Understanding the Federal Reserve

By the Center for Popular Economics

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The Federal Reserve (or Fed) is the American central bank, in charge of regulating private sector banking and maintaining the overall level of money in the economy. Money in this case is not the number of bills that are out there, but the extent to which banks can lend. They do this by buying and selling short-term US bonds, which you can buy and redeem in 3-months with interest. When it buys a lot of bonds, it's injecting cash into the economy, and when it sells a lot of bonds it's removing cash from the economy. They also do this by regulating the interest rate at which banks can lend to each other every day. The lower the interest rate a bank can borrow from another bank, the lower the interest rate it charges on the loans it makes, at least in theory.

What the Fed is supposed to do?

The control of this interest rate means that the Fed can encourage banks to lend by making it cheaper for banks to borrow from each over, or by buying the short-term bonds held by banks and giving them cash that they can lend. So if the economy is in a crisis and needs stimulus, the Fed can inject a pile of money into the banks, who can then lend it out at low interest rates, letting businesses and households borrow really cheaply to keep the economy going.

But this doesn't come for free. The Fed risks inflation everytime it does this because when the economy is kept going, prices and wages stay high (people want to keep buying things and businesses want to keep hiring workers).

"Raising the interest rate"

Fed sell bonds-> take money out of production->lower investment->lowers employment, wages and prices->risks lower inflation

"Lowering the interest rate".

Fed buy bonds-> take money out of production-> increase investment->increases employment, wages and prices->risks higher inflation.

<u>The Fed has an overwhelming bias towards keeping inflation low, regardless of what employment and wages are.</u>

Why is this Bad?

Who cares about inflation? Inflation helps people who owe money (debtors) and hurts people who are owed (creditors). If prices are going up, then the value of what is owed in the future is falling, which means that what you owe in the future is worth less.

Right now, we have too many debtors. Mortgage debt, student debt, credit card debt are all a drag on the economy. People aren't buying things because they owe too much. By generating some more inflation, we could lower that burden of debt, and get people to buy more, increasing sales so that businesses hire more workers.

Commitment to low inflation helps bankers and hurts everybody else in a recession

Why Not Gold?

Gold would benefit bankers and hurt everybody else. If the currency is anchored to gold, then when the economy crashes, the government cannot issue more money to stimulate the economy. This was one thing that happened during the Great Depression, and the countries that abandoned gold first recovered earliest. A complex financial system needs to have a supply of money that can be flexibly increased or decreased. The question is "who gets to decide? And in whose interests?".

What's the Alternative?

Right now we need a Fed that is less worried about the interest of the banks. A Fed that is willing to risk inflation in order to generate jobs. A Fed that is willing to hurt bank profits in order to relieve student and mortgage debt.

One way to do this is to open the Fed to direct elections. Right now the board of governors are appointed, and the appointments are skewed towards bankers. Politicizing and democratizing the Federal Reserve is one way to bring the control of money under the people's control.

Why Keep The Fed?

Any system that uses money and credit is vulnerable to manias, panics and crashes. Having an institution that is able to step in and regulate when things are spinning out of control can prevent a lot of unnecessary unemployment and waste.

Bottom Line: Any complex economy with money is going to need something like the Fed. Bring it under democratic control so that it works for people and not the banks.