Brounes & Associates

4607 BRAEBURN DR. ▪ BELLAIRE, TEXAS 77401 ▪ 713.962.9986 ▪ ron@ronbrounes.com

THE ALMIGHTY FED
Just Who are these Guys (Gals) and Why Should I Care?

Federal Reserve Chairman Ben Bernanke has become the EF Hutton of a new generation. (OK, are we dating ourselves?) These days, when Bernanke speaks, people listen. In fact, when any fed officials so much as opens their mouths to discuss virtually any relevant topic, the world seems to slow down for a brief moment as everyone hangs on their every word. The subprime market is spiraling out of control…what does Vice Chairman Donald Kohn think? Oil prices are rising and the dreading "I" word is creeping back into conversations…does Fed Governor Frederic Mishkin have an opinion? How long will the housing sector struggle…what say you, Janet Yellen, President of the San Francisco Fed?

Once upon a time, the mere existence of the Federal Reserve was known to maybe a handful of individuals outside of the nation's top bankers and economists. The met; they spoke; they set policy; and very few people noticed. Then came the 24-hour cable business networks and suddenly those talking heads had to find something to talk about all day. The Internet era ushered in state-of-the-art financial web sites and blogs whose authors tried to differentiate themselves by showing how smart they were. Former Chairman Alan Greenspan seemed to love the limelight and his memorable "irrational exuberance" comments (among others) kept him on the front page of the daily news (well, at least, page two or three).

In any case, while economists and investors (of all shapes and sizes alike) can name many of these fed officials and have the dates of each policy meeting clearly marked on their calendars, most do not know much about the exact role of the Federal Reserve. They can argue until they are blue in the face that the fed needs to cut interest rates, yet few can even differentiate between fed funds and the discount rate (or maybe even the bank's prime lending rate, for that matter). So just who are these guys/gals and why should we care?

The Nation's Central Bank

The Federal Reserve is the country's central bank, responsible for coordinating monetary policy and managing the flow of money supply and credit throughout the economy. It was created as an independent government agency and is required to routinely report to Congress about its activities (and the reasoning behind them). In this role, the Fed exerts influence over the growth of the domestic (and global) economy by monitoring prices, employment, and business productivity. When the economy begins to accelerate beyond acceptable limits, the Fed may limit the money flow (through higher interest rates) to prevent any accompanying price pressures or inflation from rearing its ugly head.

Conversely, when the economy becomes sluggish and recessionary fears begin to emerge, the Fed may increase the flow (through lower rates) so that businesses are better able to produce and consumers can afford to purchase more. This constant balancing act keeps these officials on their toes and subject to much second guessing. A wrong move one way or the other can move the country closer to inflation or recession and subject the Fed to the wrath of the Administration and Congress, the business community, and investors alike.

Funds vs. Discount

In exercising monetary policy, the Fed has several tools at its disposal. The most closely followed rate that investors and economists talk about constantly is known as fed funds which represents the overnight rate at which banks borrow from each other to maintain their reserve requirements. If one bank needs to increase reserves to meet the daily requirements, it will borrow at the funds rate from another bank that has excess reserves at that time. While the Federal Reserve itself is not directly involved in these daily transactions between the banks, it guides the rates by helping control the money flow and setting a target at its policy meetings.

The discount rate, on the other hand, is the lesser known of the two and represents the rate of interest at which banks would borrow directly from the Federal Reserve Bank through what is called the discount window. This rate is typically somewhat higher than fed funds as banks are encouraged to borrow from each other first and only come to the discount window as a last resort. Since banks typically borrow at the lower fed funds rate, decisions related to changes in the discount rate are perceived to be largely symbolic and depict the Fed's focus on the economy. In August, the Fed lowered the discount rate in the face of the subprime debacle a few weeks prior to cutting fed funds. In addition to the more widely watched rate moves, the Fed also buys and sells government securities on a daily basis to control the liquidity within the financial system.

Fed Composition

The Fed is comprised of seven governors who are appointed by the President of the United States and confirmed by the Senate for 14-year terms. The 12 Federal Reserve Districts located throughout the country are each guided by a regional president and board of directors. Eight times a year, the Federal Reserve Open Market Committee (FOMC) meets in DC to discuss the economy and industry sectors across the country and within each region and to set monetary policy. Its 12 voting members (seven governors and five rotating regional presidents) are ultimately responsible for setting policy. These FOMC meetings are widely followed by economists and investors, not only for the exact Fed actions, but also for the accompanying statements that lend insight into the thinking of the policy makers. The comprehensive minutes of the meetings are posted a few weeks later.

The Fed Beige Book is published eight times a year to recap the state of the economy in the 12 districts; it also includes discussions with regional business leaders, economists, and other market sources. In addition to congressional testimonies, Fed governors and presidents routinely make presentations on a variety of economic and financial topics before business trade groups, academic gatherings, industry conferences, and other venues. These days, the subprime mortgage market, the ailing housing sector, and inflation have topped their agendas. Over time, the Fed has been instrumental in guiding the economy through some challenging periods: Black Monday (1987), Long-Term Capital Management (1998), Internet bubble (2000), and now subprime.

Chairman Ben Bernanke took over the reigns at the Fed on February 1, 2006, and had previously served as a Fed Governor and Chairman of the President's Council of Economic Advisors. In his prior life, Dr. Bernanke had been a professor of economics and public affairs at Princeton University since 1985 and was an associate professor at Stanford University. Today, when Dr. B. speaks, people listen (though he doesn't seem to crave the limelight like his predecessor).

The information set forth was obtained from sources which we believe reliable but we do not guarantee its accuracy or completeness. Neither the information nor any opinion expressed constitutes a solicitation by us of the purchase or sale of any securities. Past performance is not a guarantee of future performance.