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In This Issue

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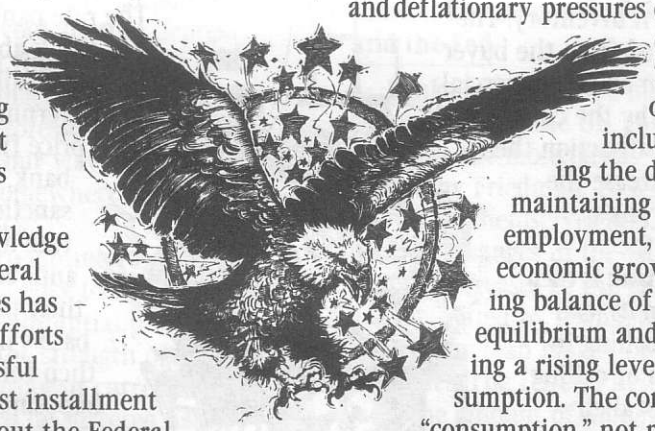
The Impact and Influence of the Federal Reserve System on the U.S. Economy

An Essay - Part I

The enormous economic power wielded by the U.S. Federal Reserve System has a very great impact on the lives of every American. Even our overseas trading partners are not exempt from its mind-boggling influence. Knowledge of how the Federal Reserve operates has supported the efforts of many successful traders. This first installment of our series about the Federal Reserve Board explores two economic views that have influenced this country. Through these views we hope to explain how the Federal Reserve System works. Next month we will dig into the mechanics and consequences of controlling U.S. monetary policy by the Federal Reserve and we will address the political connection of this arm of government.



The basic responsibility of the U.S. Federal Reserve System is to control the credit and the supply of money in the Federal Reserve System. This includes just about every money depository institution in the United States.

The Federal Reserve System was created with the passage of the Federal Reserve Act of 1913. The Act created twelve Federal Reserve banks distributed around the country which are supervised by the Federal Reserve Board and the Federal Open Market Committee (FOMC). The intent of the legislation was to give the Federal Reserve Board in Washington the authority to stabilize the credit and money markets so that inflationary and deflationary pressures could be controlled. The express objectives included stabilizing the dollar, maintaining high employment, fostering economic growth, achieving balance of payments equilibrium and maintaining a rising level of consumption. The concept of "consumption," not production, is explicitly quoted from The Federal Reserve System: Purposes and Functions, fifth edition published by the Federal Reserve Board, 1965, p. 1.

The Fiscalists and the Monetarists

The emphasis on consumption, rather than production, is a fiscal view, as opposed to the now-practiced monetarist view. The fiscal view was advanced by John Maynard Keynes, a British economist known for his economic theory circa 1919. His theory involved controlling the economy with tax rates and government spending. The monetarists, on the other hand, control the economy by manipulating the money supply and rates of credit. Keynes' theory has had its trials as applied to the American economy, but the latter view on monetary control represents the flavor of the official policy which is adopted today.

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The Impact...
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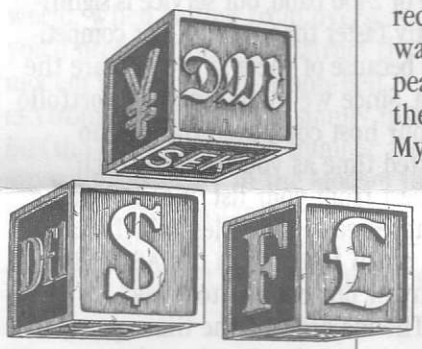


Keynes authored *Indian Currency and Finance* and *The Economic Consequences of Peace*, which were very popular works in their day. Keynes' view that peace is a deterrent to prosperity has outlasted him. My recollection following World War II was that the Keynesian "beware of peace" position was well entrenched in the minds of all well-educated people. My own money and banking professors of the '50s believed that only through "prudent fiscal policy" could we avoid another depression. I don't think I'm being unkind or inaccurate when I recall my professors saying, "We can always tax our way out of a jam or start a war somewhere to keep the economy on track."

Keynes, in attempting to apply his own economic theory to the currency markets, made substantial profits speculating on the strength of the dollar versus European currencies. However, in 1920 he suffered bankruptcy when speculating on a bearish posture for the German Mark. After replenishing his capital and reputation through his writings, he successfully speculated in commodities accumulating over one-half million pounds. In spite of his later wealth, he was known for offering his guests meager meals and sending them away hungry. In one report, he paid native boys in Algiers such a pittance for shining his shoes that he was stoned in return. His reaction: "I will not be a party to debasing the currency."

