

THE FEDERAL RESERVE SYSTEM AND ITS ROLE IN TACKLING THE GREAT FINANCIAL CRISIS

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ABSTRACT

The article delves into the pivotal role and operations of the US Federal Reserve System (FED), a cornerstone institution in maintaining financial stability and executing monetary policy, paralleling the European Central Bank's function within the European Union. It outlines the Fed's evolution since its inception in 1913, detailing its decentralized structure comprising 12 regional banks and its overarching mandate to promote price stability, maximum employment, and manage systemic risks. A substantial focus is on the Fed's response to the 2008 Great Financial Crisis. Employing both traditional tools like open market operations and innovative measures including quantitative easing and liquidity provision, the Fed mitigated systemic risks and curbed the crisis's ripple effects. These interventions underscored the institution's adaptability in deploying unconventional strategies to stabilize the financial system. The analysis highlights the Fed's dual role: as a proactive crisis manager during economic upheavals and a stabilizing force during recovery phases. This dual function reflects its enduring significance in shaping both domestic and global economic landscapes while navigating complex challenges posed by evolving market dynamics. Looking forward, a gradual reduction in key interest rates is projected for 2025, aimed at fostering economic recovery. However, vigilance regarding inflationary pressures remains paramount.

Keywords: Federal Reserve, Federal Open Market Committee, key interest rate, financial instruments.

ROLE AND FUNCTIONS OF THE FEDERAL RESERVE SYSTEM

The Federal Reserve System, or FED for short, is the most important monetary policymaker in the United States. It was created in 1913 with the Federal Reserve Act, which established the Federal Reserve Banks and provided monetary security and a flexible amount of cash. The creation of the Federal Reserve System was a response to several 'banking panics', bank failures and economic problems in the 19th century that arose when citizens suddenly tried to convert their bank deposits into cash. The Great Depression of the 1930s and the Great Depression of 2008 further expanded the powers and functions of the Federal Reserve System (Grey, 2002). Legislative reforms, notably the Banking Acts of 1933 and 1935, fundamentally changed the structure of the Fed by concentrating powers in the Board of Governors and creating a Federal Open Market Operations Committee to unify monetary policy decisions (Humpage, 2023). The Federal Reserve System currently consists of 12 Federal Reserve Banks located in the more populous counties (when the law was passed); Boston, New York, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Kansas City, Dallas and San Francisco. This decentralised model also supports the principle of independence of the Federal Reserve System, as it protects against

concentrated political pressure. The Federal Reserve Board (or FRB for short) is based in Washington DC. Each Federal Reserve Bank runs a banking system for the entire federal government. It distributes coins and banknotes and supervises and directs the banks in its area. In addition, member banks, i.e. private banks, are also members of the Federal Reserve System (Mueller, 2016). The main tasks of the Federal Reserve System are to conduct monetary policy that promotes maximum employment, price stability and moderate long-term interest rates in the US economy. It promotes the stability of the financial system by controlling and monitoring the economy in the US and around the world and aims to minimise, limit systemic risks. It promotes the safety and soundness of individual financial institutions as well as the financial system as a whole. It protects consumers and the development of local communities through consumer-oriented supervision, research and analysis to help them (Grey, 2002). Federal funds are reserve deposits held by private banks at the local Federal Reserve Bank. The purpose of this is to create a mechanism that allows private banks to lend funds to each other. Monetary policy exerts its influence by determining how much interest private banks can charge when lending funds to each other. The Federal Reserve System plays a large role in the US payment system. All 12 Federal Reserve banks provide banking services to depository institutions and the federal government. It maintains accounts for depository institutions, facilitates various payment services, transfers funds electronically, etc., and acts as a 'fiscal agent' for the federal government (Humpage, 2023). The Federal Reserve System also occasionally trades in foreign currency-denominated assets, mainly EU and Japanese securities, and thus influences the level of the US dollar. This falls under other assets, which account for less than 5% of total assets, the most important and largest asset item on the US balance sheet being government securities, which typically comprise around 55% of assets - before the crisis around 90% (Foerster & Leduc, 2019). These are mainly Treasury bills and bonds. Legal and institutional frameworks, both statutory and extra-statutory, have shaped the Fed's independence, as evidenced by its changing relationship with the Treasury and Congress. For example, although the statutory framework initially envisaged a limited role for the Fed in monetary policy, non-statutory developments such as court decisions and changes in governance practices have redefined its independence (Conti-Brown, 2016).

