

Demystifying the Federal Reserve

Structure, Tools, and Limits

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February 2026

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INTRODUCTION

This project grew out of ignorance—my ignorance. During and following the Global Financial Crisis (“GFC”), when debate regarding the Federal Reserve Bank (the “Federal Reserve” or the “Fed”) often dominated newspaper headlines and news shows, I found myself struggling to understand exactly how the Federal Reserve operated and what it was trying to accomplish. Without being arrogant, it was clear to me that if I were struggling to understand what was going on, individuals without my education and work experience in finance, law and banking had no possible chance of having even the remotest clue about the historic events occurring around them.

I started reading and reading and reading. If you look on my website in the section on Business and Finance reading you will find lots of titles regarding the Federal Reserve, its history and operations. Some of it was helpful. But most of it was written for insiders or written with a political purpose in mind that stripped it of its pedagogical value.

This is not an academic question. Having at least a basic idea of how the Federal Reserve operates is essential to understanding our banking system as well as the economy—how recessions unfold, how recoveries take shape, and perhaps most importantly why the benefits and burdens of monetary policy are distributed unevenly across society. Knowing the history of the Federal Reserve, its evolving mission and tools is also critical to appreciating why the Fed is so often asked to do more than it was ever designed to do—and why it inevitably disappoints expectations.

The goal of this project is simple but ambitious: to make the Federal Reserve intelligible to readers who have never studied finance, banking, or economics, without oversimplifying the reality or retreating into useless jargon. We will focus on how things actually work, not how they are described in the press or political speeches.

If you stick with this, you should have a better understanding of this crucially important institution. You should be able to look at a headline about interest rates, quantitative easing, or financial stress and say, I understand what they’re trying to do—and why it might or might not work. Where you want to go with that understanding is totally up to you.

That understanding is the foundation for any serious conversation about the modern economy. Without it, we are left reacting to developments we don’t fully grasp, arguing about an institution we don’t really understand, and sometimes mistaking complexity for conspiracy.

This is my personal attempt to help change that—one tiny step at a time.

1: Why the Federal Reserve Is So Widely Discussed—and So Poorly Understood

The Federal Reserve is a constant presence in the background of American economic life. Its decisions influence—to a greater or lesser extent—interest rates, financial markets, and credit conditions. When things are going well, it fades into the background. When something goes wrong—financial crisis, inflation, recession—it is front-page news, dominating the headlines, blamed or praised by business leaders, academics and politicians. While some of these folks may know what they are talking about (not the politicians), the American public is left to look on in bewilderment, looking for lucid explanations that are never forthcoming. As a consequence, the Fed remains one of the least understood institutions in public life.

This is not surprising and certainly not the public's fault. While the Federal Reserve sits at the center of the U.S. financial system, it operates largely out of sight. The Federal Reserve does not resemble any of the myriad of institutions most people encounter in their daily lives. It does not produce goods or services, set wages, build factories (or data centers). It does not levy taxes or pass laws. Much of its work takes place in markets and through mechanisms that are largely invisible unless something goes wrong. Even when the Federal Reserve is in sight it is incredibly opaque. As a result, the Fed is often discussed in abstract or symbolic terms rather than understood as an operating institution with a narrow set of specific tools operating under significant constraints.

Ask a room full of educated adults what the Fed does, and to the extent you don't get blank stares you'll likely hear a familiar list: it sets interest rates, it prints money, it bails out banks. Some may reference a vague "dual mandate" to control inflation while supporting full employment. None of these statements is entirely wrong—but none of them is very precise or helpful and together they don't form a coherent and meaningful picture.

This often-referenced "dual mandate" formalized by Congress long after the Fed's creation, shapes almost all public conversation and debate and is the standard against which the institution is judged. The dual mandate also frames much of the public frustration with the Fed, especially when outcomes fall short of expectations. But these mandates, important as they are, do not explain how the Fed actually operates or the mechanisms through which it seeks to influence those outcomes.

To understand the Federal Reserve, it is not enough to know what it is expected to achieve. We need to understand what it actually does—the Fed's day-to-day work—the tools it has at its disposal, how those tools function, and the financial plumbing through which their effects flow. It is critical to remember that over time, the structure of our economy, the financial system, and the way the Federal Reserve operates within it have all changed almost beyond recognition.

We begin, therefore, with a discussion of the financial system that existed before the creation of the Fed—a financial system that repeatedly broke down under stress—despite the presence of discipline, prudence, and private safeguards. For ease of understanding we are going to approach this from two distinct vantage points. First, in Section 2 we are going to discuss the liability side of banks’ balance sheets and the constant risk of a bank run. Second, in Section 3 we will turn our attention to an even lesser understood aspect of the banking system—settlement, which creates a host of different challenges and problems. The two are certainly intertwined—but let’s walk before we try to run. Understanding that earlier system, and why it failed, is the first step toward understanding why the Federal Reserve exists at all.

2: Before the Fed: A Financial System Without a Backstop

Imagine you are running a perfectly respectable and profitable commercial bank in the United States in the late nineteenth century. The bank takes deposits from local businesses and households. It makes loans to merchants, farmers, and manufacturers. You hold some cash in your vault, keep balances with correspondent banks in larger cities, and invest the rest in loans and securities designed to earn a positive spread over the cost of your deposits. If you are prudent, you try to maintain a margin of safety—enough liquid assets to meet normal withdrawals and unexpected needs. There are no regulations defining what is prudent and safe, and you know that practices at banks vary widely.

In the ordinary course of business, your depositors do not all demand their money at once. Withdrawals are made, but loans are repaid; new deposits arrive. Confidence sustains the system, and the fact that the system is working—money is regularly moving in and out of the bank—masks the fragility of the bank, how thin its actual liquidity is, and how little cash is sitting in the vault. This should surprise no one. Cash in the vault is idle, earns no interest, and contributes nothing to the profitability of the bank.

In this system, “money” was not a single, uniform thing controlled by a central authority. In the late nineteenth century, money consisted primarily of gold coin, silver coin, and paper notes issued either by the federal government or by nationally chartered banks. Many of these notes were backed, directly or indirectly, by government bonds or specie. But most transactions did not involve physical money at all. Instead, payments were made using bank deposits—balances recorded on a bank’s books that could be transferred by check. These deposits functioned as money because they were widely accepted, even though they were simply liabilities of private banks rather than claims on a central authority. The supply of money expanded and contracted largely through the private decisions of banks, constrained by their access to cash and the confidence of depositors. There was no institution charged with managing the overall supply of money or ensuring that liquidity was available when the system as a whole came under stress.

Most of the time, this worked—until it didn’t. There were times when many depositors wanted cash at the same time. Unfortunately, cash has never been something a bank can summon at will. But as a bank you must provide it—or close your doors.

Rumors spread easily. News traveled surprisingly fast, even without modern communications. A failure at one bank—perhaps in another city—could raise doubts about banks everywhere. Depositors began to wonder whether their money was really safe. A few people showed up to withdraw funds “just to be safe.” Others noticed the line and grew uneasy. Soon the line grew longer. We all remember Bailey Bros. Building & Loan Association from “It’s a Wonderful Life.”

From your perspective as a banker, the problem is not that your loans are bad. The vast majority of them are perfectly sound. **The problem is the nature of banking itself.** Banks incur liabilities in the form of deposits made by customers which are by their nature short term. On the other hand, much of banking is about making long-term loans. Those loans generally cannot be turned into cash quickly, if at all, without significant losses. If you sell assets (*i.e.* loans) to meet withdrawals, you do so at distressed prices. That weakens your balance sheet, which further erodes confidence. What began as a liquidity problem starts to look like a solvency problem—even if it never truly was one.

