The Federal Reserve System
or
The Creature from Jekyll Island
ECON 135, Spring 2009

Origins of the Fed

From the beginnings of the Republic and into the twentieth century, the American people distrusted banks generally and central banks particularly. The first Bank of the United States and the Second Bank did not last very long. The Treasury began issuing banknotes during the Civil War, but it was only in 1913 that the Federal Reserve System, our current central bank, began operations on a limited basis. Although its basic structure is unchanged, the Fed (as the Federal Reserve is generally called) has taken on many additional roles during its nearly one hundred years of operations.

The period from about 1900 to 1915 is generally known as the "progressive era." The "reforms" that were enacted during those years were promoted as a means of curbing monopoly power, but in fact, they served to *establish and strengthen* monopoly power. The two most powerful financial interests of the time were the Morgans and the Rockefellers, together with their respective allies. Both camps agreed on the need to form a banking cartel, and saw a central bank as the best way to do that. They began a campaign to sell this idea, and the Panic of 1907 helped their cause. The result was the Federal Reserve Act, passed by Congress in 1913. Detailed planning of the Federal Reserve actually took place in 1910 at a secret conference organized by Wall Street financier J. P. Morgan at an island he owned off the coast of Georgia.

> Picture a party of the nation's greatest bankers stealing out of New York on a private railroad car under cover of darkness, stealthily riding hundreds of miles South, embarking on a mysterious launch, sneaking onto an island deserted by all but a few servants, living there a full week under such rigid secrecy that the names of not one of them was once mentioned, lest the servants learn the identity and disclose to the world this strangest, most secret expedition in the history of American finance. The utmost secrecy was enjoined upon all. The public must not glean a hint of what was to be done. Senator Aldrich notified each one to go quietly into a private car of which the railroad had received orders to draw up on an unfrequented platform. Off the party set. New York's ubiquitous reporters had been foiled...

> Nelson (Aldrich) had confided to Henry, Frank, Paul and Piatt that he was to keep them locked up at Jekyll Island, out of the rest of the world, until they had evolved and compiled a scientific currency system for the United States, the real birth of the present Federal Reserve System, the plan done on Jekyll Island in the conference with Paul, Frank and Henry... [1]

There was general disagreement as to whether the Federal Reserve should be privately owned or government-owned. This disagreement, added to the lingering general distrust of banks, led to a rather strange hybrid institution. To begin with, the Fed was given some of the trappings of private ownership, in particular the issuance of shares of stock. Secondly, it was set up as a decentralized system of twelve member banks located in the most prominent commercial and industrial cities. The New York Fed had special privileges and in fact was initially more powerful than the headquarters operation in Washington.

The Fed's initial functions

The Fed's primary initial roles were to provide an elastic currency and to serve as a "lender of last resort." It was thought that only a central bank could provide a prompt and adequate supply of currency when needed, as in recessions, at harvest time, or Christmastime. As a lender of last resort, the Federal Reserve would stand ready to provide commercial banks a source of funds in case they should run short of reserves or experience excess loan losses. Of course, the predictable result of this sort of "backstop" operation was moral hazard: the temptation to engage in riskier practices.

The New York Fed

The New York Fed has always a special role. To begin with, it is located in the nation's financial center, where many of the largest commercial banks, investment banks, and brokerage firms are headquartered. Secondly, the New York Fed conducts open-market operations on behalf of the entire Federal Reserve, as explained below. Also, the president of the New York Fed is a permanent member of the Fed's powerful Open Market Committee. The president of the New York Fed exercised more power and influence than the Chairman of the Board of Governors into the 1950's. Timothy Geithner, the current Secretary of the Treasury, was previously president of the New York Fed.

[1] G. Edward Griffin, "The Creature from Jekyll Island : A Second Look at the Federal Reserve."

Open Market Operations

Perhaps the most important function of the Fed is its conduct of monetary policy. The Federal Open Market Committee meets regularly and issues targets for the federal funds interest rate, which, until very recently, were widely reported. To understand how open market operations work, we first have to understand what federal funds are and how open-market operations influence them.

Banks need to hold reserves to back their deposits. In the case of demand deposits, the Fed requires banks to hold 10% reserves in the form of vault cash or a reserve account at the Fed. There is no minimum requirement for reserves backing savings deposits, but prudent management does require some reserves.

When a commercial bank's reserves fall below the minimum requirement, or seem about to do so, the bank's management must take immediate action. Most often, banks in this situation borrow funds from other banks, often on a overnight basis. They negotiate a mutually agreeable interest rate, and the loan is done. Funds loaned between commercial banks are called, perhaps misleadingly, "federal funds."

Although federal funds rates are negotiated, the Fed can steer this rate toward a target figure. It does this by creating new money. New money has the effect of lowering short-term interest rates generally, and the fed funds rate in particular. Slowing the pace of money creation or withdrawing money has the opposite effect.