STRUCTURE OF THE FEDERAL RESERVE SYSTEM

The Constitutive Act provides for three levels of management with intertwined responsibilities. These are centralised government institutions: the Board of Governors of the Federal Reserve System (FRB), the 12 Federal Reserve Banks, and the Federal Open Market Committee, or FOMC for short. Recommendations, in turn, are proposed by the Federal Advisory Council (FAC for short), the Consumer Advisory Council, and the Thrift Institutions Advisory Council (Gray, 2002). The two key governance committees are the Federal Open Market Operations Committee and the Board of Governors of the Federal Reserve System. The Federal Open Market Committee (FOMC) is the main monetary policy decision-making body of the Federal Reserve System. It has 12 voting members - 7 of the Board Governors and 5 of the 12 regional Federal Reserve Bank Presidents, whose membership rotates. This group oversees the most important and widely used tool of US monetary policy, namely the setting of the target price of bank reserves and the interest rate. The Board of Governors of the Federal Reserve System is composed of 7 members appointed by the President and confirmed by the Senate. Their tasks are economic and financial analysis and the drafting of legislation on credit to the public (St. Louis Fed, n.d.). The 12 Federal Reserve Banks together make up the Federal Reserve System (Fed),

the largest of which is the New York Fed, which is the only one that also holds its reserves in gold. The banks are not entirely public, as commercial banks in the District also have some ownership. A central bank can only be effective when it is independent in making monetary policy decisions and these decisions are made with a degree of accountability and transparency (Adrian & Khan, 2019). This is why the Federal Open Market Operations Committee, unlike the European Central Bank, communicates a lot of information about its activities. However, it is difficult to find information that is actually useful to the public in this volume" (Cecchetti, 2006).

OBJECTIVES OF THE MANAGEMENT OF THE FEDERAL RESERVE SYSTEM

The primary objective of the Federal Reserve has never been price stability, which is the main objective of the European Central Bank (ECB). The origins of the current monetary objectives can be traced back to the post-World War II period (Apel, 2003). As a consequence of the economic collapse and the Great Depression, a law was created which stated that the most important objectives of the US in this area were to maximise employment, output and purchasing power. The war brought huge budget expenditures and the US Congress feared a possible recession. As a result, monetary policy was not based on price stability but on debt financing. In the US, inflation and too low aggregate demand emerged after 1970, and Congress passed the Full Employment and Balanced Growth Act. The following objectives were adopted: maximum employment, output, rising real income, balanced growth, a balanced federal budget and at least loose price stability. In addition, the stability of interest rates and of foreign exchange and financial markets was modified (Bordo, 2021). The Federal Reserve System influences the level of the interest rate, called the federal funds rate, by means of government securities. At this rate, depository institutions borrow money from each other overnight. The Federal Open Market Committee sets target interest rates for trading in the Federal Reserve market. Lower interest rates, and thus a larger money supply, are passed through the financial system to businesses and consumers, which in turn stimulates investment and consumption, and thus economic growth. The potential danger of low interest rates is inflation - price inflation. This is why interest rate cuts are particularly relevant in times of recession, when the potential for inflation due to a fall in aggregate demand is much less likely (Hillenbrand, 2021; Shambaugh et al., 2021). "For many decades, the key interest rate has been the primary instrument of monetary policy in the United States. When it fell to almost zero in 2009, the Federal Reserve implemented large purchases of Treasury and mortgage-backed securities as an alternative instrument to influence long-term interest rates" (Hamilton, 2019). For example, Federal Reserve Chairwoman Janet Yellen during Obama's presidency saw maximum employment and price stability as the Fed's main objectives, while current US President Trump would like to see a change in exchange rates to help his trade policy (STA, 2019).

Federal Reserve System instruments

The traditional monetary policy instruments of the Federal Reserve System can be divided into three subgroups (similar to the ECB):

- Open Market Operations (OMOs for short)
- reserve requirements
- discount rate

These instruments help to achieve the ultimate goals of a successful economy; low inflation and unemployment, and rapid growth in output. Open market operations are the most common

monetary policy instrument of the Federal Reserve System. These operations include purchases and sales of U.S. government securities. The purpose is to influence the quantity of bank reserves by influencing their price. There are permanent and temporary open market operations. Permanent operations are usually used to accommodate long-term factors that encourage the expansion of the Federal Reserve System's balance sheet. These are purchases and sales of securities. Temporary operations, on the other hand, are used to meet reserve requirements. These operations include repos and reverse repos. Reserve variations are the setting and changing of the legal reserve ratio on deposits with banks and other financial institutions. Legal reserve requirements are an important part of the mechanism that allows the Federal Reserve System to control the money supply. The discount rate policy consists of setting the interest rate, called the discount rate, at which commercial banks and other depository institutions can borrow funds from the Federal Reserve Bank. At one time, the discount rate policy was the primary means of providing reserves to the Federal Reserve. The Federal Reserve System offers primary, secondary and seasonal loans, each with its own interest rate. Unlike open market operations, which affect the supply of short-term funds in the market as a whole, loans directly affect individual institutions through the discount rate. Another difference is that open market operations are conducted using government bonds (Hayes, 2024), whereas discount rate lending allows for a wider range of possible collateral.