This dynamic feeds on itself. You try to borrow from other banks, but they are facing similar pressures and are reluctant to lend. Everyone wants liquidity at the same time. In this world, even well-managed banks can fail; not because they made reckless loans, but because fear spreads faster than cash can move. When enough institutions face the same problem at the same time, the financial system “seizes up.” Payments are delayed. Credit disappears. Businesses that depend on short-term financing are forced to cut back or shut down. Workers lose jobs. The real economy feels the consequences of a breakdown that began entirely within the financial system.

The private banking system tried to support itself. Clearinghouses attempted to coordinate responses. Strong banks supported weaker ones. Influential financiers (e.g. J. Pierpont Morgan) stepped in during moments of crisis. These efforts sometimes worked—but they were improvised, uneven, and dependent on cooperation that could not be guaranteed when fear was widespread.

The essential problem remained unresolved. There was no **lender of last resort**. There was no institution, public or private, charged with supplying liquidity to the system as a whole when confidence collapses. As a consequence, there was no mechanism to separate temporary panic from genuine insolvency. The stability of the financial system depended on confidence alone—and confidence, once shaken, is extraordinarily difficult to restore.

In the decades following the Civil War, the United States experienced repeated banking panics and financial crises that followed this same basic pattern. Periods of rapid economic growth were punctuated by a sudden loss of confidence, widespread withdrawals, bank failures, and sharp contractions in credit.

The Panic of 1873, the Panic of 1893, and the Panic of 1907¹ were not isolated accidents. They were recurring manifestations of a financial system without a reliable backstop. In

¹ If you are interested in reading more about this, I highly recommend Bruner and Carr, [The Panic of 1907: Lessons Learned From the Market's Perfect Storm](#) (New York: John Wiley and Sons, 2007). I routinely assigned this book to my students, and they seemed to really enjoy it.

each case, stress within the banking system quickly spilled into the broader economy, triggering business failures, unemployment, and prolonged economic disruption.

The Federal Reserve was in large part created to address this problem²—not to manage the economy, not to fine-tune growth, and not to allocate credit across society, but to provide a stabilizing center to a system that lacked one. Understanding that original problem is the first step toward understanding what the Fed does today—and what it was never designed to do.

² The creation of federal deposit insurance in 1933 fundamentally altered this dynamic by reducing the incentive for insured depositors to run in response to rumors or localized distress. While deposit insurance has significantly reduced the frequency of retail bank runs, it does not eliminate liquidity risk, particularly in wholesale funding markets or for uninsured deposits.

3: Before the Fed—How Money and Credit Were Constrained

As we have just seen prudent bankers kept some of the funds deposited with them in their own vaults or at other banks to ensure they had adequate liquidity to meet customer demands. This operated as a meaningful constraint on the financial system though it certainly did not prevent bank runs and panics. But remember that while gold and currency sat at the base of the system, when banks made loans, they typically (as they do today) credited deposit accounts or issued notes, thereby expanding the effective money supply. But this process was not unconstrained. Even before the creation of the Fed there were several factors that operated to restrain the creation of money.

The most important constraint—but one which is very poorly understood—operated through the requirements of interbank settlement. When a bank extended a loan, it created a deposit³—but that deposit did not remain confined to the originating bank. Borrowers spent the funds, and those payments flowed to other banks. A check written on one bank might be deposited at another, triggering an obligation between the two institutions. At that point, the originating bank incurred an obligation to settle with its peers. Before the creation of the Fed and the advent of reserves (discussed in section 6), that obligation had to be met with specie or currency. A bank that expanded lending more rapidly than others would consequently experience net outflows of settlement assets as payments cleared. Moreover, the same balances that banks relied upon to meet customer withdrawals were also needed to settle interbank payments. This created a binding operational constraint. If those outflows became sufficiently large, the bank would be forced to curtail lending, sell assets, or attempt to raise cash under unfavorable conditions. This requirement did serve as a significant constraint on the creation of money and credit. However, it did so unevenly and could be very pro-cyclical, tightening precisely when the system was already under strain.

Correspondent banking added another layer of constraint—and fragility. Smaller banks held balances with larger institutions in financial centers, treating those balances as reserves. In normal times, this arrangement provided flexibility. In periods of stress, it transmitted panic outward. When correspondents hoarded liquidity or suspended payments, smaller banks were left exposed. What appeared to be a reserve turned out to be another promise in a long chain of promises.

In major cities, clearinghouses attempted to impose collective discipline. Member banks shared information, coordinated responses, and in crises issued temporary instruments designed to conserve cash and maintain payments. These arrangements helped at the

³ You can be forgiven for confusion here (and perhaps even a bit of a headache) as loans involve deposit accounts as well. The point to keep in mind is that a customer creating a deposit with external funds is generating a bank liability; a bank extending a loan to a customer through a deposit account is creating an asset of the bank (*i.e.* an obligation of the customer to repay).

margin. But they were local, voluntary, and reactive. They depended on cooperation at precisely the moment when self-preservation was most rational.

Finally, there were personal and reputational constraints. In many periods, bank owners faced personal liability. Failure could mean ruin. Reputation mattered. These factors encouraged caution—but they also encouraged extreme defensiveness when confidence wavered. Hoarding liquidity and refusing to lend were rational responses for individual banks, even though they destabilized the system as a whole.

Taken together, these mechanisms imposed discipline on individual banks. They worked tolerably well in calm conditions but often failed simultaneously under stress. Individual banks faced real limits on expansion, yet no institution could ensure its own liquidity in the face of a system-wide loss of confidence. **The financial system as a whole was highly fragile, setting the stage for recurrent crises that were always painful and sometimes devastating.**

Only with that context in place does the modern Federal Reserve begin to make sense.

4: The Federal Reserve's Core Function — Systemic Stability

The Federal Reserve was created in 1913 to stabilize a financial system that, though disciplined by bankers and settlement mechanics, was structurally fragile and prone to recurrent panics. The Federal Reserve was designed first and foremost as a stabilizing institution. Its purpose was to reduce the likelihood that ordinary stresses—shifts in confidence, fluctuations in credit demand, or temporary shortages of liquidity—would cascade into crises that disrupt the broader economy. This stabilizing role is the thread that connects the Fed's original creation to its modern responsibilities, even as its tools and formal mandates have evolved over time.

It is important to be precise about what “stability” means in this context. The Fed is not tasked with preventing all economic downturns, eliminating risk, or guaranteeing favorable outcomes. Financial systems, by their nature, involve uncertainty, risk-taking, and periodic adjustment. Stability does not mean stasis. It means preserving the basic functioning of the system—payments clearing, credit flowing, institutions remaining solvent—so that the economy can adapt without collapsing.

This focus on systemic stability reflects the lesson embedded in the Fed's origin story. Before the Fed, discipline existed, but it was self-imposed and enforced through the fragility of the entire banking system. Banks were constrained by the threat of sudden withdrawals, settlement pressures, and the loss of confidence. Those mechanisms worked tolerably well in calm periods but often failed systemically under stress. The Fed was created to change the nature of that discipline—not to remove it, but to coordinate it.

