CHAPTER THREE

Relationship of the Federal Reserve Bank and The U.S. Treasury Department

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Purpose of the Federal Reserve

U.S. Treasury Department

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Money Origination

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Purpose of the Federal Reserve ("The Fed")

The Federal Reserve
The central bank of the United States.

The Federal Reserve is the bank to the commercial banking system, and the banker of last resort.

- The Fed is the bank to the banks.
- The Central Bank: a national bank that provides financial and banking services for its country's government and commercial banking system - conducts monetary policy by manipulating the supply of money.
- An independent institution that typically works hand-in-hand with the government and was created by the Federal Reserve Act of 1913.

Purpose of the Federal Reserve ("The Fed")

The Fed is comprised of 12 regional banks and 25 branches.

Led by the Board of Governors – seven (7) people

- Nominated by the president and confirmed by the senate
- Each board member serves in this position for 14 years

The Board of Governors' most important job is overseeing the Federal Open Market Committee (FOMC)

- FOMC - allows the Board to carry out its monetary policy, seeking to bring stable levels of employment and moderate inflation

The U.S. Treasury Department

The U.S. Treasury Department
The department of the U.S. government that is responsible for managing government accounts, collecting tax revenue, overseeing issuance of debt and paying bills.

- Created by congress in 1789 with the purpose of managing the country's money
- Many branches of the Treasury department, including the Internal Revenue Service (IRS)
  - The IRS is the collection agency for the Treasury
  - Money collected goes to paying the government's bills

The Fed and The Treasury

The Fed and The Treasury work together to carry out their respective duties to promote economic health.

- The Fed serves as the government's bank.
- The Treasury manages the government’s money

The Fed is a non-profit organization.

- All funds are returned to the Treasury’s account at the Fed
- Disbursements are made from the Treasury’s account to different government funded programs

Where does money come from?

Money originates from the U.S. Bureau of Engraving and Printing (branch of Treasury)

- Department charged with printing paper money for delivery to the Federal Reserve

The U.S. Mint (branch of Treasury)

- Department has authority over coins

Where does money come from?

After the creation of money, the Fed purchases the money from the treasury.

- The purchase credits the Treasury's account at the Fed - counted as an asset, which is a debit on the account entry
- The Fed sells the money to regional Federal Reserve banks - counted as a credit on the account
- Banks carry the currency as assets on their balance sheets

The Fed makes a profit by selling the money to Regional Federal Reserve banks at face value – the profit is called Seigniorage.

Where does money come from?

All profit made from the sale of currency is returned to the Treasury - benefits the U.S. citizens because it may eventually reduce taxes.

The start and end of the value system of money starts and ends with the government.

- Money is simply a representation of liabilities of our government
- The defined value is based on what the government promises to honor during the exchange process
- The U.S. government will only accept U.S. money in payments for taxes

Deficits and Debts

While debt and deficits are related, they are defined as different terms:

- National Debt - the total amount of money that a country's government has borrowed
- Government Deficit- a shortfall in a government's income compared with its spending over a given period of time

A deficit adds to the national debt.

- Short term debts are financed through the sale of Treasury Bills.
- Long terms debts are financed through the sale of Treasury Bonds.

Government Bonds

Government Bond
A form of security sold by the government.

- Often called a fixed income security because it earns a fixed amount of interest every year for the duration of the bond

Government bonds are issued to raise money for government operations.

The price of government bonds is influenced by future value and present value.

- Future value - the value of an asset at a specific future date
- Present value -the current value of a future sum of money or stream of payments, based on a specific rate of return

Government Bonds

A bond price is calculated by the following function:

Bond Price = \$C/(1+R) + \$C/(1+R)^2 + \$C/(1+R)^3 + …. + \$C/(1+R)^29 + (C+F)/(1+R)^30

Where C is the coupon payment, R is the interest rate, and F is the face value

The Fed is involved in bond purchases.

- The Fed will purchase treasury securities in times of low economic confidence
- The purchase of bonds causes both benefits and drawbacks to citizens
- Once economic confidence is restored, neutrality returns to the equation

Government Bonds

The economy becomes wealthier when GDP rates are higher than the growth rate of debt.

It is crucial to pay attention to the efficiency of the government's spending – it will lead us to economic health or economic destruction.

Wise spending will improve the ratio of debt to GDP and can return the economy to equilibrium.