Newer instruments have emerged since the global financial crisis, which showed that the traditional ones were not effective enough. New mechanisms have been introduced; the ECB has mainly introduced instruments to provide liquidity to the banking system, while the Federal Reserve System emphasises instruments to provide liquidity in financial markets, as the US economy is financed to a greater extent than the EU through financial markets. Newer instruments of the Federal Reserve System include (Berger et al., 2017; Cecioni et al, Term Auction Facility (lending to depository institutions that are in financially sound condition), The Primary Dealer Credit Facility (overnight lending that provides private sector financing in exchange for some form of collateral), Commercial Paper Funding Facility (increasing liquidity in the commercial paper market in the shorter term by providing greater stability for both issuers and investors). There are also instruments to provide more liquidity in an international environment (Swap Deals - providing dollar liquidity abroad and foreign liquidity in the US).

THE ROLE OF THE FED IN TACKLING THE GREAT FINANCIAL CRISIS

It's been more than 15 years since the collapse of the US investment bank Lehman Brothers. This is considered to be the beginning of the global financial crisis and the worst recession since the Second World War, which also hit Slovenia. The main causes of the crisis were mainly deregulation and too little supervision of the US financial industry, combined with a very expansionary monetary policy previously conducted by the Federal Reserve (Jenko, 2018). In 2008, a liquidity crisis threatened the survival of many large financial institutions in the US. The Federal Reserve bailed out firms such as Bear Stearns and AIG with emergency loans, but it did not bail out Lehman Brothers, which was left without money to operate. Lehman Brothers was declared bankrupt in September 2008, which was followed by an acceleration of the financial crisis around the world (Mishkin, 2011). At the time, the US economist Bernanke stated that Lehman Brothers could only be saved by breaking the law, which he considered inappropriate.

The ECB and the Federal Reserve played a key role in resolving the global financial crisis. They did so quite well, through so-called standard and non-standard measures. The Federal Reserve's most important interest rate is the federal funds rate. It does not change this rate directly, but through the regulation of open market operations. It was 5.25% before the crisis, but the lowest level during the crisis was only 0.25%. Another very important interest rate is the discount rate, at which banks borrow funds overnight directly from the Federal Reserve. Its value is always set below the key interest rate, as the Fed's desire is to limit borrowing at the discount rate (Mishkin, 2011).

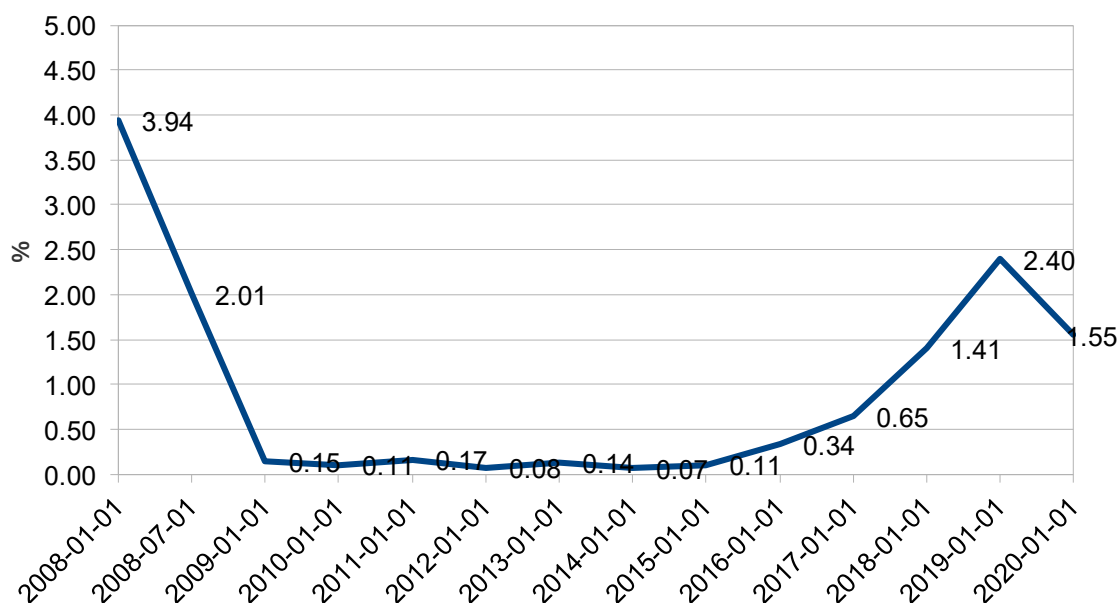


Figure 1: Key interest rates 2008-2020 (adapted from: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis)