Initially, the Fed had two core functions each of which we will explore in some detail in the following two sections. First, the Federal Reserve assumed the role of lender of last resort. When a bank faced unusually large demands for cash or settlement balances, it could obtain liquidity by borrowing from the Fed against qualifying assets, rather than being forced to liquidate loans under distress. This function addressed a core vulnerability of banking: the inherent mismatch between short-term liabilities and longer-term assets. By centralizing settlement and supplying liquidity to solvent institutions under stress, the Federal Reserve reduced the likelihood that localized liquidity problems would escalate into system-wide collapses.

The other mechanism the Fed used to promote system-wide stability was the introduction of reserve requirements, which obligated banks to hold specified percentages (*i.e.* fractions) of reserves against certain deposit liabilities, with those reserves held either in vault cash or as balances at the Federal Reserve. Hence, the term “fractional reserve banking.” These reserves supported both customer withdrawals and interbank settlement, providing a uniform and reliable settlement asset for the system as a whole.

To be clear, the Fed did not invent fractional reserve banking, which had long been a defining feature of the system. However, it did formalize and centralize the discipline that had previously operated in a fragmented and uneven way.

Over time, the Fed's role expanded beyond crisis prevention, even as its original stabilizing function remained intact. In 1977, Congress formally expanded the Fed's responsibilities, charging it with promoting price stability and maximum employment—goals that now dominate public discussion of the institution. These new objectives are real and consequential. But they do not alter the fundamental way the Fed operates. It influences financial conditions—liquidity, interest rates, credit availability, and confidence—that impact economic behavior over time, though often in ways that are not fully predictable.

This distinction matters. The Fed is judged by outcomes it can only influence indirectly, using tools originally designed to stabilize a financial system rather than to fine-tune the economy. That gap between responsibility and control helps explain both the intensity of public debate surrounding the Fed and the persistence of frustration with its performance.

Seen in this light, the Fed's various activities—lending to banks, supervising institutions, setting the price of reserves, expanding or contracting its balance sheet—are not independent or ad hoc. They are different expressions of the same core function: maintaining stability in a system where instability can spread quickly and impose large costs on the economy as a whole.

The sections that follow examine these functions one by one. Rather than starting with abstract goals or policy debates, they focus on what the Fed actually does day in and day out, how its tools work, and how those tools are meant to support the objectives the Fed is ultimately held accountable for achieving. Only by understanding that machinery can we sensibly ask whether the Fed is succeeding, where its limits lie, and what it can—and cannot—be expected to deliver.

The most fundamental of these tools—and the one closest to the Fed's original purpose—is its role as lender of last resort. We begin there.

5: Lender of Last Resort — Preventing Liquidity Stress from Becoming Collapse

The most fundamental tool the Federal Reserve possesses, and the one most closely aligned with its original purpose, is its role as lender of last resort. This function exists to address a specific and recurring problem in financial systems: the tendency for liquidity stress to spread rapidly, turning otherwise manageable strains into full-blown crises.

At its simplest, a lender of last resort is an institution willing to lend when others will not. But that description, while accurate, is incomplete. The Fed's role is not primarily to intervene after panic has taken hold. It's more important task is to act early enough—and credibly enough—to prevent panic from taking hold in the first place.

To understand why this matters, it is helpful to return briefly to the distinction between liquidity and solvency. A solvent institution has assets that exceed its liabilities. A liquid institution has enough immediately available cash or funding to meet near-term obligations. The two are related but not identical. The essence of banking is to borrow short-term and lend long-term. Banks routinely hold assets that are sound but not easily or quickly converted into cash. Funding sources, however, can shrink or even disappear in a matter of days.⁴ In calm conditions, this poses little problem. Under stress, it can be fatal.

The lender-of-last-resort function exists to bridge this gap. By providing liquidity against sound collateral, the Fed allows institutions to meet short-term demands without being forced to sell long-term assets at distressed prices. In doing so, it prevents liquidity problems from becoming solvency problems—and, critically, prevents those solvency fears from spreading through the system.

Eligible collateral refers to assets the Federal Reserve is willing to accept as security for its loans. These typically include high-quality loans and securities that can be reasonably valued and are expected to retain their worth under stress. While the precise definition has evolved over time—particularly as financial markets themselves have changed—the underlying principle has remained consistent: the Fed lends against collateral it believes will ultimately be repaid, even if markets are temporarily unwilling to provide funding.

Timing and credibility are central. If market participants believe that liquidity will be available when needed, many runs never begin. Depositors do not rush to withdraw funds. Lenders do not pull back preemptively. In this sense, the most successful lender-of-last-resort interventions are often invisible. When the system holds together, it can appear as though nothing happened at all.

The Fed carries out this role through several mechanisms. The most traditional is the discount window, through which banks can borrow directly from the Federal Reserve

⁴ In March 2023 Silicon Valley Bank (“SVB”) experienced a run and \$40 billion of deposits were withdrawn from the bank on a single Thursday. The expectation was for an even bigger run the following day. I wrote about SVB's failure in my article “As Unbelievable As It First Appeared” which you can find on my website, www.simonjawitz.com.

against eligible collateral. In principle, this is a straightforward tool. In practice, it is complicated by the fear that banks utilizing the discount window will be viewed as weak or in distress. Either is a stigma banks are anxious to avoid. Consequently, institutions are often reluctant to borrow openly from the central bank, fearing that doing so will signal weakness to markets or counterparties. Managing this tension—ensuring access to liquidity without encouraging over reliance by particular banks or instigating a panic—is a recurring challenge.

In normal times, borrowing through the discount window is minimal, often amounting to only a few billion dollars or less across the entire banking system. During periods of acute stress, however, usage can rise sharply, sometimes reaching into the hundreds of billions of dollars as institutions seek short-term funding. This pattern reflects the window's role as a backstop rather than a routine source of financing.

During the 2008 financial crisis, discount window borrowing rose from negligible levels to well over \$100 billion as institutions sought liquidity amid widespread stress. A similar surge occurred in March 2023 during regional banking turmoil, underscoring the window's role as a backstop when private funding markets retrench.

During periods of broader stress, the Fed has also relied on standing facilities designed to provide liquidity on an ongoing basis under predefined terms. These permanent facilities are intended to smooth routine strains in funding markets and to anchor expectations about liquidity availability, even outside of crisis periods. Their presence reduces the likelihood that ordinary stress escalates into panic. For example, the Standing Repo Facility allows eligible counterparties to borrow reserves overnight against Treasury and agency securities at a predetermined rate, helping to prevent short-term funding markets from spiking above the Fed's policy target.

In extraordinary circumstances, the Fed has supplemented these standing tools with temporary emergency programs created in response to specific market breakdowns. These programs are typically narrow in scope, time-limited, and withdrawn once conditions normalize. They reflect the reality that no standing framework can anticipate every form of financial stress in advance, while still maintaining a commitment to restraint and eventual withdrawal. During the GFC the Fed created the Primary Dealer Credit Facility to provide short-term funding to key market participants when private liquidity evaporated.

Importantly, the lender-of-last-resort function is not about shielding institutions from losses or insulating them from the consequences of poor decisions. The Fed does not—and cannot—make insolvent institutions solvent through lending alone. Its role is narrower and more precise: to ensure that temporary shortages of liquidity do not trigger unnecessary failures and cascading collapse.

These liquidity operations inevitably affect the quantity and composition of money and credit in the system, a subject we will return to later when discussing monetary policy and

the money supply. But their immediate purpose is not to manage aggregates or fine-tune economic outcomes. It is to stabilize confidence at moments when confidence is most fragile.

