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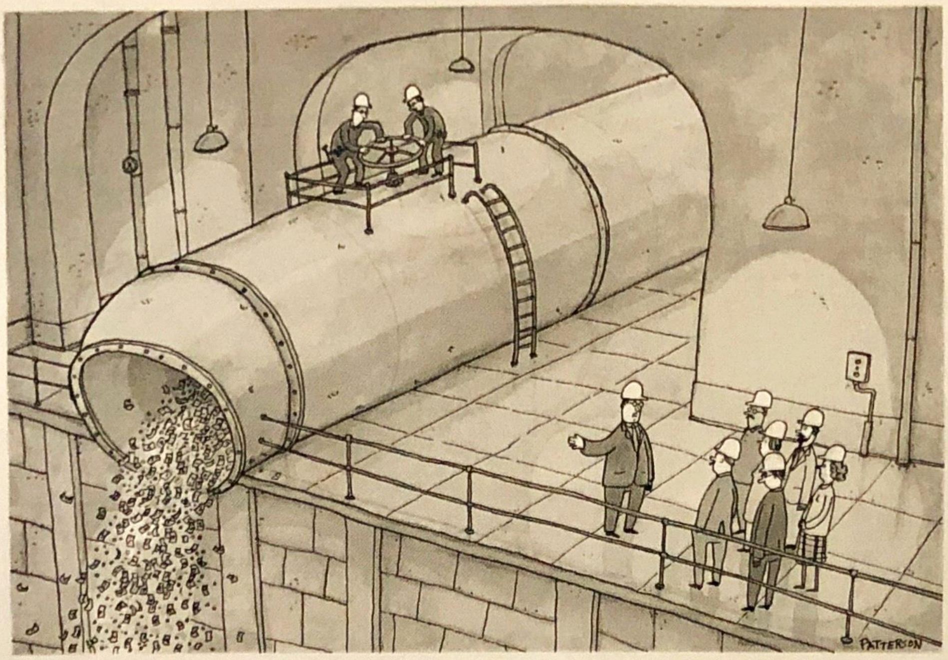
Is the Fed Good for America?



"And this is where we adjust the interest rate."

Overview: This Mini-Q investigates the role of the Federal Reserve Bank ("The Fed") in regulating the money supply in the US economy. Because the Fed has so much power, its actions are closely watched by politicians, the media, and the American public. This Mini-Q asks the bottom-line question: Is the Fed good for America?

Documents:

Document A: The Fed: How Does It Work? Part I

Document B: The Fed: How Does It Work? Part II

Document C: A Fed Success: The "Soft Landing" of 1994

Document D: A Fed Failure: The "Market Bubble" of 2008

Document E: "The Worst Sort of Politics"

Document F: "Short-Term Pain for Long-Term Benefits"

A Mini Document Based Question (Mini-Q)

Step One: The Hook

Teacher Note: The purpose of the Hook Exercise is to create some initial interest in the Mini-Q and get students talking with each other. Place students in pairs or small groups and provide them with the Hook handout. Have students make their own list of the five most powerful people in the US and rank them from 1 to 5 ("1" being most powerful). They should provide a rationale for their ranking in the space next to the name.

You may want to discuss different kinds of power, including political power (e.g. the ability to make or change laws), economic power (e.g. the ability to produce, buy, and sell things), and cultural power (e.g. the ability to change the interests and tastes of people).

Answers to the task will vary. Below is one possible set of responses.

The Most Powerful People in the US

Person	Position	Rationale
1. Barack Obama	ex-president of the US	He remains an important political voice in the country.
2. Bill Gates	founder of Microsoft	He is one of the richest and most influential people in the world.
3. Beyoncé	singer, businesswoman	She is one of the most talented singers and fights for civil rights.
4. Donald Trump	president of the US	He currently has more political power than anyone in America.
5. Tom Brady	Patriots quarterback	He has the most Super Bowl wins.