The Fed creates new money by purchasing assets with money that it creates "out of thin air." Although it could theoretically purchase anything it wanted with new money, it has, until very recently, purchased only short-term Treasury securities in its open-market operations. These securities are not purchased directly from the Treasury, but from a select group of New York bond dealers who are licensed to do this business. But although the Treasury is not directly involved in open market operations, it can benefit substantially from them. By soaking up some of the supply of Treasury securities, it makes it easier for the Treasury to issue more securities, and at a lower interest rate than it would otherwise have to pay. This process of replacing Treasury securities with new money is called "monetizing the debt."

At one time the Fed targeted the money stock figures, mainly M1. But over time, financial innovation led banks to offer ways for customers to move funds out of M1 categories which paid little or no interest, into interest-bearing assets that were part of M2 or M3. So the Fed began targeting the fed funds rate instead.

Again we should emphasize that the Fed can only target the fed funds rate and not control it directly. And indeed, in the fall of 2008 the weighted average fed funds rate began to drift substantially away from the Fed's announced target – it was losing control. As of April 2009, the Fed's target is now a range of zero to 0.25%. The Fed has clearly "run out of room" to manipulate the economy via the fed funds rate, since no nominal interest rate can drop below zero.

Other functions of the Fed

The Fed performs several other functions that are less prominent than its open-market operations. It distributes new currency to commercial banks and receives their old worn-out currency. (The Fed does not print the currency; that job is handled by the Bureau of Engraving and Printing). It operates a check-clearing business in competition other private firms, and an electronic clearing function called FedWire. It makes discount loans to member banks, and also engages in bank regulation and examination, in competition with and sometimes in conflict with other regulatory agencies.[2]

All banknotes are now Federal Reserve notes, the last Treasury notes having been printed around 1965. Banknotes still bear a letter indicating the Federal Reserve District with which they are associated. For example, I have a $20 bill in my wallet marked L12, which stands for the San Francisco federal reserve. This is a holdover from the time when the various districts actually issued distinct currency.

Expansion of Fed authority

During late 2008 and continuing into 2009, the Fed took on functions that were seen as unprecedented, though in fact it had engaged in some similar activities earlier in its history. A summary is shown below.

The next two pages are copied from Chapter 6 of Hummel & Gibson

[2]The Office of Thrift Supervision, a part of the Treasury Department, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

	Dec 2008	Dec 2007
Gold certificate account	11,037	11,037
Special drawing rights certificate account	2,200	2,200
Coin	1,688	1,680
Securities, repurchase agreements, term		
auction credit, and other loans	1,219,723	1,597,146
Securities held outright	495,629	740,627
U.S. Treasury	475,921	740,627
Bills	18,423	78,916
Notes and bonds, nominal	410,491	470,984
Notes and bonds, inflation-indexed	41,071	36,911
Inflation compensation	5,936	4,892
Federal agency	19,708	0
Repurchase agreements	80,000	56,750
Term auction credit	450,219	4,923
Other loans	193,874	186,630
Net portfolio holdings of Commercial Paper		
Funding Facility LLC	334,102	0
Net portfolio holdings of Maiden Lane LLC's	73,925	0
Items in process of collection	979	(192)
Bank premises	2,194	2,134
Other assets	620,057	66,711
Total assets	2,265,904	925,701

Source: Federal Reserve Table H.4.1

Figure 1: Federal Reserve assets for year-end 2007 and 2008.

Figures 1 and 2 present consolidated Federal Reserve balance sheets for 2007 and 2008. We have chosen not to use the usual T format, so as to highlight the drastic changes that took place during 2007 and 2008. The most significant items are these

- "Treasury securities held outright" are securities (bills, notes, bonds) that the Fed has acquired by open market operations (section **??**). These sums represent debt that has been monetized, i.e., paid for with newly created money. The decline is due to open-market sales of some of these securities.
- "Term auction credit" is an item that barely existed in 2007. Most of this item is collateral that has been accepted for loans made to depository institutions under the new Term Auction Facility, a "temporary" program to assist depository institutions that are "in generally sound fi-

nancial condition" and "are expected to remain so over the terms of TAF loans."

- "Commercial paper LLC" is a limited liability corporation that was set up in the fall of 2008 when the market for commercial paper dried up, threatening corporations which rely on them for short-term financing as well as money market funds and other institutionss that buy them as safe, short-term assets.

- Three LLC's have been set up under the name "Maiden Lane." The first advanced funds to JPMorgan to acquire Bear Stearns, an investment bank that was on the brink of failure. The second was used to purchase mortgage-backed securities from American International Group, an insurance company that had expanded into this and other forms of derivative securities. The third purchase collateralized debt obligations from AIG.