Seen in this light, the lender-of-last-resort function is not an emergency add-on to the Fed's responsibilities. It is the foundation on which the rest of its tools rest. Without a credible backstop, supervision loses much of its force, monetary policy becomes less effective, and the financial system reverts toward the same fragile equilibrium that prevailed before the Fed's creation.

The sections that follow build outward from this core function, examining how the Fed supports the daily functioning of the financial system and how it seeks to influence broader financial conditions over time. But it is here—at the point where liquidity stress is either contained or allowed to spread—that the Fed's stabilizing role is most clearly revealed.

6: Reserves, Settlement and the Operational Core of the Fed

Much of the Federal Reserve's most important work happens far from headlines and far from moments of crisis. Every day, the Fed operates the core infrastructure that allows money to move reliably through the financial system. This function is so routine, and so consistently successful, that it is almost entirely invisible—until it fails.

Failure, in this context, means that institutions hesitate to make payments because they are unsure whether incoming payments will arrive as expected. When banks delay or refuse to settle obligations, even briefly, routine transactions back up, funding markets tighten, and liquidity is hoarded. What is normally automatic becomes conditional—and the system begins to seize up.

This is not merely a theoretical risk. During the GFC, disruptions in short-term funding markets brought the payments system under acute strain. Following the failure of a major financial institution, banks became uncertain about their counterparties and increasingly reluctant to part with liquidity. The danger was not that money vanished, but that routine payments would no longer be made with confidence. Extraordinary central bank intervention prevented widespread settlement failures—but the episode revealed how quickly the system can seize up when trust breaks down.

At the center of this system are **reserve accounts**. A reserve account is best thought of as a bank's deposit account at the Federal Reserve. These balances exist only on the Fed's books and can be held only by eligible financial institutions, not by households or businesses. Unlike customer deposits, reserves are created by the Federal Reserve itself—typically when it lends to banks or purchases financial assets. The importance of reserves to the banking system is hard to overstate. They form the foundation of the modern payments system and through that provide vital stability to the entire financial system.

In the first instance reserves are used to settle payments between banks; they do not circulate in the broader economy. When one bank owes another money at the end of the day—because customers have written checks, made electronic payments, or transferred funds—those obligations are settled by moving reserves across accounts at the Fed. This may sound mechanical, but its significance is profound. A modern financial system depends on the ability to complete payments with certainty and finality. When a payment is settled in reserves at the Federal Reserve, it is final because it is discharged in central bank money. There is no counterparty risk beyond the central bank itself. This eliminates a vast web of uncertainty that would otherwise exist if banks had to rely on one another's promises to settle obligations.

The Fed's role as settlement agent also enables it to fulfill a broader stabilizing function. Because all banks ultimately settle through the Fed, the central bank occupies a unique position at the center of the system. It can observe stresses as they emerge, supply liquidity where needed to keep payments flowing, and ensure that temporary disruptions do not cascade into broader breakdowns. In practice, this means ensuring that banks have access to reserve balances—either by lending them directly or by adding reserves to the system—

so that payment obligations can be settled even when private funding markets are under strain.

Before 2020, reserve requirements obligated banks to hold specified amounts of reserves against certain deposit liabilities, most notably transaction deposits (such as checking accounts that can be withdrawn on demand). These requirements acted as a constraint on bank lending, limiting the deposits that could be loaned to customers. However, the process was indirect, and it is worth taking a moment to appreciate how it actually operated.

Reserve requirements did not limit lending directly at the moment a loan was made. A bank would extend a loan to a customer by crediting the customer's deposit account. Once funds left the bank, a binding settlement obligation was created. The originating bank was required to transfer reserves to complete payment. It was at that point the bank needed to ensure that it had sufficient reserves to meet the settlement obligation and to comply with minimum reserve requirements. If reserves became scarce relative to settlement or deposit liabilities, the bank could borrow reserves from other banks or the Fed. Moreover, reserve requirements were measured over a maintenance period. All of this explains why the classic textbook paradigm—a bank receives \$100 deposit, has a 10% reserve requirement, and therefore can loan only \$90 to customers, was always a gross oversimplification.

Over time the Fed began to provide reserves more elastically. In March 2020, amid the onset of the pandemic, the Federal Reserve reduced reserve requirements to zero. This move did not represent a sudden abandonment of discipline. By that point, the Fed had long been operating in an abundant-reserves framework in which reserve quantities were determined primarily by balance sheet policy, and short-term interest rates were controlled through administered rates rather than reserve scarcity. Required reserves had become largely non-binding. Eliminating them simplified the regulatory framework without materially altering the way monetary policy was implemented. Banks remained constrained by capital requirements, liquidity standards, and market discipline—not by fixed reserve ratios.

Today, banks are not constrained in their lending by fixed reserve requirements.⁵ However, reserves continue to play a central role in the activities of the Federal Reserve. Rather than acting as an absolute cap on the volume of loans made by a bank, the Fed manages the supply of reserves to place direct pressure on short-term interest rates. When reserves are scarce relative to banks' demand for settlement and liquidity, short-term interest rates rise; when reserves are abundant, those pressures ease. Through this and related mechanisms, the Fed directly influences short-term interest rates and indirectly broader financial conditions.

⁵ There are other regulatory regimes that impact directly and indirectly the amount of lending that banks can undertake. These are enforced by both Federal and state agencies. A fuller discussion of these rules is contained in Appendix A. While the Fed is responsible for enforcing these rules with respect to a relatively small set of "systematically important banks", its primary roles continue to revolve around stability, payments and its dual mandate.

Recognizing that without a reliable payments system the Fed would lose its ability to effectively pursue any policy goals, it is to those topics we now turn.

7: How the Federal Reserve Implements Monetary Policy

Monetary policy refers to the set of actions the Fed undertakes to pursue its statutory objectives under the **Federal Reserve Act of 1913**, as amended. Most notably, the **1977 amendments** clarified that the Fed is charged with promoting both price stability and maximum sustainable employment. As noted above in section 1, this is often referred to as the Fed’s “dual mandate.” The tools described in this section are the means by which the Federal Reserve seeks to advance those congressionally defined goals.

From Monetary Quantities to Interest Rates

For much of the twentieth century, monetary policy was often discussed in terms of quantities: the money supply, bank reserves, and measures such as **M1 and M2**. These frameworks reflected an earlier operating environment in which reserves were relatively scarce, and reserve requirements were binding. Over time, however, it became clear that monetary aggregates provided an unstable and unreliable guide to policy. Banks did not make lending decisions based on excess reserves; attempts to steer the economy by targeting money supply growth produced uneven results.

Modern monetary policy therefore operates primarily through **interest rates**, not reserve or other monetary quantities. Rather than attempting to control how much credit banks create, the Federal Reserve seeks to influence the **price of short-term liquidity**. By shaping short-term interest rates, the Fed affects (but by no means controls) borrowing costs, asset prices, and financial conditions more broadly, which in turn influence spending, investment, and risk-taking throughout the economy.⁶

Milton Friedman famously argued that inflation is “always and everywhere a monetary phenomenon.” At a high level, this insight remains valid: sustained inflation cannot occur without sustained expansion of nominal spending, which ultimately reflects monetary and financial conditions. What has changed is not the importance of monetary policy, but the mechanism through which it operates. Modern central banks influence inflation primarily through interest rates and financial conditions rather than through direct control of monetary aggregates. The relationship between measured money supply growth and inflation has proven unstable in practice, even if the broader principle—that persistent inflation reflects persistent monetary accommodation—remains conceptually sound.