Each year, *Forbes* magazine produces a list of the 100 most powerful people in the world and the US. Below are the top five US selections for 2016. Ask students if they have any explanation why Janet Yellen might be number two on the list. It is probably safe to say that many Americans don't even know her name.

1. Donald Trump, president of the US
2. **Janet Yellen, chairman of the Federal Reserve Bank**
3. Bill Gates, founder of Microsoft and the Bill and Melinda Gates Foundation
4. Larry Page, founder and CEO of Google
5. Mark Zuckerberg, founder of Facebook

Hook Exercise: Who Are the Most Powerful People in the US?

Directions: With a partner, make a list of who you think are the five most powerful people in the US and rank them from 1 to 5. Provide a rationale for your ranking in the space next to the name. Think about the different kinds of power different individuals have, including political power, economic power, and cultural power (e.g. the ability to change the interests and tastes of people). Be prepared to explain your thoughts.

The Most Powerful People in the US

Person	Position	Rationale
1.		
2.		
3.		
4.		
5.		

Every year, *Forbes* magazine produces a list of the 100 most powerful people in the world. Your teacher will now read you the names of the top five Americans on the 2016 list. Write their names below. How many of these people made your list? How many of you included the person in the #2 spot? How many of you have ever heard of this person?

1.

2.

3.

4.

5.

Is the Fed Good for America?

If you doubt the importance of the Federal Reserve, reach into your pocket and pull out a dollar bill. What do you see written just above George Washington's face? *Federal Reserve Note.* That's right. Without The Fed, you can't purchase anything from the dollar menu at McDonald's. And you definitely can't buy the next iPhone. The Fed controls our money; therefore, we should understand what the Fed does and how well it does it.

The Fed is our national bank. Originally called the First Bank of the United States, it was created in 1791 at the urging of Alexander Hamilton, the country's first treasury secretary, the bank was controversial from the start. Some felt that a national bank stabilized the economy because it allowed for government borrowing and the printing of money in times of need. Others felt a national bank was unconstitutional and concentrated too much power in the hands of too few people. The bank survived, off and on, until 1836, when Congress voted to abolish it. But the debate continued.


The Federal Reserve Bank in Washington, DC

As the economy industrialized, public support for a national bank grew. Several financial panics caused bank runs that led to numerous bank closings. When a panic occurred, people ran to the bank to pull out whatever cash they could. Small, local banks did not have the funds available and they collapsed; people lost their savings. Because there was no national bank, the **money supply** was fixed and could not expand during times of high demand.

Congress finally acted to deal with this problem, and in 1913 passed a law establishing the **Federal Reserve system.** This system divides power between a board of governors in Washington, DC, and regional banks that control twelve Federal Reserve districts. Members of the board of governors are appointed by the president and approved by the Senate for 14-year terms. The Fed chair is chosen by the president from the board of governors and can serve multiple four-year terms. The Fed chair is perhaps the most visible and scrutinized person in our nation's financial system, but, like the other members of the Fed board, the chair is not an elected official. Although the Fed must report to Congress and respond to its questions, the board members can act independently, without the worry of being re-elected.

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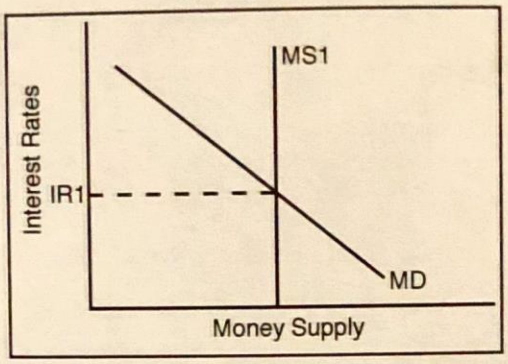
The Fed's main job is to control our nation's money supply through **monetary policy**. The goal of monetary policy is to promote long-term economic growth and stability. The Fed does this by influencing **interest rates** and **inflation rates**.

