The Federal Reserve: CNBC Explains

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The Federal Reserve System—or the "Fed" as it's known—arguably plays the most crucial role in the U.S. economy.

Andrew Harrer | Bloomberg | Getty Images

Yet most people have little idea how the Fed works, what it actually does and why its decisions have so much impact. Here are the details.

What is the Federal Reserve?

The Fed is the gatekeeper of the U.S. economy and is part of the federal government.

Based in Washington, D.C., the Fed is the bank of the U.S. government and regulates the nation's financial institutions. It's comprised of a network of 12 Federal Reserve Banks and a number of branches. This is all overseen by the Fed's Board of Governors, which we'll detail a little later.

Two signs the market may be near a top

Besides being the nation's central bank, the Fed studies economic trends and makes policy decisions on how to make the economy "run better."

The Fed is an independent agency—which means it can make decisions on its own, without needing approval from any other branch of government. However, it is subject to questions from Congress over its actions. The Federal Reserve chairman regularly testifies to both the Senate and the House.

But while the Fed has to explain itself, it is theoretically free from political pressure. One caveat on this 'freedom'—Fed board members are nominated by the President and must be approved by the Senate.

What does the Federal Reserve System do?

The Fed's mandate is "to promote sustainable growth, high levels of employment, stability of prices to help preserve the purchasing power of the dollar and moderate long-term interest rates," according to the Federal Reserve's web site.

To do that, the Fed makes decisions over monetary policy to help maintain employment, keep prices stable, and keep interest rates at a level that helps the economy. It also supervises and regulates banks to make sure they are safe places for people to keep their money, and to protect consumers' credit rights.

But there's more.

The Fed plays a major role in clearing checks, processing electronic payments, and distributing coin and paper money to the nation's banks, credit unions, savings and loan associations. For example, when you cash a check or have money electronically transferred, there is a good chance that a Fed Bank will handle the transfer of money from one bank to another.

The Federal Reserve System also conducts research on the U.S. and regional economies and distributes information about the economy to the public through published articles, speeches by board members, seminars and web sites.

This information is released to the public as part of the Fed's mandate to study the economy.

Two important outlets for this information are:

- The Beige Book—named this way because of the report's tan cover. It's a report published eight times per year. Each Federal Reserve bank gathers anecdotal information on current economic conditions in its district. The beige book generally consists of reports from bank and branch directors and interviews with key business contacts, economists, market experts, and other sources.

- Fed Minutes—these are notes from discussions the Federal Open Market Committee has over economic policy. They are released eight times a year, after each meeting. They often detail disagreements between members over what policy to follow.

These two reports are followed very closely—by the stock market and economists in general— to gauge how the economy is doing and what the Federal Reserve board is thinking.

When was the Federal Reserve created and why?

The U.S. Congress created the Federal Reserve System on December 23, 1913, with the signing of the Federal Reserve Act by then-President Woodrow Wilson.

Before then, the U.S. has had two major periods of central banks—which could be considered an over-simplified form of the Federal Reserve—one starting in 1791 and the other in 1816. Each was an attempt to create a disciplined banking policy and help avoid economic collapses.

However, fears of a central bank being too powerful in setting financial policy brought about their ends. Congress failed to renew the first national bank's charter in 1811.

The 1816 central bank period ended in 1836 when then President Andrew Jackson refused to renew its charter—claiming the bank would be run, in his words, by "Eastern Elites."

However, a series of U.S. bank collapses in 1873, 1893 and especially in 1907, pushed many in Congress to call once again for a centralized banking system.

In 1907, there was a massive run on the banks—people demanding their money—and the banks started recalling all of their loans to pay off customers. This was started after large blocks of fraudulent stocks and bonds were sold to corner the market on one firm—the United Copper Company.

The scheme failed and banks who were part of the effort went bankrupt—and that spread to other banks across the country.

The bank panic of 1907 resulted in a congressional investigation that concluded: "a central bank was necessary so that these kinds of panics would never happen again."

However, it wasn't until 1913 before a law was actually passed—when Congress was able to work out a compromise on the Fed's mandate.

What is monetary policy?

We've mentioned that the Fed makes decisions over monetary policy. So what is that? It's the regulation of interest rates and the availability of money in order to provide economic growth and prevent downturns. This is the nuts and bolts of what the Fed does.

If the economy needs to grow faster and create more jobs, the Fed can supply more credit to banks for lending.

It can also lower interest rates that banks use to borrow money from the Fed, making it cheaper for banks to lend. This is referred to as the Discount Rate—the interest rate that an eligible depository institution is charged to borrow short-term funds directly from a Federal Reserve Bank.

The Fed can also lower banks' reserves—meaning banks would need to carry less money on their books—and can lend more to businesses and consumers as well as to other banks. This tactic increases the money supply in the economy.

Another way the Fed increases the money supply is by buying government securities, like treasury bonds, from the public. This is a form of what's called **quantitative easing** . Buying government securities makes more money available with the aim of increasing consumer spending and boosting the economy.

