Article

The Federal Reserve

The history and functions of the United States' central bank

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Banks are places where people deposit money. The Federal Reserve is the central bank of the United States. The Federal Reserve System is made up of 12 regional banks and 25 branches. The Federal Reserve System is a bank for banks. The Federal Reserve is also called the Fed.

Central Banks in the U.S.

The Federal Reserve we have today was the third try at creating a U.S. central bank. Congress established the first central bank in 1791. It was called the First Bank of the United States and was located in Philadelphia, Pennsylvania. Support for the bank was strong in the North but not in the South. The South had less need for a central bank. After 1811, the bank only served the people of Pennsylvania.

A second bank lasted from 1816 to 1836. After the bank closed, many banks issued their own currency. Some businesses would accept money from one bank, but not another. About 30,000 different bank notes (what banks call paper money) were in circulation. Imagine going to a store and not knowing if they will accept your money. Because there were so many different kinds of money, fraud was very common. About one-third of paper money used in this “free banking” era was counterfeit.

How the Fed works

Finally, Congress passed the Federal Reserve Banking Act, and President Woodrow Wilson signed it into law on December 23, 1913. This is the Fed we know today.

It took another year for the government to establish the 12 banking Districts. The Fed identifies Districts by number, letter, and the city where the District’s Reserve Bank is located.

1. Boston, Mass. (A)
2. New York, N.Y. (B)
3. Philadelphia, Pa. (C)
4. Cleveland, Ohio (D)
5. Richmond, Va. (E)
6. Atlanta, Ga. (F)
7. Chicago, Ill. (G)

8. St. Louis, Mo. (H)
9. Minneapolis, Minn. (I)
10. Kansas City, Mo. (J)
11. Dallas, Texas (K)
12. San Francisco, Calif. (L)

The Federal Reserve System is controlled by the Board of Governors, located in Washington, D.C. There are seven members on the Board of Governors. They are appointed by the president of the United States and confirmed by the Senate.

A board member can serve one 14-year term. The chairman and vice-chairman of the Board serve four-year terms. They may be reappointed for additional terms. William McChesney Martin, the longest-serving Fed chairman, was in office from 1951 until 1970.

The current chairman of the Federal Reserve is Ben S. Bernanke. He became chairman in 2006, and was appointed to another term in 2010.

Inflation

The Fed's main responsibility is to keep inflation low. Inflation is the increase in price of goods and services. Inflation means that it takes more money to buy the goods and services people need.

Wages, the money paid to people who work, rarely keep up with inflation. When inflation increases, working people are unable to buy as many goods and services. Unions can bargain on behalf of their members for better wages, but only 12.3 percent of workers in the United States belonged to a union in 2009.

Inflation happens slowly over the course of time. Goods and services become more expensive. The difference in the cost of a new car in 1924 and 2010 is a good example. In 1924, a new car from the Ford car company cost about $350. The average annual salary was $1,124. A person would have to spend about 31 percent of their yearly salary to buy a new Ford.

In 2008, a new Ford cost about $17,000. The average annual salary was about $38,500. A person would have to spend 44 percent of their average salary to buy a new Ford.

Inflation can also happen very quickly. During times of high inflation, people can't afford to buy goods and services, meaning there is less demand for their production. When production slows, people may lose their jobs. Unemployment means more people can't afford to pay for goods and services. The economy slows down, causing inflation to rise even further.

Interest Rates

The Fed can tame inflation by raising and lowering interest rates. Interest is the fee that banks charge to borrow money. Individual banks charge interest to people and businesses that borrow money from them. The Fed charges interest to individual banks.

Interest rates fall into two broad categories: the discount rate and the federal funds rate. The discount rate is the interest rate the Fed charges to member banks. The federal funds rate is the interest rate member banks charge each other. The discount rate is usually higher than the federal funds rate.

The discount rate and the federal funds rate are set by the Federal Open Market Committee (FOMC). The FOMC is made up of the seven members of the Board of Governors, the president of the Federal Reserve Bank of New

York, and four regional bank presidents. The regional bank presidents serve one-year terms and are replaced by a bank president from another region when their term is up.

The FOMC meets eight times a year in Washington, D.C. The bank presidents, Board of Governors, and Federal Reserve staff talk about economic news around the world and how they believe it will affect the U.S. economy. They study statistics like the Consumer Price Index (CPI), which measures the prices that U.S. consumers pay for goods and services. They talk to bank representatives in their district.

What the FOMC decides to do will affect how easy or hard it will be to borrow money from a bank.

If the Fed believes the economy is slowing down, they will lower interest rates. This allows people and businesses to borrow money more easily because it is easier to pay the bank back. Low interest rates make it easier for people to take out loans to buy houses and cars. Businesses can use low interest rates to take out loans to buy new equipment or hire more people.