Let's tackle interest rates first. They are a powerful force in the economy. Think about interest rates as the cost of borrowing money. When interest rates are low, money is "cheap" and the borrower will have less to pay back on the loan. When interest rates are high, money is "expensive" to borrow and more must be paid back on the loan. Lower interest rates tend to stimulate the economy because they encourage consumers to borrow money to buy things, like cars. This results in more cars being built and more auto workers being hired. The opposite is true, too. High interest rates discourage purchasing, which may result in lower production and fired workers.

We see that interest rates are important. But how does the Fed influence these rates?

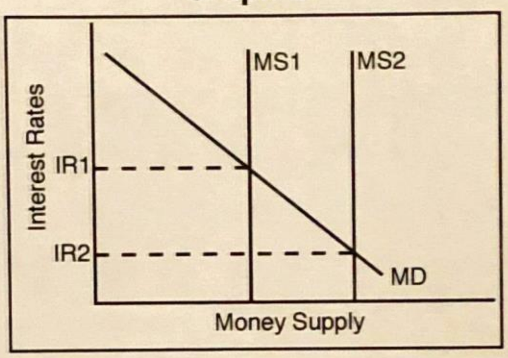
Take a look at Graph A on the following page. This is a money market graph. It shows the relationship between interest rates and the money supply. Note that the supply of money is on the horizontal axis and interest rates are on the vertical axis. Now find the money demand curve (MD). This curve slopes downward to the right because (as explained above) people want to borrow more money when interest rates are low and less money when they are high. The other important element of the graph is the money supply curve (MS1). It is shown as a vertical line because the money supply is fixed at a given point in time. This graph shows that interest rates (IR1) are set at the point where the money supply intersects with the money demand.

Graph A



But what would happen if the Fed were to alter the money supply? Take a look at Graph B. This graph shows that the Fed has increased the money supply from MS1 to MS2, creating a new intersection point for MD and MS2. At this new point, interest rates have gone down from IR1 to IR2, showing that an increase in the money supply causes a decrease in interest rates. This is an example of an **expansionary monetary policy.** (Although it's not shown, you can imagine that if the money supply decreased – that is, the line shifts left – then interest rates would go up.) The reaction you see in Graph B occurs because when more money is out in circulation, more of it will end up in banks. And when banks have more money on hand, they do not charge as much interest when they loan it out.

Graph B



It is important to understand that banks get to set their own interest rates. The Fed can't dictate what the rates should be. Instead, the Fed uses special monetary policy tools you will read about in documents A and B that encourage banks to change their rates.

But wait, there's more! Besides interest rates, the Fed also worries about inflation rates. During periods of inflation, prices are higher, so the money in our pockets does not buy as much as it did in other times. The basic solution to slowing down inflation is to decrease the money supply. This is known as **contractionary monetary policy**. When there is less money in circulation, interest rates go up, which leads to less spending and should cause prices to decrease.

Recent events have proven how difficult the Fed's job really is. Consider these two problems: In the late 1970s and early 1980s, the US economy had high rates of inflation *and* slow economic growth, a double whammy called **stagflation**. The Fed had to decide whether to tackle inflation, which might slow growth even more, or try to boost the stagnant economy even if it led to more inflation. A second big problem occurred in the early 2000s, when the nation experienced a roller coaster rise and fall in stock prices and housing prices. Some economists felt that the sharp price increases were triggered by the Fed keeping interest rates too low, causing the economy to grow too quickly.

The Fed has a lot of influence on what happens in the economy, and because economics and banking are imperfect sciences, the Fed has had to take some real heat when things don't go well. Your task in this Mini-Q is to examine the documents that follow and answer the question, *Is the Fed good for America?*

Background Essay Questions

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1. Historically, why have some people opposed a national bank?