Now, if the Fed believes the economy is growing too fast and needs to slow down and avoid inflation—the increased costs of goods and services—it's going to do the opposite of what we've just mentioned.

To put some brakes on the economy, the Fed will increase interest rates for borrowing, make banks hold on to more of their money and therefore decrease lending. It will also stop buying securities, a strategy that in turn cuts down on the amount of money that's in the economy.

What is the FOMC?

This is the group within the Fedthat makes the decisions we just mentioned. FOMC stands for the **Federal Open Market Committee**.

The FOMC meets eight times per year to set key interest rates and to decide whether to increase or decrease the money supply—which the Fed does by buying and selling government securities.

The FOMC consists of 12 members—the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and four of the other 11 Reserve Bank presidents.

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The four Reserve Bank presidents serve one-year terms on a rotating basis. Non-voting Reserve Bank presidents attend the meetings of the Committee, participate in discussions, and contribute information about economic conditions in their District.

Where does the Fed get its money?

The Federal Reserve makes money—lots of it. The Fed had over $4.5 trillion in assets, as of March 12, 2015. The majority of revenue comes from open market operations—specifically the interest on the Fed's portfolio of Treasury securities as well as the money that comes from the buying/selling of the securities and their derivatives.

Other Fed revenue come from sales of financial services like check and electronic payment processing and discount loans to banks. There's also interest on foreign deposits within the Federal Banking system.

However, the Fed doesn't really keep the money. The government receives all of the system's annual profits—after certain expenses. In 2014, the Fed sent $98.7 billion of its $101.5 billion total net income in 2014 to the U.S. Treasury.

How does the Fed affect U.S. citizens?

It has a major impact on daily lives of nearly every American. As we mentioned above, the Fed can raise interest rates to slow down the economy. That means buying a home or a car can be more expensive if you have to pay more interest on a loan. Credit card interest rates can also go up.

An even greater impact could be fewer jobs as business costs to borrow money go up—those interest rates again—and firms may want to lay off people instead of hiring them.

And if the Fed cuts back on buying securities (quantitative easing) it is lowering the amount of money circulating in the economy—and creating less consumer spending.

Of course, the opposite is true. If the Fed lowers interest rates and borrowing costs, that makes a home or car purchase cheaper. And that could also mean businesses would borrow money at a cheaper rate and think about hiring if the economy picks up steam and consumers are spending.

How is the Federal Reserve System made up?

Under the Federal Reserve System, the United States is divided into 12 districts. Each district has an actual bank, called a reserve bank, serving it. But it's not the type of bank where the average citizen deposits money. Rather, it hold the funds of the Fed, which we'll describe below.

The 12 Reserve Banks are named after the city in which they are located. Those are Boston, New York, San Francisco, Philadelphia, Cleveland, Chicago, Richmond, St. Louis, Minneapolis, Atlanta, Kansas City, and Dallas.

Each reserve bank is run by a staff headed by a president or chairman, who also help make up the very important Federal Open Market Committee.

What is the Board of Governors?

The Board of Governors oversees the Fed. It is made up of seven members who, as we mentioned above, are appointed by the President and confirmed by the Senate. The full term of a Board member is 14 years, and the appointments are staggered so that one term expires on each even-numbered year.

The board members can come from within the Fed—many Federal Reserve bank presidents have gone from the banks to the board—or they can come from academia and other places. The President can appoint anyone he believes is qualified to serve.

A Chairman and Vice Chairman lead the Board. They too, are appointed by the President and confirmed by the Senate. But the nominees to these posts must already be members of the existing board.

The terms for these two top positions are four years, but the Chairman and Vice Chairman may be reappointed for additional four-year terms —as long as their term as Board member is active.

How Has the Fed Changed Over the Years?

Various changes over the years have given the Fed more power and responsibilities. Before 1937 for example, there was no FOMC issuing economic policy statements.

In the 1940s, the Fed and the banking industry developed the routing numbers that you see at the bottom of your checks—to identify the bank and account from which the check is written. This move led to the automation of check processing.

In response to banking and other financial problems that developed in the 1980s, the Fed Board adopted a policy in 1985 requiring the Reserve Banks to inspect once a year the various holding companies of the nation's larger banks. This is to make sure the banks themselves have enough reserve funds.

In 1991, the Right to Truth in Savings Act empowered the Fed to require that banks disclose account information to consumers, including the annual percentage yield; regulated advertising of savings accounts; and prohibited certain methods of calculating interest.

As a result of the Recession of 2007-2009, the Fed will oversee the **Bureau of Consumer Financial Protection** (CFPB)—an independent bureau within the Fed to help give consumers the information they need to make financial decisions.

Janet L. Yellen is the current Fed chairperson. Yellen was appointed Chair of the Board of Governors of the Federal Reserve System on February 3, 2014, for a four-year term ending February 3, 2018. Yellen also serves as Chairman of the Federal Open Market Committee, the system's principal monetary policy-making body.

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