bank can promote maximum sustainable growth and employment, which are keys to the nation's economic health.

IV. Since lower interest rates can be used to stimulate employment and growth in the short run, some people wonder why we don't do it *all* the time.

A. The answer is that there's a long-run cost to such a strategy. And the cost is an inflationary environment.

1. Both research and experience have shown that if we stimulate the economy all the time, the gains against unemployment are temporary, at best.

2. The reason is that, in the long run, unemployment depends on things that are *beyond* the reach of monetary policy.

3. Instead, it depends on things like

    a. technological change,

    b. and people's preferences for saving, risk, and work effort.

B. But the inflation we get from overstimulating is *permanent*.

1. It has to be wrung out of the economy,

2. and the way to do that, unfortunately, is to go through the pain of slow growth or even recession.

C. So, if the Fed tries to achieve too much of a good thing, it ends up making things worse.

V. So far, I've tried to give you a broad overview of how the Fed tries to strike a balance in conducting monetary policy--

   A. --a balance between concern over the short-term measures of economic performance, and attention to the long-term goals of sustainable growth and employment and low inflation.

   B. I think it's fair to say that our efforts to strike the right balance have worked well for the country's economy for some time now.

      1. For the past several years, we've been in a pretty good position.

         a. Long recovery

         b. Robust growth

         c. Low unemployment

         d. Well-behaved inflation

   C. But there are challenges ahead.

      1. Financial problems in Asia have swollen the trade deficit and led to some slowing in our economy.

         a. Things could get worse before they get better, as the situation in that part of the world has deteriorated further in recent months.

         b. In fact, other economies, especially Russia and some in Latin America, are of concern.

            (1) It's too soon to tell how problems in these other areas will affect the U.S. economy.

      2. But as the world situation gets riskier, and the U.S. economy shows signs of slowing, we've recently seen conditions "tighten" in financial markets considerably.

         a. Investors have been pulling back from the risks of the stock market, which has contributed to declines in equity values.

(1) Equity values in the U.S. have fallen.

(2) And while “safe-haven” demands have lowered U.S. Treasury yields, risk spreads have increased, so that interest rates on risky loans have risen.

D. Both the strength in our economy in recent years and the recent Fed action to cut interest rates should give us some resilience in the face of shocks like these.

1. As we monitor further developments, our aim, of course, will remain keeping the U.S. economy on the expansion track while maintaining low inflation.