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Students, Economics, and the Federal Reserve

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Social studies teachers are charged with helping students learn one of life's most essential lessons: we can't always get what we want. Rather, scarcity forces us to prioritize and make choices from among our unlimited wants. Though I do not think Mick Jagger and Keith Richards of the Rolling Stones intended that their hit song "You Can't Always Get What You Want" describe the study of economics, the title does capture the fundamental nature of the discipline. Students with an economic understanding are better equipped to understand how their decisions and others' decisions about what to produce and consume determine our standard of living and overall financial well-being.

I became interested in economics long before I had heard of the Rolling Stones and well ahead of my formal education in economics. When I was young, my grandma would recount stories of her life in New England during the worst part of the Great Depression. She described how many of the children in the town where she lived went to school barefoot because their parents did not have money to buy them shoes. When I asked her why, she explained that many people in town had lost their jobs at the local shoe factory. I could not understand why on one side were boarded-up shoe factories and shoe workers with no jobs; on the other, children without shoes. This illustrates the kind of paradox that can occur when our market system does not work the way it should. I learned later that economics helps those of us who study it identify the causes of problems—like the one my grandma described—and, one hopes, find the best solutions. And broad-based economic literacy supports an environment where students can participate in our democracy as well-informed and responsible citizens, whose collective actions may contribute to the effective functioning of our economy, leading to growth and prosperity over time.

A Primer on the Fed

The Federal Reserve System, or "the Fed" as it is commonly called, is the central bank of the United States, and it aims to foster a safe, flexible, and stable monetary and financial system. The Fed uses its policy tools to influence financial conditions and promote maximum employment and stable prices. The Fed—along with other agencies—also supervises and regulates banks; serves as a bank to banks; and clears checks, makes electronic payments, and provides cash and coin to depository institutions. The Federal Reserve strives to act in the best interests of the American people to keep the economy on a path of sustained growth and prosperity.

The Federal Reserve System is composed of the Board of Governors in Washington, D.C.—the government agency of the Federal Reserve—and 12 regional Federal Reserve Banks, which were established by the Congress as the operating arms of the central bank. The seven members of the Board of Governors are appointed by the president and confirmed by the Senate and have general oversight responsibility for the Federal Reserve System, as well as a key role in the Fed's policy decisions. Because of its unique structure, the Federal Reserve is referred to as a "decentralized" central bank. Monetary policy—decisions that influence the availability and cost of money and credit—is made by a Federal Open Market Committee, consisting of the governors at the Federal Reserve Board and the presidents of the 12 regional Reserve Banks, all of whom participate in discussions and deliberations. This structure brings together diverse perspectives and information that informs the Committee's decisions.

The Congress established the Federal Reserve as an independent agency within the government; that is, its decisions are insulated from short-term political pressures. Therefore, the Fed can make choices because they are best for the economy over the longer term even if they are politically unpopular. But the Federal Reserve is "within" the government in that it reports to the Congress under the authority in the Constitution that gives the Congress the power to "coin money" and "regulate the value thereof."

The Federal Reserve conducts monetary policy by influencing financial

Federal Reserve Photo by Britt Leckman

conditions in an effort to promote its objectives of maximum employment and stable prices. To do so, it must lean against the wind by tightening monetary policy when inflationary pressures are building and by easing policy when the economy may be weakening. Typically, when the Federal Reserve tightens policy, interest rates rise, therefore making it more expensive to borrow, which tends to reduce business and household spending. Conversely, when the Federal Reserve eases monetary policy, interest rates fall, therefore making it less expensive to borrow, which tends to encourage business and household spending. In conducting monetary policy, the Federal Reserve attempts to keep total spending in the economy reasonably in line with the economy's potential to produce goods and services—that is, it tries to keep total demand consistent with total supply. By doing so, the Federal Reserve can help to minimize the costs of economic downturns and also keep inflation low and stable over time. A stable economy with low inflation promotes economic growth and contributes to the well being of all Americans.