2. What are two reasons why support for a national bank grew in the early 1900s?

3. Economists have described the Fed as a "decentralized central bank"? What do they mean?

4. How do changes in (a) interest rates and (b) inflation rates impact the economy?

5. How would an expansionary monetary policy likely impact (a) interest rates and (b) inflation rates?

6. How would a contractionary monetary policy likely impact (a) interest rates and (b) inflation rates?

7. Define these terms:
   - money supply
   - Federal Reserve system
   - monetary policy
   - interest rates
   - inflation rates
   - expansionary monetary policy
   - contractionary monetary policy
   - stagflation

Timeline

1791 — First Bank of the United States is established

1836 — Second Bank's charter is not renewed

1893 — First of several devastating financial panics cause bank runs

1913 — Federal Reserve Act passes, creating a decentralized central banking system

1980s — Fed Chairman Paul Volcker raises interest rates to tame years of high inflation

1990s — Fed Chairman Alan Greenspan presides over nation's longest economic expansion

2008 — Housing-market collapse causes Fed to drop interest rates to near 0%

Document A

Source: Compiled from various sources, including *Economics: Principles, Problems, and Policies* by C.R. McConnell and S. L. Brue, 2002.

The Fed: How Does It Work? Part I

One of the Fed's most important powers is its influence over the money supply and interest rates. The Fed cannot just set interest rates. Instead, it sets a target for the **federal funds rate**, which is the rate that banks charge one another on short-term loans. Banks are required to keep a certain percentage of their deposits on hand (called reserves). This is to assure the public that its money is always accessible. It discourages panics. Sometimes, an individual bank's reserves fall short of this percentage, so it borrows money from another bank on an overnight basis to make up the difference. The amount of interest banks pay on these loans is the federal funds rate and, because it so crucial to how banks operate, it ends up influencing the rates banks charge on home loans, car loans, business loans, etc. When the federal funds rate is higher, banks charge higher rates of interest on the money they loan out.

The Fed can't just set the federal funds rate. But it can *influence* it, by controlling how much money is in circulation. Expanding the money supply will lower the federal funds rate. Shrinking the money supply can increase the rate.

When the Fed wants to change the rate, it uses **open-market operations** to alter the money supply. Here is how it works: The Fed will either sell or buy securities in the open market, primarily to banks. Most of these securities are government bonds, which are basically IOUs between the Fed and the banks. When the Fed sells a security, it receives money from the bank. In this way, money is taken out of circulation. When the Fed buys a security, money goes back to the bank, putting money back into circulation.

Buying or selling these securities impacts the amount of money in circulation, which impacts the amounts banks charge for loans. So, if the Fed wanted to lower the federal funds rate, it would use open-market operations to buy securities and put more money in the banks. The banks, now with more cash on hand, will not charge as much to one another on overnight loans. In other words, the fedral funds rate has decreased and the Fed's goal is accomplished.