On the other hand, if the economy is doing better, the Fed will likely raise interest rates. The Fed does not want the economy to grow too quickly. Inflation can occur if there is too much money in the banking system.

Money Supply

The Fed is also responsible for controlling the money supply in the United States. The Fed controls the money supply by buying and selling U.S. Treasury securities. Treasury securities, often called Treasuries, are loans people and businesses make to the United States. The government uses Treasuries to create programs used by Americans, such as disaster relief or the federal highway system. The government pays back Treasuries after a certain period of time.

There are three kinds of Treasuries: treasury bills, treasury notes, and treasury bonds. Treasury bills (T-bills) have a one-year life span, meaning the money will be paid back in one year. Treasury notes (T-notes) mature in one to seven years. Treasury bonds (T-bonds) last more than seven years.

The Fed distributes money created by the U.S. Treasury to its member banks. You can tell what District bank money came from by looking at the circular mark on the left side of a dollar bill’s face. The mark will have a letter, circled by the name of the bank. The letter E, for example, says the bill came from the Federal Reserve Bank of Richmond, Va.

The Fed is responsible for destroying currency that becomes too worn out to use. These “Fed shreds” are put in landfills or are given out as souvenirs in places like the Chicago Money Museum.

VOCABULARY

Term	Part of Speech	Definition
appoint	*verb*	to assign to a position.
bank	*noun*	organization that loans, protects, and exchanges money to and from individuals and organizations.
banknote	*noun*	paper money, or notes with a value supported by a bank or government.
bargain	*verb*	to negotiate or come to an agreement.
Ben S. Bernanke	*noun*	(1953-present) chairman of the Federal Reserve.

Congress	*noun*	legislative branch of the government, responsible for making laws. The U.S. Congress has two bodies, the House of Representatives and the Senate.
Consumer Price Index (CPI)	*noun*	statistic that tracks the costs of a number of common goods and services. Also called headline inflation.
counterfeit	*verb*	to make a false or imitation version of a product.
currency	*noun*	money or other resource that can be used to buy goods and services.
deposit	*verb*	to place or deliver an item in a different area than it originated.
discount rate	*noun*	interest rate charged by the Fed to member banks.
distribute	*verb*	to divide and spread out materials.
economic	*adjective*	having to do with money.
engraving	*noun*	image produced by cutting into the surface of an object.
establish	*verb*	to form or officially organize.
federal funds rate	*noun*	interest rate charged by banks to other banks.
Federal Open Market Committee (FOMC)	*noun*	group within the Federal Reserve that determines interest rates and makes decisions about the money supply.
Federal Reserve	*noun*	central bank of the United States. Also called the Fed.
Fed shreds	*noun*	ripped up pieces of currency that are too worn to be used.
fee	*noun*	price or cost.
fraud	*noun*	lie, trick, or misrepresentation played to gain goods and services.
government	*noun*	system or order of a nation, state, or other political unit.
inflation	*noun*	increase in the price of goods and services.
interest	*noun*	fee charged by lenders for borrowing money.
interest rate	*noun*	amount of money a lender charges a customer for a loan.
issue	*verb*	to distribute, give away, or sell.
landfill	*noun*	site where garbage is layered with dirt and other absorbing material to prevent contamination of the surrounding land or water.
loan	*noun*	money, goods, or services given to a person or organization with the intention that the person or organization will return it.
Martha Washington	*noun*	(1731-1802) wife of George Washington, first president of the United States.
Pocahontas	*noun*	(1595-1617) Native American (Powhatan) princess who married English settler John Rolfe.
portrait	*noun*	image of a person's face.
salary	*noun*	wages paid regularly over a fixed amount of time.
souvenir	*noun*	object kept to remind someone of an event.
statistics	*noun*	the collection and analysis of sets of numbers.
tame	*verb*	to domesticate or make useful for humans.

the Fed	*noun*	the Federal Reserve, the central bank of the United States.
treasuries	*noun*	loans people and businesses make to the U.S. government. Also called Treasury securities.
treasury bill	*noun*	loan issued to the U.S. government that matures after one year. Also called a T-bill.
treasury bond	*noun*	loan issued to the U.S. government that matures after more than seven years. Also called a T-bond.
treasury note	*noun*	loan issued to the U.S. government that matures in one to seven years. Also called a T-note.
unemployment	*noun*	state of not having a job.
union	*noun*	group of people or countries that work together for a common goal or set of goals.
U.S. Treasury securities	*noun*	loans people and businesses make to the U.S. government. Also called treasuries.
wage	*noun*	money paid to a person for providing goods or services.
Woodrow Wilson	*noun*	(1856-1924) 28th president of the United States.

For Further Exploration

Websites

- Federal Reserve Education

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