- "Other Federal Reserve assets" are primarily securities denominated in foreign currencies.

The most important liabilities are these

- "Currency in circulation:" technically this item belongs on the liability side but in fact, Federal Reserve Notes are not redeemable for anything but more such notes. There is no actual or potential obligation to pay anything as there is with ordinary liabilities.

- "Deposits other than reserve holdings" consists mostly of funds that the Treasury has deposited at the Fed to support bailout operations. The Treasury has recently borrowed much more than it needs to meet current expenditures, taking advantage of its opportunity to do so at historically low rates.

- "Reserve balances" are commercial bank reserves, both required and excess. Excess reserves skyrocketed at the end of 2008. This was in part due to a policy change whereby the Fed pays interest on reserves, thereby making them more attractive to hold than they formerly were. But it also likely reflects banks' wariness about making loans in a recessionary environment.

End of excerpt from Chapter 6

Liabilities	Dec 2008	Dec 2007
Federal Reserve notes	853,168	849,716
Reverse repurchase agreements	88,352	88,317
Deposits	1,248,034	1,241,984
-- Depository institutions	860,000	819,404
-- U.S. Treasury, general account	106,123	118,058
-- U.S. Treasury, supplementary financing account	259,325	289,247
-- Foreign official	1,365	1,190
-- Other	21,221	14,085
Deferred availability cash items	(2,471)	(2,537)
Other liabilities and accrued dividends	31,728	33,673
Total liabilities	2,223,753	2,216,227
Capital accounts		
Capital paid in	21,076	21,071
Surplus	21,076	16,846
Other capital accounts	0	4,600
Total capital	42,152	42,517

Source: Federal Reserve Table H.4.1

Figure 2: Federal Reserve liabilities for year-end 2007 and 2008.

The ballooning of reserves in 2008-2009

In September 2008 the Fed began paying interest on reserves held by member banks. This had been planned for some time, the idea being to make it easier for the Fed to control the fed funds rate. Open market operations would keep the rate from getting too high while interest payments would keep them from dropping too low. This new policy is at least in part responsible for the drastic increase in reserve levels, from about $800 billion, a figure that included very little in the way of excess reserves, to $1,600 billion, most of the increase being excess reserves. A great deal of the new money that the Fed has injected into the economy has looped right back into its coffers in the form of these reserve increases.

But the role of these interest payments should not be overstated. It is likely that banks are putting funds in reserves largely because they cannot find enough good loan opportunities for the money.

Independence versus Accountability

The Fed enjoys a greater degree of independence than do ordinary government agencies. To begin with, the Fed sets its own operating budget. It does not have to appeal to the House Appropriations Committee for annual funding as do other agencies. How does this work?

The Fed, though not organized to seek profits, actually does enjoy profits. Its main source of profits is the interest it earns on its portfolio of Treasury securities. Although the law requires the Fed to rebate its interest earnings to the Treasury, it does so *only* after it deducts its operating expenses. This of course gives it an incentive to spend lavishly for facilities and salaries, but it must not overdo its spending lest there be a political backlash.

The independence that the Fed enjoys helps insulate it from short-term political pressures. This supposedly allows the Fed leadership to focus on the needs of the nation as a whole, and on long-run consequences and not just the immediate effects of its actions.

But if independence is one side of a coin, accountability is the other. We live in a democratic society, in which government officials are supposed to be accountable to the people through their elected representatives. And in fact, the Congress does enjoy a degree of oversight over the Fed. The chairman is required to testify before a Congressional committee on a regular basis. The Congress passes legislation from time to time that gives the Fed new responsibilities. Ultimately, since the Congress created the Fed, it could, at least in theory, alter in any way or abolish it as it sees fit. However, politicians benefit from the independence of the Fed in a way – they can rail against it in speeches or committee hearings for the benefit of the folks back home, knowing they lack the power to do any real damage by following up.

The Fed is ***not*** privately owned

The formal structure of the Fed, in particular the shares of stock that member banks hold, is fodder for conspiracy theorists who say that the Fed is privately owned. The reality is more complex. As we shall see, the Fed enjoys a greater degree of independence than ordinary government agencies.

The record of the Fed

How well has the Fed done its job over the nearly hundred years of its existence? Not very well, generally speaking. The Fed presided over the Great Depression, a cataclysmic and unprecedented economic upheaval which saw 9,000 bank failures, unemployment reaching 25%, and an explosive growth in federal government power. After the war, the economy entered a period of expansion and prosperity, but then came the "stagflation" (stagnation plus inflation) of the 1970's, followed by severe recessions in 1980 and 1982. Another boom period was followed by the crash of 2008, whose ultimate causes and outcome will not be known for some time.

And during these nearly hundred years, the dollar has lost at least 95% of its purchasing power. We must conclude that the record of the Fed has been spotty at best.