Document Analysis

1. According to the document, what is the federal funds rate and what other rates does it influence?

2. What are open-market operations and how do they impact the money supply?

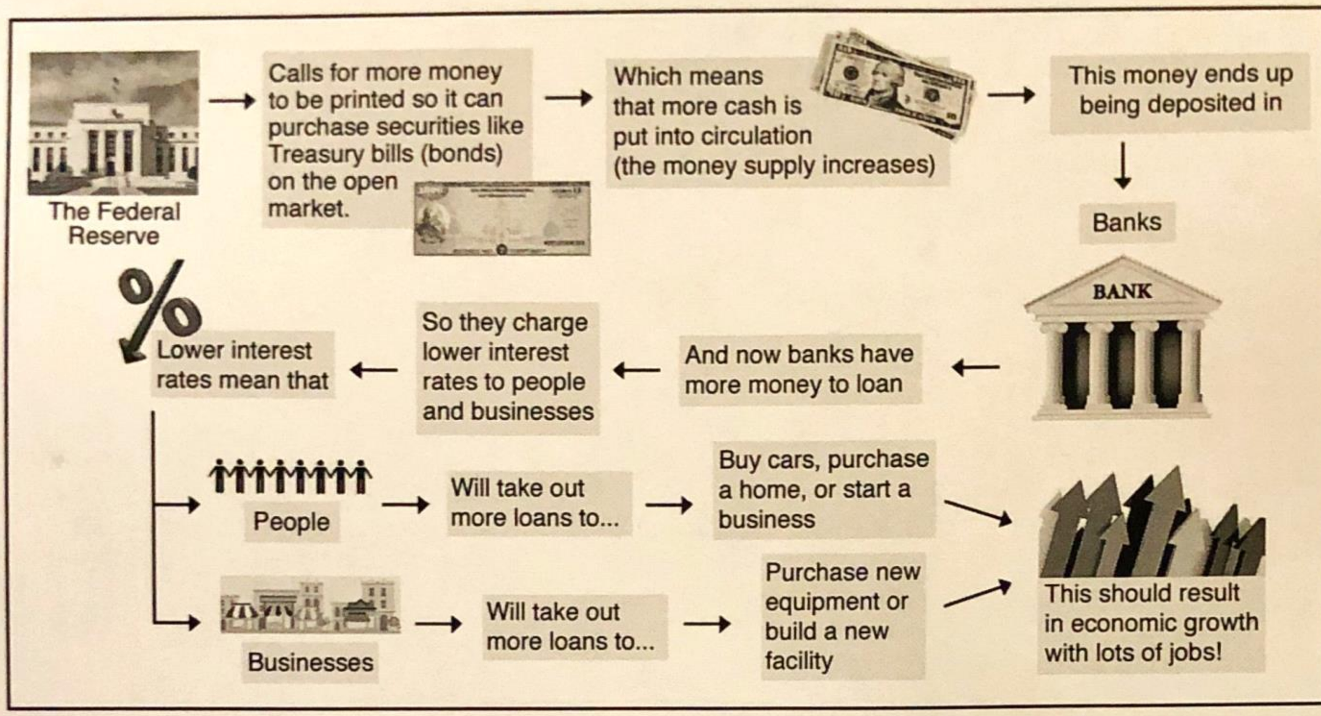
3. What does the Fed do if it wants to influence the federal funds rate? (Hint: Be sure to include open-market operations in your answer).

Document B

Source: Compiled from various sources, including *Economics: Principles, Problems, and Policies* by C.R. McConnell and S. L. Brue, 2002.

Note: This chart shows the chain reaction that occurs when the Fed decides to engage in an expansionary monetary policy through open-market operations. When the Fed wants a contractionary monetary policy, it sells securities and the opposite outcome occurs.

The Fed: How Does It Work? Part II



Document Analysis

1. According to the document, what type of monetary policy is the Fed carrying out and how will it impact the money supply?

2. According to the document, what happens when:
   a. The Fed buys securities?
   b. Banks have more money to loan?
   c. People take out more loans?
   d. Businesses take out more loans?

3. What is the end result of the Fed's decision to buy securities?

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Document C

Source: Compiled from various sources, including "U. S. Economy Experiences 'Soft Landing' in 1995; Look for More of the Same in 1996" by J. Robert Gillette, the University of Kentucky, 1996; and the Federal Reserve Bank of St. Louis.

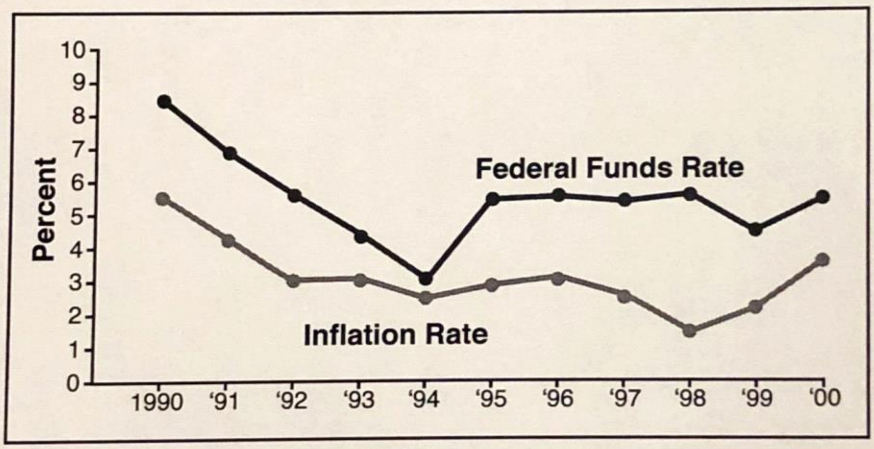
A Fed Success: The "Soft Landing" of 1994