A Brief Word on the Money Multiplier

The familiar “money multiplier” was a simplified way of thinking about how deposits could expand under an earlier regulatory and monetary regime, when reserve requirements were binding and reserves were scarce. It was never a description of how banks actually made lending decisions, and it does not describe how monetary policy is implemented

⁶ For a compelling argument that the Fed’s control over interest rates is much exaggerated, *see* “Fed Up With Fed Talk? Central Banks and Interest Rates—Fairy Tales and Facts”, Prof. Aswath Damodaran, NYU Stern School of Business, 9/18/2024.

today. Banks extend credit based on capital, risk, and demand, while the Federal Reserve supplies reserves elastically to support its interest-rate objectives. In short, the multiplier is best understood as a historical teaching device rather than a guide to modern policy.⁷

The Federal Funds Market: The Policy Anchor

At the center of the Federal Reserve's operating framework is the **federal funds market**, where banks and certain other institutions lend and borrow reserve balances overnight. The interest rate on these transactions—the **federal funds rate**—serves as the Fed's primary policy target.

The federal funds rate matters because it anchors a wide range of other short-term interest rates. Rates on Treasury bills, repurchase agreements, and other money-market instruments tend to move closely with it. Importantly, the Fed does not set the federal funds rate by decree. Instead, it influences the rate by managing the supply of reserves and the terms under which reserves are held.

The Fed's Core Tools for Controlling Short-Term Rates

Historically, the Federal Reserve relied on **open market operations**—the purchase and sale of government securities—to adjust the supply of reserves in the banking system. Buying securities added reserves, selling them drained reserves. These transactions were conducted with a group of designated **primary dealers**, who acted as intermediaries between the Federal Reserve and the broader financial system. Because primary dealers were deeply integrated into Treasury and funding markets, transactions between the Fed and these firms quickly influenced asset prices, funding rates, and liquidity conditions throughout the market.

Before the GFC reserves were deliberately kept scarce. Because reserves earned no interest, banks sought to hold as few as possible, making short-term interest rates sensitive to relatively small changes in reserve supply. This allowed the Fed to control the federal funds rate through fine adjustments to reserve quantities.

Following the global financial crisis, the scale of the Fed's balance sheet expanded substantially, and the operating framework evolved. While open market operations were historically the Federal Reserve's primary tool for controlling short-term interest rates, the post-crisis expansion of reserves led to an operating framework in which administered rates—such as **interest on reserve balances**—played a more central role. By paying interest on the reserves banks hold at the Federal Reserve, the Fed establishes a floor

⁷ My advice is to forget about the concept.

beneath short-term interest rates. Banks have little incentive to lend reserves in the market at rates below what they can earn, risk-free, from the central bank.

Standing facilities, including the discount window and other permanent liquidity backstops, reinforce this framework by placing an upper bound on short-term rates. Because eligible institutions can obtain reserves directly from the Federal Reserve on demand, against approved collateral and at a known rate, they have little reason to borrow in private markets at higher rates. Together, administered rates and standing facilities form an interest-rate corridor that in practice keeps short-term market rates aligned with the Fed's policy target.

What the Federal Reserve Can—and Cannot—Control

By controlling short-term interest rates, the Federal Reserve influences financial conditions throughout the economy. It does not, however, control lending decisions, asset prices, or economic outcomes directly. Banks decide whom to lend to. Businesses and households decide whether to borrow. Longer-term interest rates reflect expectations about inflation, growth, fiscal conditions, and risk, and can move independently of the Federal Reserve's actions. At times, long-term rates have risen even as the Fed has reduced its policy rate, reflecting shifts in inflation expectations or fiscal outlook rather than immediate central bank decisions.⁸ Understanding these limits is essential. The Federal Reserve is powerful, but not omnipotent. Its tools shape the environment in which economic decisions are made; they do not determine those decisions outright.

To understand how the Federal Reserve implements these policies in practice, we must look more closely at its balance sheet — the operational foundation of everything described above.

⁸ This was clearly evident during the period 2023-24.

8. The Federal Reserve's Balance Sheet and Large-Scale Asset Purchases

The Fed's Balance Sheet is the Basis of All of Its Activities

The interest-rate framework described in the previous section operates through the Federal Reserve's balance sheet. To see how, we need to examine that balance sheet directly. This is not an accounting curiosity or a technical detail reserved for specialists; it is the mechanism through which reserves are created and supplied to the banking system. Because reserves are the settlement asset of the financial system, any sustained change in their quantity must originate on the balance sheet of the Federal Reserve.

Like any corporate or personal balance sheet, the Fed's has assets and liabilities. On the asset side are Treasury securities, agency mortgage-backed securities, and loans extended to depository institutions through various facilities. On the liability side are reserve balances held by banks and physical currency in circulation. Physical currency appears on the Fed's balance sheet as a liability because it represents a claim on the Federal Reserve—just like reserve balances—rather than an asset the Fed owns. Like any other entity with a balance sheet, when the Fed expands its assets, its liabilities must expand as well; when assets contract, liabilities contract with them. That is Accounting 101. In this sense, changes in the Fed's balance sheet are not ancillary features of monetary policy—they are its operational foundation.

This framing helps avoid a common source of confusion. The Fed does not “inject money into the economy” in a vague or metaphorical sense. It changes the composition and size of its balance sheet, and in doing so alters the quantity of reserves available to the banking system. Understanding that mechanism is essential to developing an intuitive understanding of the Fed's operations, and it provides the foundation for examining asset purchases and quantitative easing.

How Asset Purchases Create Reserves

When the Federal Reserve purchases assets, it does not transfer existing money from one account to another. It creates **new reserve balances** by crediting banks' accounts at the Fed. The mechanics are straightforward. The Fed buys securities—typically from primary dealers—by crediting the reserve account of the dealer's bank. The Fed's assets increase by the value of the securities purchased; its liabilities increase by the same amount in the form of newly created reserves.

Although transactions are conducted with primary dealers, their impact is not confined to those institutions. As already noted in Sec. 7 primary dealers sit at the center of Treasury and funding markets, so adjustments to their balance sheets quickly transmit through repo markets, money markets, and the broader financial system.

It is important to emphasize what these operations are—and are not. From the perspective of the private sector as a whole, asset purchases are largely an exchange of one asset for another: Treasury securities are swapped for reserve balances. No household or business

receives spendable income as a direct result of the transaction. The immediate effect is on balance sheets and financial conditions, not on spending.

Reserves Versus Deposits: Clearing a Persistent Confusion

A frequent source of misunderstanding is the distinction between reserves and bank deposits. Asset purchases increase reserves, not deposits. Reserves are created exclusively by the Federal Reserve and circulate only within the banking system. Deposits, by contrast, are created by commercial banks when they extend credit and circulate in the broader economy.

This distinction matters because reserves cannot “leak” into the real economy on their own. Households and businesses do not hold reserve accounts at the Fed, and reserves cannot be used to purchase goods or services directly. Their role is to settle obligations between banks and to anchor short-term interest rates. Whether increased reserves ultimately lead to more lending or higher spending depends on decisions made by banks, borrowers, and investors—not on the mere presence of reserves themselves.