Milton Friedman promoted the monetarist view that the quantity of money, prices, national income, and velocity of money interact to keep our economy in check. Mr. Friedman was born in 1912, some 22 years after John Maynard Keynes and one year after the enactment of the Federal Reserve Act. He was short in stature (five feet five inches), but a giant in his contribution to economic theory.

He was not the first to advance monetaristic views concerning the supply of money, but he was an avid lecturer and probably the most consistent advocate of monetary policy. He believed that control of the money supply, not government fiscal policy, should be the primary means to manage the economy. He also believed that an insufficient money supply was the major contributor to the Great Depression.

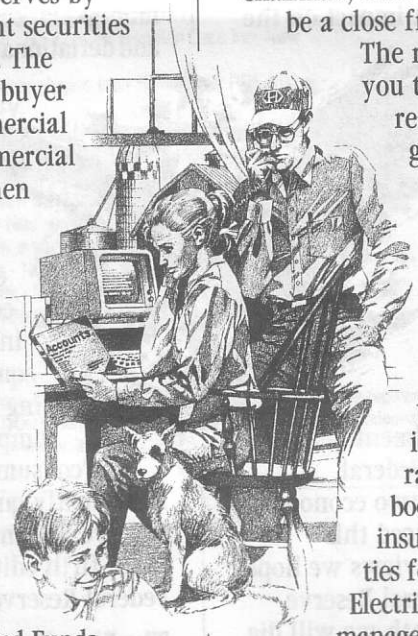
Banks, The Money Supply and the Fed

Banks represent one mechanism through which the U.S. government exercises the monetarists view espoused by Friedman. To a large extent, the banks themselves implement Fed-directed changes in the nation's money supply. Increases in the money supply are facilitated by commercial banks when they loan money or purchase securities. The Federal Reserve regulates the amount of money a bank can loan by requiring the bank to maintain a percentage of its assets on deposit at the commercial bank's regional Federal Reserve Bank. This percentage is known simply as the *Reserve Requirement*. If a commercial bank, for example, has $1000 on deposit in the Federal Reserve bank and the Federal Reserve is currently imposing a *reserve requirement* percentage of 10%, then the bank can grant loans totaling $1000/.10 or $10,000 and effect a $10,000 increase in the nation's money supply.

If the Federal Reserve wants to increase the money supply, it might buy U.S. Government securities (T. Notes, for example) on the open market with a check drawn on the U.S. government. (The only cost to this transaction is the ink used to write the check because the money is created out of thin air.) When the seller of the securities deposits the government check in his commercial bank, the bank's deposits (reserves) at the

commercial bank's Federal Reserve regional bank increase. With these increased reserves, the commercial bank can now increase the money supply (at a multiple of 10 times the amount of the government check using the above example) by making new loans based upon the increased reserves from the seller's deposit.

In reverse sequence, the Federal Reserve can decrease the money supply and commercial bank reserves by simply selling government securities out of its own inventory. The check received from the buyer that is drawn on a commercial bank is paid by the commercial bank. This transaction then serves to decrease the commercial bank's reserves and the commercial bank is then forced to trim its loan portfolio by calling in loans. In lieu of calling in a portion of their loan portfolio, other alternatives for the commercial bank would be to borrow excess reserves from some other commercial bank at the Fed Funds rate or to borrow the necessary funds at the Federal Reserve discount window.



This latter alternative, although less expensive for the borrower, is taken by the Fed as a sign that the borrower is overextended. Therefore, to keep the Fed from imposing an audit, banks usually get their needed funds from other banks who are operating below the Federal Reserve's *reserve requirement.* Such loan transactions are usually temporary measures by banks which keep them from having to abruptly disturb their loan portfolios.

The Fed is not responsible for the spread between the prime rate and the federal funds rate (the interest rate commercial banks charge each other) or the spread between the prime rate and the federal discount rate (the rate of interest charged by the Federal Reserve District banks of commercial banks). But this spread represents the minimum gross total margin a bank earns for arranging a loan to a favored business. The spread represents an enormously lucrative opportunity for banks in general. It is no wonder that current Federal Reserve Chairman, Alan Greenspan, is known to be a close friend to the banker.