The Economic Situation: "The US economy in 1994 went gangbusters. Real gross domestic product (GDP), the value of all final goods and services produced in the US adjusted for inflation, grew at an annual rate of 4.1 percent, which represents the highest growth rate of real GDP since 1984.… The unemployment rate declined throughout the year, starting at 6.7 percent in January and declining to 5.4 percent in December."

The Fed Response: When the economy starts to slow or inflation starts to rise, the Federal Reserve increases or decreases the money supply to create a **soft landing** for the economy. A soft landing means that the shift in the economy will be gentle. If the economic landing is soft, the turn in the economy will affect fewer people.

One example of a soft landing occurred in 1994. At that time, the economy was emerging from a recession and started growing fast, at a rate of over 4 percent. In a fast-growing economy, the concern is always inflation: People are employed, they spend a lot of money, and prices go up. Given this situation, the Fed increased the federal funds rate, which in turn decreased the money supply.

The Outcome:



Document Analysis

1. According to the document, what was the state of the American economy in 1994?

2. In 1994, what was the Fed's economic concern?

3. Give a step-by-step explanation of how a federal funds rate increase can keep inflation in check.

4. Examine the outcome. Can you make the case that the Fed is good for America? Explain.

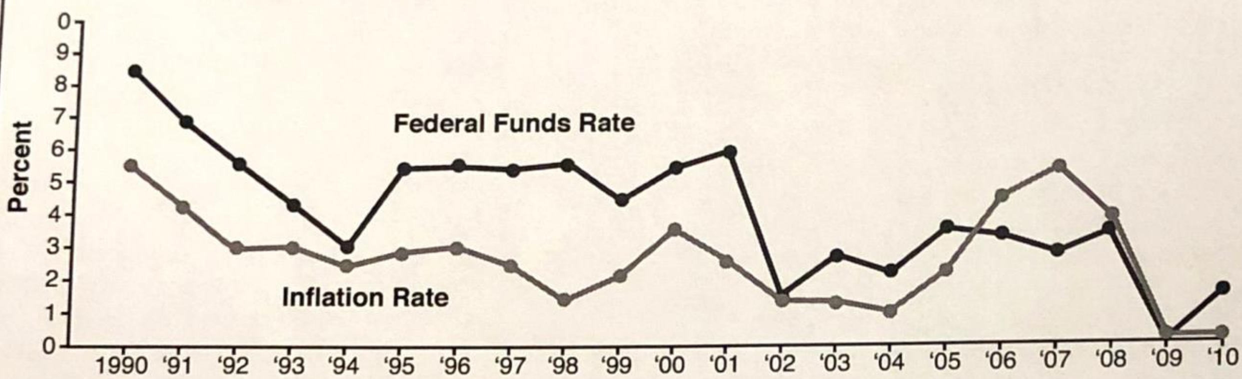
Document D

Source: Compiled from various sources, including *Greenspan's Bubbles: The Age of Ignorance at the Federal Reserve*, by William Fleckenstein and Frederick Sheehan, 2008; and the Federal Reserve Bank of St. Louis.

A Fed Failure: The "Market Bubble" of 2008

The Economic Situation: Ten years after the soft landing of 1994, the economy was doing well. Real GDP growth in 2004 was 3 percent, unemployment was 5.7 percent, and inflation, 2 percent.

The Fed Response: To keep the ball rolling, the Fed chose not to raise the federal funds rate, keeping it at around 1 percent.