Recognizing this separation helps explain why expansions of the Fed’s balance sheet do not mechanically translate into proportional increases in inflation or economic activity. Reserves are a necessary part of the financial infrastructure, but they are not, by themselves, a transmission mechanism to the real economy. This was evident during the GFC, when the Federal Reserve dramatically increased reserve balances, yet banks largely accumulated excess reserves rather than expand lending to the private sector.

Routine Balance Sheet Operations Versus Quantitative Easing

Since the GFC the term quantitative easing (“QE”) has become a part of the public lexicon. However, not every asset purchase by the Federal Reserve constitutes quantitative easing. This distinction matters because conflating routine balance sheet operations with QE has led to widespread misunderstanding of what the Fed is doing—and why.

Historically, the Federal Reserve conducted asset purchases as part of ordinary open market operations to manage reserves and maintain control over short-term interest rates. These purchases—involving short-dated securities such as Treasury bills—were operational in purpose: they helped offset routine fluctuations in reserves arising from Treasury spending, tax collections, and changes in currency demand, so that money markets remained stable and overnight rates stayed aligned with the Fed’s target.

Quantitative easing emerged in a very different context. The Fed’s first large-scale asset purchase programs were undertaken during the GFC, after short-term interest rates had been pushed to their effective lower bound and conventional rate policy could no longer provide additional support. In these circumstances, QE was introduced as a supplementary tool rather than a replacement for interest-rate policy.

From a legal standpoint, QE did not require new Congressional authorization for the classes of assets purchased. The Federal Reserve Act already granted the Fed authority to purchase U.S. government securities and certain agency securities in open market operations. QE represented a change in the scale and purpose of those purchases, not a change in the underlying legal framework.

QE refers to large-scale purchases undertaken specifically to influence broader financial conditions when rate policy has reached its limits—by removing longer-duration securities from private portfolios and replacing them with bank deposits for non-bank investors and reserve balances within the banking system. The intent is to affect longer-term interest rates and broader financial conditions, rather than simply to maintain control over overnight funding markets.

While it is true that long-term interest rates are influenced by many factors outside the Fed’s control—including inflation expectations, growth prospects, fiscal dynamics, and global capital flows—empirical studies by Federal Reserve researchers and academic economists⁹ have generally found that QE programs lowered longer-term Treasury yields, primarily by compressing term premia. By removing duration risk from the market, large-scale asset purchases can bid up the prices of longer-term securities and lower their yields, even if the magnitude of those effects varies across time and market conditions.

This distinction also helps in understanding contemporary headlines. Asset purchases undertaken to manage reserves or support market functioning may expand the Fed’s balance sheet, but they do not carry the same policy implications as QE programs explicitly designed to ease financial conditions beyond what short-term interest rates alone can achieve.

What Quantitative Easing Is Trying to Achieve

Quantitative easing is best understood not as an attempt to increase the quantity of money circulating in the economy, but as an effort to influence financial conditions when conventional interest-rate policy has reached its limits. Once short-term rates are at or near zero, the Federal Reserve can no longer provide additional stimulus by lowering the overnight policy rate. QE is an attempt to work around that constraint.

The primary channel through which QE operates is often described as the “portfolio balance channel.” By purchasing large quantities of longer-duration Treasury securities and agency mortgage-backed securities, the Fed removes duration risk and, in the case of

⁹ See, for example, Gagnon et al. (2011), “Large-Scale Asset Purchases by the Federal Reserve: Did They Work?,” *FRBNY Economic Policy Review*; Krishnamurthy & Vissing-Jorgensen (2011), “The Effects of Quantitative Easing on Interest Rates,” *Brookings Papers on Economic Activity*; and Bernanke (2020), *21st Century Monetary Policy*.

mortgage backed securities, prepayment risk from private investors' portfolios. Investors who sell those securities receive bank deposits, which are more liquid but offer lower yields. In response, they may seek to rebalance their portfolios toward other longer-term or riskier assets, bidding up their prices and lowering their yields.

QE may also operate through a signaling channel. Large-scale asset purchases can reinforce the Fed's commitment to maintaining accommodative financial conditions for an extended period, shaping expectations about the future path of short-term interest rates. Even if the direct effect on long-term yields is modest, the signal conveyed by QE announcements can influence market behavior and confidence.

Finally, QE can play an important role in market functioning, particularly during periods of stress. By acting as a large and reliable buyer of key securities, the Fed can stabilize markets that have become illiquid or dysfunctional, helping restore normal price discovery and trading activity.

What Quantitative Easing Cannot Do

While QE can influence financial conditions, it has important limitations. Most notably, the Federal Reserve cannot use QE to force banks to lend, households to borrow, or businesses to invest. Asset purchases alter the composition of balance sheets and relative prices, but they do not compel private actors to take on additional risk or spending.

QE can influence asset prices by lowering yields and supporting financial markets, but those effects do not translate uniformly into broader economic activity. Rising asset prices do not guarantee stronger consumption, investment, or wage growth, and their economic impact depends on how households and firms respond.

Recognizing what QE cannot do is essential to evaluating it realistically. It is a tool for influencing financial conditions, not a substitute for fiscal policy, structural reform, or private-sector risk-taking.

Treasury Operations, QE, and the Myth of "Debt Monetization"

Because QE involves the Federal Reserve purchasing government securities, it is often described as "monetizing the debt." This characterization is potentially misleading and obscures the distinct roles of the Treasury and the Fed.

Treasury spending, tax collection, and debt issuance all affect the level of reserves in the banking system. Treasury spending adds reserves; tax collection and debt issuance drain them. These flows occur automatically as a consequence of how payments are settled through the Treasury's account at the Fed. The Federal Reserve does not control these flows, but it must respond to them to maintain control over short-term interest rates.

QE is not undertaken to finance government spending. When the Fed purchases Treasury securities, it does so in secondary markets, typically from primary dealers, and for

monetary policy purposes. The objective is not to provide funding to the Treasury but to influence financial conditions by altering the composition of assets held by the private sector.

Critics sometimes argue that by purchasing Treasury securities and holding down interest rates, the Federal Reserve is implicitly supporting government deficits. It is true that Fed purchases can lower Treasury yields and reduce the cost of government borrowing. But this effect is indirect and incidental, not the objective of policy. The Fed does not purchase securities to fund government spending, and it has no control over fiscal decisions. Lower borrowing costs are a byproduct of monetary policy aimed at financial conditions, not evidence of deficit financing. Whether one views that indirect effect as beneficial or problematic depends on one's broader views about fiscal and monetary interaction. What matters institutionally is that the Fed's mandate is monetary, not fiscal.

Why Balance Sheet Size Still Matters in a Rate-Based Regime

Even in a framework where short-term interest rates are the primary policy tool, the size and composition of the Federal Reserve's balance sheet continues to matter. Large and persistent changes in reserve supply can affect money market functioning, risk-taking, and the transmission of monetary policy.

An environment of abundant reserves tends to reduce volatility in overnight funding markets and makes it easier for the Fed to maintain control over short-term rates using administered rates such as interest on reserve balances. Conversely, an environment in which reserves become scarce can lead to sudden funding stresses, as seen in episodes where small imbalances in reserve supply produced outsized market reactions, such as the September 2019 disruption in overnight repo markets.

The Fed's standing facilities—such as repo and reverse repo operations, which allow institutions to borrow from or lend to the Fed at preset rates—interact closely with its balance sheet size, helping establish effective upper and lower bounds on short-term interest rates. These facilities reduce the likelihood that temporary fluctuations in reserve demand will translate into instability in money markets.