The rate banks charge, if you think about it, is realistically a form of government sanctioned price fixing. A major bank, noting a Fed sanctioned discount rate hike, will announce a change in their prime rate. Other banks in the U. S. will then follow suit by imposing the exact same rate change on their books. Obviously, banks are insulated from any illegalities for price fixing. General Electric and Westinghouse management officials spent considerable time in jail for fixing the prices of heavy electrical equipment in the early 1960s. It is difficult to understand how banks all over the U.S. can not be cited for price fixing when nearly every commercial bank in the country can adopt a fixed pricing policy for loans pegged to an arbitrarily large spread above the Federal Discount rate.

To make matters worse, commercial banks sometimes jump the prime rate advance by double the marginal jump in the discount rate and 99% of such banks adopt the same published differential. Conversely, when the Fed moves the discount rate down in an attempt to ease, the banks as a group uniformly maintain the same or an

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Ask Customer Service

Each month in this column, the CSI Customer Service staff addresses a topic of interest to many of our subscribers. This month, they'll field questions about phone connections to the CSI host computer and offer tips for getting the best results.

Q. *How can I take advantage of the new lines, modems and computer ports CSI has added?*

A. If you access via either Telenet or Tymnet, your call is automatically routed to the best available line for every call. If you dial direct, you should be sure you are calling the top of the rotary for the baud rate you are using. These numbers are:

14.4/9600 Baud: (407) 368-5306
2400 Baud: (407) 392-0572
1200 Baud: (407) 392-1332
300 Baud: (407) 392-1213

If your computer dials one of the numbers listed here and the line is busy, your call will automatically shift to the next available line. If you are currently using a number that isn't listed here, you may be accessing the rotary at a point that is less than optimal, increasing the likelihood of reaching a busy signal.

Q. *I use the direct-dial phone number you recommend, but every time I try to collect data, my first call does not go through. Should I try a different phone number?*

A. Perhaps. The only reason your User Constants should list a Long Distance phone number other than the one shown here for your baud rate is if the first number consistently fails to connect for you. In this case, calling a different modem may solve the problem. Before making a change, please contact one of our service representatives. We can review your transmission statistics to determine which phone number might be best for you.

Q. *I just upgraded to a 14.4 modem and I'm eager to benefit from the higher baud rate. I am told that since I use the networks, I'll still be limited to 2400 baud. Why so slow, and will you be increasing this soon?*

A. We're looking into doubling the baud rate for network service through Tymnet. We hope to have more on this next month when, and if, the installation work is complete. At the current rate of 2400 baud, our service is significantly faster than most of our competitors because of the way we prepare the data. Since we maintain your portfolio on our host computer, there is no wasted time as you transmit each request from your list. We also send compressed binary files, which transmit much faster than the ASCII files many of our competitors use.

The majority of the time spent on any transmission involves the computers shaking hands, the file request and our system generating your update. Unless you have a very large portfolio or retrieve large amounts of history, the advantage of a faster baud rate is minimal.

Q. *Your documentation shows a 14.4 baud phone number for direct-dial access, but I've been told to use only 9600 baud. Is it possible for me to use a faster baud rate when I pay for the call?*

A. Technically, our top-level modems support 14.4 baud transmissions. However, they are not completely compatible with the universe of modems dialing into our service at that baud rate. If you want to use 14.4, by all means, try it. Use the 14.4/9600 baud phone number shown above and enter 1920 as the Baud Rate in User Constants. Watch your transmission closely to see if many lines are re-sent due to line errors. If so, you'll want to switch down to 9600 baud and recollect. If 14.4 retrieval works for you, please continue on at that speed.

Q. *I'll be traveling abroad this summer and I would like to continue retrieving data on my laptop*

computer. Is this possible and, if so, can I use network access?

A. We are told that several of our customers collect data from laptop computers as they travel around the world. When calling from overseas, you'll probably need to instruct the modem to function in a non-Bell environment. To do this, simply insert B0 (the letter B and the number zero) anywhere after AT in the Modem Init string in User Constants.

We offer network access via Sprintnet (Telenet) and Tymnet from major cities around the world. Overseas network access can be expensive, so you should weigh the cost against your savings in phone bills. Our charge for each month of access will reflect the most expensive method used at any time in the billing cycle. You must notify us whenever you are accessing data from a country that is different from your billing address. A complete information package with details on network locations and prices is available upon request. Please call or send us a message if you are interested. ✦