The Outcome:

The Fed's decision not to raise the federal funds rate in 2004 led to an unexpected consequence—a market bubble. A market bubble is when the price of something, like houses or stocks, is inflated and sells at a price greater than its actual value. In the early 2000s, the US economy experienced such a bubble in the housing market. Low interest rates encouraged home buyers to overborrow and purchase overpriced houses they really couldn't afford. Eventually, the bubble burst. Real estate prices fell and people were left with loans that were greater than the new value of their houses. Many were unable to make their monthly mortgage payments. Banks foreclosed and buyers lost title to their houses. Critics such as economic analysts William Fleckenstein and Frederick Sheehan blamed the Fed chairman, Alan Greenspan, arguing that "Greenspan erred by continually picking an interest rate that was too low."

Document Analysis

1. According to the document, what was the condition of the American economy in 2004?

2. How did the Fed respond to these economic conditions?

3. During this time, with the federal funds rate set at 1 percent, the US economy was experiencing a bubble in the housing market. What is a housing-market bubble?

4. Examine the outcome. Can you make the case that the Fed is good for America? Explain.

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Document E

Source: "The Case Against an Unaccountable Federal Reserve" by Ron Paul, former congressman from Texas,ronpaul.com, July 2009.

Note: Ron Paul, a libertarian, has been an outspoken critics of the Federal Reserve. He is author of the book *End the Fed* (2009) and ran for president of the United States in 1988, 2008, and 2012.

Politics and the Fed: A Case in Point

"The Worst Sort of Politics"

> [Defenders of the status quo] claim the Fed must remain apolitical. No organization is apolitical that relies on the President to appoint the Chairman. In fact, it is subject to the worst sort of politics.... The Fed typically enacts monetary policy that is favorable to particular administrations close to elections, to the detriment of long-term considerations.

Document Analysis

1. According to the document note, who is Ron Paul and what book did he write?

2. What does it mean to "defend the status quo"?

3. Paul writes, "Defenders of the status quo claim that the Fed must remain apolitical." What does this mean?

4. Does Paul believe that the Fed is politically independent?

5. Does Paul provide an example of "the worst sort of politics"?

6. According to this document, is the Fed good for America?

Document F

Source: Chart compiled from various sources.

Note: Newly elected presidents often retain the Fed chairman from the previous presidential administration.

Chairmen of the Federal Reserve Bank, 1979-2017

Chair	Appointed By	Served Under
Paul Volcker (1979 - 1987)	Carter (D)	Carter (D), Reagan (R)
Alan Greenspan (1987 - 2006)	Reagan (R)	Reagan (R), Bush 1 (R) Clinton (D), Bush 2 (R)
Ben Bernanke (2006 - 2014)	Bush 2 (R)	Bush 2 (R), Obama (D)
Janet Yellen (2014 -)	Obama (D)	Obama (D), Trump (R)

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Politics and the Fed: A Case in Point

"Short-Term Pain for Long-Term Benefits"

Source: Various sources, including the documentary film *Money for Nothing: Inside the Federal Reserve,* 2013.

In the early 1980s, the US experienced a double-whammy, recession and inflation, which are not supposed to happen at the same time. A new word, "stagflation," was coined to describe this unusual occurrence. In response, the Federal Reserve made the difficult decision to raise interest rates in order to reduce inflation, knowing that economic growth would suffer. Slow growth means higher unemployment. The good news was that inflation dropped and the economy did recover. Former Fed vice chairman Alan Blinder supported the Fed's action and its chairman, Paul Volcker: *Had those decisions been left to politicians, it's inconceivable that they would have "voted" for such a deep recession to bring the inflation rate down. That's...a generic flaw of political systems. Ask members of Congress to vote for things that cause short-term pain for long-term benefits and it's pretty hard. It's pretty hard to get the votes.*

Document Analysis

1. Which Fed chairmen served under both Democratic and Republican presidents?

2. Does your answer to question one support or refute Ron Paul's criticism (Document E) that the Fed chairman is in the president's pocket? Explain.

3. What is stagflation?

4. In the early 1980s, how did the Fed deal with stagflation?

5. Is Alan Blinder in favor of Fed independence? Why? Would Ron Paul (Document E) agree?

6. According to this document, is the Fed good for America?