In practice, the Federal Reserve influences short-term interest rates by managing the supply of reserves through its balance sheet and by setting the terms on which those reserves can be borrowed or held. As noted in Sec. 7, the balance sheet determines the quantity of reserves in the system; administered rates and standing facilities determine their price. Together, these tools allow the Fed to maintain control over short-term rates.

From Tools to Tradeoffs

By this point, the mechanics of the Federal Reserve's balance sheet and its use of asset purchases should be clearer. These tools allow the Fed to supply reserves, influence interest rates, and stabilize financial markets—but they do not eliminate uncertainty or resolve the underlying tradeoffs inherent in monetary policy.

Understanding how the Fed operates is a necessary precondition for evaluating what it can be asked to do. However, it does not resolve the deeper questions about what it should be asked to do or how competing economic objectives ought to be balanced. With the tools now laid out, the next step is to examine the mandates, constraints, and tensions that shape how those tools are deployed in practice.

9. Mandates, Independence, and the Limits of Central Banking

The Federal Reserve’s Mandate: Then and Now

When most Americans think about the Federal Reserve’s job, they think of inflation and employment. That association is understandable, but it reflects a later evolution of the Fed’s role rather than its original purpose.

The Federal Reserve was created in 1913 in response to repeated financial panics and a banking system that lacked a reliable backstop. Its early mission focused on financial stability: providing an elastic currency, serving as a lender of last resort, and improving the functioning of the payments and settlement system. The Fed was not originally conceived as a macroeconomic manager charged with steering employment or inflation across the entire economy.

That changed over time. As the U.S. economy grew more complex—and as expectations about government responsibility for economic outcomes expanded—Congress gradually broadened the scope of economic policymaking. The Employment Act of 1946 articulated a national commitment to promoting maximum employment, production, and purchasing power, though it did not directly amend the Federal Reserve Act or assign new responsibilities to the Fed itself. Rather, it reflected a broader shift in how economic performance was understood as a matter of public concern.

In 1977, Congress amended the Federal Reserve Act to formalize the Fed’s “dual mandate”—a shorthand that subsumes the statute’s three stated objectives: maximum employment, stable prices, and moderate long-term interest rates. This expansion of responsibility is important for two reasons. First, it underscores that the Fed’s modern role is the result of explicit legislative choices, not institutional mission creep. Second, it helps explain why debates about the Fed often feel so charged: the institution is now tasked with objectives that are central to economic well-being but inherently difficult to define, measure, and achieve simultaneously.

What the Mandate Does—and Does Not—Actually Require

Although the Federal Reserve’s mandate is often summarized succinctly, it does not provide a precise operating rule. Terms such as “maximum employment” and “stable prices” define objectives, not instructions. They require interpretation, judgment, and continual reassessment as economic conditions evolve.

Maximum employment, for example, is not uniquely defined or directly measurable. It depends on demographic trends, productivity, labor market dynamics, and structural features of the economy that lie largely outside the Fed’s control. Similarly, stable prices must be translated into an operational definition—such as an inflation target—adopted by the Federal Reserve for purposes of policy implementation.

As a result, the mandate inevitably involves tradeoffs. Actions taken to restrain inflation may slow economic activity or weaken labor markets in the short run; efforts to support employment may risk higher inflation if pursued too aggressively. The mandate does not resolve these tensions. It requires the Fed to navigate them.

This is a critical point for understanding both the power and the limits of central banking. The Fed's mandate defines the objectives it is meant to pursue, but it does not dictate the path it should take to reach them. That path must be chosen in real time, under uncertainty, using tools that influence financial conditions indirectly rather than controlling economic outcomes directly.

Independence: What It Means—and What It Does Not

Debates about the Federal Reserve frequently invoke the concept of independence, often without clarity about what that independence actually entails. In institutional terms, Fed independence refers to operational independence, not political autonomy.

The Federal Reserve is a creature of Congress. Its mandate, structure, and authorities are established by statute, and Congress retains the power to amend them. Independence does not mean freedom from oversight or accountability. It means that, within the framework Congress has set, the Fed should be insulated from day-to-day political pressures when making monetary policy decisions.

This design reflects a judgment about incentives and credibility. Monetary policy decisions often involve short-term economic pain in pursuit of longer-term stability. Shielding those decisions from immediate political considerations is intended to enhance credibility by anchoring expectations about inflation and future policy, thereby reducing the risk that short-term political pressures destabilize longer-term economic behavior.

At the same time, independence does not imply infallibility or immunity from criticism. The Fed's decisions have real consequences, and public debate about those decisions is both inevitable and appropriate. Independence is best understood not as a privilege granted to technocrats, but as a structural feature designed to support the effective pursuit of goals that Congress itself has defined.

Why the Fed Is So Often Asked to Do Too Much

Over time, the Federal Reserve has become the most visible—and often the most responsive—economic policymaker in the United States. When financial markets seize up, the Fed can act quickly. When recessions hit, it can ease financial conditions without waiting for legislative action. When uncertainty rises, its signals and decisions can influence behavior almost immediately. This speed and flexibility are genuine strengths.

But they also create expectations.

Because the Fed can act when other institutions cannot or will not, it is frequently asked to address problems that extend well beyond the scope of monetary policy. Weak growth, stagnant wages, rising inequality, asset price booms, fiscal imbalances, and even climate-related risks are increasingly discussed in the context of what the Fed should do. In many cases, this reflects **frustration with the limits of other policy tools** rather than confidence in the Fed's ability to solve such problems directly.

Monetary policy, however, is a blunt instrument. Its primary channel of influence runs through financial conditions—interest rates, credit availability, asset prices, and expectations about future policy and inflation. While those variables matter enormously, they do not determine many of the structural features that shape long-term economic outcomes. Productivity growth, labor market institutions, education, taxation, and fiscal policy lie largely outside the Fed's control.

This tension helps explain why debates about the Fed often feel unsatisfying. The institution is powerful enough to matter, but not powerful enough to deliver outcomes that depend on forces beyond monetary conditions. When the economy performs poorly, the Fed is often criticized for not doing more; when it acts aggressively, it is criticized for doing too much. Both reactions stem from a mismatch between the problems being highlighted and the tools available to address them.

Balancing Interests in a Complex Economy

Monetary policy does not affect all participants in the economy equally. Changes in interest rates and financial conditions inevitably benefit some groups more than others, at least in the short run. Borrowers and savers, asset owners and wage earners, homeowners and renters—all experience the effects of monetary policy differently. These differences may not be the result of favoritism or intent, but they are nonetheless real.

This unevenness has become more salient after decades of relatively weak wage growth for large segments of the workforce, even as asset prices have risen substantially. For many households, price stability has coincided with stagnant real incomes and growing insecurity, while gains from rising equity and real estate values have accrued disproportionately to those who already owned assets. Against that backdrop, it is natural to ask whether monetary policy has implicitly favored financial markets over workers, or whether the Federal Reserve could do more to support broad-based improvements in living standards.

The difficulty is that the Fed's tools are ill-suited to target distributional outcomes directly. Addressing distributional outcomes is not part of the Federal Reserve's statutory mandate, even though its actions can have distributional effects. Monetary policy influences the economy primarily by shaping financial conditions—not by determining how income and wealth are generated or distributed. While tight labor markets can strengthen workers' bargaining power and contribute to faster wage growth, sustained real wage gains ultimately depend on productivity growth, institutional arrangements, and fiscal choices that lie outside the Fed's control.