The Fed: Its Past and Its Future

As the Federal Reserve approaches its centennial anniversary, it seems appropriate to reflect on the past and future of the U.S. central bank and its historical role in the country's economy. The United States has a long history of concerns about concentrating financial power in a single institution. Alexander Hamilton pushed for the creation of a central bank, and his efforts resulted in the creation of the First Bank of the United States in 1791. However, the First and Second Bank of the United States were each granted charters that expired after only 20 years. After the charter for the Second Bank of the United States expired in 1836, the political climate at the time prevented the establishment of a permanent central bank. During the 1800s and early 1900s, the United States suffered frequent and severe financial panics and economic downturns. A particularly severe panic and economic downturn in 1907 finally convinced the public and elected representatives that the United States needed a permanent central bank. After several years of study and debate, the Federal Reserve was established in 1913.

The 1930s stand out as a difficult decade in Federal Reserve history. During the Great Depression, the U.S. and global economy experienced extraordinarily severe financial and economic strains. The U.S. banking system all but collapsed and unemployment rose to the high level of 25 percent of the labor force. It is generally accepted that the Federal Reserve and other central banks around the world at that time did not respond forcefully enough to the unfolding crisis, and the financial and economic problems were made worse because of a poor fiscal policy response and by the actions of some countries to create trade barriers. The failure of the Federal Reserve and other policymakers over this period resulted in the most severe and long-lasting economic downturn in U.S. history.

One of the Federal Reserve's most critical successes in the past century was bringing down inflation beginning in the early 1980s—following the period of very high inflation in the 1970s. During that period, a combination of demand and supply pressures resulted in escalating inflation that became embedded in inflation expectations and in wage and price setting behavior by businesses. The high level of inflation, in turn, contributed

to weak economic performance and also hurt the credibility of the Federal Reserve as the key institution charged with maintaining price stability. The Federal Reserve, under Chairman Paul Volcker, made courageous and politically unpopular decisions in the early 1980s that brought inflation under control; but the policy actions were very costly in terms of the job losses and business failures resulting from the "tight money" policy needed to fight inflation. This period illustrates the problems that can arise when the public begins to anticipate high levels of inflation in the future, and the difficulties of changing those expectations once they become embedded in the behavior of businesses and households.

More recently, the Federal Reserve took the steps necessary to prevent a collapse of the global financial system in 2008 and 2009. Brought on in part by a downturn in housing prices, the recent financial crisis threatened the stability of the entire economy. So, the Fed arranged loans for some interconnected and systemically critical financial institutions to try to limit the negative consequences to Americans. A financial crisis is very damaging to businesses and households, and without these important steps, the economy would likely be much worse off than it is today. Even though the economy still experienced a recession, many more people could have lost their jobs or even more of their investments and savings. As the Federal Reserve dealt with the financial crisis, we were mindful of economic lessons from history. The Fed made money and credit available to prevent deflation, and it took the necessary steps to keep the banking system from collapsing.

The Federal Reserve faces several upcoming challenges. Even though our economy is stabilized and growing, it remains a difficult time for many Americans who have been affected by the recent financial crisis and the resulting recession. The Federal Reserve has a responsibility, along with other policymakers, to ensure that our recovery is sustained.

Another very important imminent responsibility is the implementation of the new financial regulatory reform legislation. The Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in July 2010 and it is the most ambitious overhaul of our financial regulation since the 1930s. The Federal Reserve and other regulatory agencies must implement the law, which requires that we devise and enforce rules and regulations for financial firms and other regulated entities to follow. The Fed must continue to strengthen its supervisory capacity and ensure that we have the resources and talent to succeed.

You and the Fed

The Federal Reserve works to help educators promote financial literacy and economic education. This issue of *Social Education* will provide you with information on how to access free educational materials for you and your students. You can also review our website, **www.federalreserveeducation.org**, which provides a resource search engine for teachers and games for students of various ages and knowledge levels.

Your work is critical to cultivating within students an understanding of economics and the Federal Reserve so that they have the skills and tools necessary to build successful financial futures for themselves and for the nation. Perhaps if they make the right financial choices, students will find that they may not always get what they want but, sometimes, "they get what they need."

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