THE FEDERAL RESERVE:
HOW THE "FED" AFFECTS YOU

What Is The Federal Reserve System?

The Federal Reserve System was established by Congress in 1913. It consists of a Board of Governors headquartered in Washington, D.C. and 12 Reserve Banks located in major cities throughout the country. The Federal Reserve System is an independent entity within the government. As the nation's central bank, it derives its authority from Congress, except its decisions do not have to be ratified by the president or anyone in the executive or legislative branches of government; however, it is subject to oversight by Congress. The Federal Reserve System does not receive funding from Congress; its income comes primarily from the interest on U.S. government securities that it trades, interest on foreign currency investments, fees received for services it provides to depository institutions (commercial banks, savings banks and other financial institutions), and interest on loans it makes to these depository institutions.

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How the Federal Reserve's Monetary Policy Affects You

The Federal Reserve's day-to-day activities usually go unnoticed by most people. It's usually during periods of economic downturn or accelerating inflation that we hear about the Federal Reserve's monetary policy.

When the economy is weak, you may hear that the Federal Reserve is "loosening its monetary policy." That usually means that the central bank is reducing interest rates in an effort to make more money available to consumers and businesses. The Federal Reserve doesn't lower all interest rates; it trims only the *federal funds rate*, which is the rate that banks charge each other for overnight loans.

A reduction in the federal funds rate often triggers a reduction in the *cost of borrowing* for consumers and businesses. As a result, interest rates on credit cards, automobile loans, mortgages, and business loans usually decline, making it more attractive for consumers to purchase goods and services, and for businesses to spend more on hiring workers, buying equipment, or investing in the development of new products. Increased spending on the part of consumers and businesses over time boosts economic growth.

During periods of accelerating *inflation*, you are likely to hear that the Federal Reserve is

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tightening monetary policy. Inflation is the increase in the price of goods and services, and tightening monetary policy usually refers to an increase in the federal funds rate, with the goal to decrease spending by making money more expensive to borrow. As costs rise, the purchasing power of the dollar declines because it will buy fewer and fewer goods and services. Over time, the annual rate of inflation has fluctuated greatly, but the Federal Reserve tries to maintain an annual rate of inflation in the 2% to 3% range.

When inflation moves out of that range, often during periods of robust economic growth, the Federal Reserve may raise the *federal funds rate*. As interest rates rise, the *cost of borrowing* goes up and consumers tend to purchase fewer goods and services and businesses often reduce spending. Over time, as consumer and business demand declines, the economy cools, the cost of goods and services tends to go down, and the rate of inflation drifts lower.

Over the years, the Federal Reserve's actions have brought stability to the country's economy and financial system.

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