This reality creates a persistent tension. Allowing the economy to run “hotter” may support employment and wage growth for a time, but if wage increases outpace productivity, inflationary pressures can emerge. In such cases, the Fed may be forced to tighten policy to preserve price stability, even if doing so weakens labor market conditions. There is no purely monetary solution that can reliably deliver both low inflation and sustained, broad-based wage growth in the absence of supportive conditions elsewhere in the economy.

Credibility, Expectations, and the Role of Communication

In modern central banking, expectations matter almost as much as actions. Because monetary policy works largely by influencing financial conditions and behavior, the Federal Reserve’s credibility—its ability to convince markets, businesses, and households that it will act consistently with its stated objectives—is itself a policy tool.

This helps explain the growing prominence of communication in central banking. Statements, press conferences, economic projections, and forward guidance are intended to shape expectations about future policy and inflation. When those expectations are well anchored, the Fed can sometimes influence longer-term rates and broader financial conditions without large immediate changes in policy settings.

This emphasis on communication represents a significant evolution. For much of its history, the Federal Reserve operated with a high degree of opacity. It did not even publicly announce its target for the federal funds rate, and market participants inferred policy intentions from observed operations. Over time, the Fed moved toward greater transparency in an effort to improve predictability, accountability, and the effectiveness of policy transmission.

Greater transparency, however, carries risks. Economic relationships are uncertain, and the future path of inflation, employment, and growth cannot be known with confidence. Overly precise guidance can create false certainty or constrain future policy choices, while vague or inconsistent messaging can undermine credibility and amplify volatility. Communication is therefore an imperfect tool—necessary, but not sufficient.

The Limits of Central Banking

Understanding what the Federal Reserve can do requires equal clarity about what it cannot. Central banking is powerful, but its power is bounded.

The Fed can supply liquidity, stabilize financial markets, and influence financial conditions. It can help prevent temporary disruptions from cascading into systemic crises and can moderate the amplitude of economic cycles. These are significant achievements, and they matter enormously for economic stability.

What the Fed cannot do is generate productivity growth, determine the long-term distribution of income and wealth, or resolve structural challenges such as weak labor market institutions, demographic change, or fiscal imbalances. Monetary policy does not

create skills, build infrastructure, set tax policy, or allocate public spending. When those forces weigh on wage growth or living standards, the Fed's tools can at best provide temporary relief, not lasting solutions.

Recognizing these limits is not an argument for a weaker central bank or a stronger one. It is an argument for clearer expectations—about what monetary policy is designed to do, and about the complementary role of fiscal, regulatory, and structural policies in shaping long-run economic outcomes.

Understanding the Fed in Context

The Federal Reserve occupies a central place in the modern U.S. economy, not because it controls everything, but because it sits at the intersection of finance, money, and macroeconomic stability. Its tools are powerful precisely because they operate at the core of the financial system. Yet those same tools are necessarily blunt, indirect, and constrained.

Much of the confusion and controversy surrounding the Fed arises from a failure to distinguish between mechanics and mandates, between capability and responsibility, and between short-term stabilization and long-term prosperity. When these distinctions are blurred, it becomes easy to overestimate what the Fed can deliver—and to misinterpret its actions when outcomes fall short of broader economic aspirations.

Understanding the Federal Reserve, then, requires more than knowing what it does. It requires understanding why it was created, how its role has evolved, and where its authority—and effectiveness—end. Only with that context can debates about monetary policy move beyond caricature and toward more constructive engagement with the real tradeoffs involved.

Appendix A

The Federal Reserve and the Structure of Bank Supervision

While much of this paper has focused on the Federal Reserve's role in monetary policy and financial market operations, the Fed also serves as a bank supervisor and regulator. Its supervisory responsibilities are distinct from, but closely related to, its broader mandate to promote financial stability.

The U.S. banking system does not have a single regulator. Oversight is divided among several agencies:

- The Office of the Comptroller of the Currency (OCC) supervises national banks.
- The Federal Deposit Insurance Corporation (FDIC) insures deposits and supervises state-chartered banks that are not members of the Federal Reserve System.
- The Federal Reserve supervises state-chartered banks that are members of the Federal Reserve System, as well as bank holding companies, financial holding companies, and certain systemically important financial institutions.
- These distinctions reflect differences in charter and structure rather than differences in basic banking activity. A **national bank** is chartered under federal law and supervised primarily by the Office of the Comptroller of the Currency. A **state-chartered bank** is chartered under state law; if it chooses to join the Federal Reserve System, it is supervised by the Federal Reserve, and if it does not, it is supervised by state regulators in coordination with the FDIC.
- A **bank holding company** is a corporate parent that owns one or more banks. Because large banking organizations often operate through holding companies, the Federal Reserve supervises these parent entities on a consolidated basis. The largest and most interconnected of these institutions are designated as systemically important and subject to enhanced oversight.

This overlapping structure reflects the historical evolution of the U.S. banking system rather than a single unified design.

Capital, Liquidity, and Risk Oversight

Bank supervision today centers on three broad areas:

1. Capital adequacy – ensuring that banks maintain sufficient equity to absorb potential losses.
2. Liquidity management – ensuring that banks can meet funding obligations during periods of stress.
3. Risk management and governance – ensuring that institutions have appropriate internal controls, stress-testing processes, and oversight mechanisms.

Modern capital standards are influenced by internationally coordinated agreements known as the Basel Accords, developed through the Basel Committee on Banking Supervision. These agreements provide a framework for minimum capital levels, risk-weighted asset calculations, and liquidity standards adopted across major banking systems.

The Federal Reserve plays a central role in implementing and enforcing these standards for the institutions it supervises. For the largest and most systemically important banks, the Fed conducts annual stress tests to evaluate whether capital levels remain adequate under adverse economic scenarios.

Distinguishing Supervision from Monetary Policy

Although both functions reside within the Federal Reserve, bank supervision and monetary policy serve different purposes.

Monetary policy seeks to influence short-term interest rates and broader financial conditions in pursuit of statutory goals such as price stability and maximum employment.

Supervision and regulation, by contrast, aim to ensure that individual institutions remain safe and sound, and that risks within the banking system do not threaten financial stability.

These functions intersect during periods of stress. A well-capitalized banking system enhances the effectiveness of monetary policy, while stable funding markets support orderly payment and settlement. But the tools and objectives differ. Adjusting the federal funds rate is not the same as setting capital requirements, and expanding the Fed's balance sheet is not the same as supervising loan portfolios.

The Federal Reserve's Role in Systemic Stability

For the largest banking organizations and globally systemically important banks (GSIBs), the Federal Reserve serves as the primary consolidated supervisor. This reflects the recognition that large, interconnected financial institutions can pose risks that extend beyond individual balance sheets.

In this capacity, the Fed evaluates not only capital and liquidity but also resolution planning, interconnected exposures, and operational resilience.

The supervisory role complements, but does not replace, the Fed's monetary policy function. Together, these responsibilities reflect the Federal Reserve's dual identity as both a central bank and a banking regulator.

Why This Matters

Understanding the Federal Reserve requires recognizing both sides of this institutional structure. The same central bank that sets interest rates also supervises key financial

institutions. Yet these responsibilities operate through different mechanisms and legal authorities.

The distinction helps clarify debates about the Fed's power and its limits. Monetary policy cannot substitute for prudent bank supervision, just as supervisory oversight cannot deliver price stability.

Each function addresses a different dimension of financial stability.