The reduction of the key interest rate to almost zero meant that all options to resolve the financial crisis through the normal monetary policy instruments were exhausted. They therefore had to resort to non-tariff measures, which, when implemented, have an impact on the balance sheet assets of the US economy (Trifonova & Kolev, 2021). The first group of measures consisted of operations that provide short-term liquidity to financially sound institutions. They have created new facilities to conduct auctions and allow 'primary buyers' as well as banks to borrow funds at a discount rate (Cecchetti, 2009). An example of these measures is the reduction of the maturity of discount loans from overnight to 90-day loans. The Federal Reserve System has also created the Term Auction Facility programme, which provides desired liquidity to depository institutions through auction sales. The Primary Dealer Credit Facility also provides liquidity funds indirectly to businesses. These measures have the effect of reducing the spread between the key rate and the discount rate. The second group of measures sought to change the direct supply of liquidity to borrowers and investors in the credit markets (Allen & Carletti, 2008), by allowing the purchase of commercial paper with a high credit rating and a maturity of 3 months, and by providing a liquidity buffer for the mutual fund money market. When some important funds collapsed in 2008, investors began to withdraw funds from the money market, where certificates of deposit and commercial paper are traded, in large numbers. In response, the Federal Reserve

System has put in place facilities that allow banks to purchase facilities that allow them to buy highly rated commercial paper from mutual funds. This has successfully transferred liquidity to the funds and helped them to repay their obligations to investors without incurring excessive losses from asset sales. The Fed, together with the US Treasury, has put together a special joint facility that has allowed the issuance of securities that also use student loans and loans backed by the US Small Business Administration as collateral (Gramigma, 2012). The third group of measures to keep credit markets functioning includes purchases of long-term securities that the Federal Reserve can use to increase its assets. Examples of these measures are the purchase of USD 100 billion of debt by the government in support of business and the purchase of USD 500 billion of mortgage-backed securities. These measures have resulted in lower mortgage interest rates, which are expected to support the real estate sector (Kohn, 2010). The third group of measures to keep credit markets functioning includes purchases of long-term securities that allow the Federal Reserve to increase its assets. Examples of these measures are the purchase of USD 100 billion of debt by the government in support of business and the purchase of USD 500 billion of mortgage-backed securities. These measures have resulted in lower mortgage interest rates, which are expected to support the real estate sector.

These interventions were designed to reduce systemic risk and prevent a catastrophic financial meltdown. Evidence shows that liquidity assistance and open market operations have been effective in reducing systemic risk, with OMOs showing a particularly strong statistical relationship with systemic stability. However, the impact of so-called lender of last resort measures has been mixed, with some measures possibly even exacerbating moral hazard by encouraging risky behaviour by banks (Sedunov, 2021). Critics argue that rapid and large-scale interventions signalled implicit guarantees, which encouraged risky behaviour and contributed to financial fragility. For example, the securitisation of risky mortgages and lax regulatory oversight contributed significantly to triggering the financial crisis, and the subsequent resolution raises questions about the bearers of liability and moral hazard (Schoen, 2017).

CONCLUSIONS

The Fed is not bailing out banks because it is interested in financial interests, but because it is pursuing limits to "systemic risk" (Özgöde 2022). During the Covid-19 crisis, the Fed reactivated many of the measures introduced in the great financial crisis, including quantitative easing and liquidity provision, but the context was different. This crisis was primarily a "Main Street" crisis, not a banking crisis, and rapid government responses mitigated systemic risks more effectively. Therefore, the link between Fed actions and the reduction of systemic risks was weaker during Covid-19 than during the Great Financial Crisis (Sedunov 2021). Nevertheless, interventions such as the extension of open market operations to a wider range of financial instruments were key to maintaining liquidity and market confidence. The Federal Reserve System continues the process of reducing its balance sheet at the end of 2024 and the beginning of 2025. This process, called quantitative tightening, is being undertaken to reduce the amount of money in circulation, prevent the economy from overheating, and curb inflation, which has again become a significant macroeconomic challenge in recent years. The Fed considers that the current key interest rate of between 4.25% and 4.50% is appropriate given the current economy, but it is projected to fall gradually in 2025 (US Bank 2024).

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