

## Handout 5-4-3 The Federal Reserve System and Monetary Policy

The amount of money in an economy is important because it affects the level of spending in a country. Too much spending can cause inflation while too little spending can cause unemployment and declining levels of production. In the United States, Congress has assigned the responsibility for controlling our money supply to the Federal Reserve System.

The Federal Reserve System or "Fed" has functioned as the central bank of the United States since 1913. It consists of a seven-member Board of Governors in Washington, D.C., plus twelve regional banks throughout the country. The Federal Reserve System is designed to be as nonpolitical as possible.

As a central bank, the Fed manages the money supply by influencing the lending activity of commercial banks and other financial institutions. But the major part of its direct influence comes about through its relations and dealings with commercial banks, from which the effects spill over to the financial system as a whole.

The deliberate actions of the Federal Reserve System to expand or contract the money supply are called monetary policy. The purpose of monetary policy is to maintain economic output, employment, and prices at desired levels. The Board of Governors and the twelve heads of the regional reserve banks regularly meet eight times a year to decide on Federal Reserve monetary policy. A policy of the Fed designed to expand the growth of money and credit in the economy is known as an expansionary (or loose) monetary policy. A policy to restrict the growth of money and credit in the economy is known as a contractionary (or tight) monetary policy. The creation of too much money can cause inflation, and the creation of too little money can cause recession.

The Fed has three primary tools with which to carry out monetary policy. These are open market operations, reserve requirements, and the discount rate.

**Open market operations** refer to the Fed's buying and selling of U.S. government securities in order to add to or subtract from the reserves of the nation's commercial banking system. Government securities, such as U.S. Treasury bills, notes, and bonds, are issued by the U.S. Treasury in return for money borrowed from individuals and businesses in order to finance government spending. If the Federal Reserve wants to put money into the economy, it buys some of these government securities by writing a check on itself. If, for instance, the Fed buys \$10,000 worth of government securities with such a check, it creates the \$10,000 used to pay for them. The sellers are not \$10,000 richer, since they no longer own the securities, but the money supply grows because there is \$10,000 of new money in the economy. If the Fed wants to pursue a contractionary monetary policy, it sells some of the government securities it owns. The money that is

paid to the Federal Reserve for the securities is removed from the economy, so the money supply shrinks. Open market operations is the most frequently used tool of monetary policy.

A second important tool of monetary policy consists of **reserve requirements** for bank deposits. The Federal Reserve requires that banks keep as reserves a certain fraction of the deposits they hold. These reserves must be kept as balances at Federal Reserve banks or as cash the banks have on hand (i.e., vault cash). Banks that fail to meet their reserve requirements are subject to penalties. These required reserves cannot be lent to borrowers.

If the Fed wants to pursue a contractionary monetary policy, it can raise reserve requirements, thereby restricting the amount of funds banks can lend. If the Fed wants to pursue an expansionary monetary policy, it can lower reserve requirements. Let's say you deposit \$10,000 at your local bank and the reserve requirement on deposits is 15 percent. This means that your bank would have to keep \$1,500 on reserve at the Fed ( $.15 \times \$10,000 = \$1,500$ ). It could create new deposits by lending the other \$8,500 to borrowers. If the Fed were to lower its reserve requirement to 10 percent, then the bank could lend \$500 more, or a total of \$9,000. Such an expansion of bank lending causes the amount of money in the economy to increase. However, if the Fed were to raise its reserve requirements to 20 percent, the bank could lend only \$8,000 of the \$10,000, thus curbing the possible increase in the amount of money. Changes in reserve requirements can be a very powerful tool of monetary policy but this tool is used infrequently precisely because it is so powerful. Most often, the Fed desires to make gradual or minor changes in policy, aims for which changes in reserve requirements are not suitable.

The **discount rate**, the third tool of monetary policy, is the interest rate the Federal Reserve charges banks that borrow money. If a bank borrows from the Federal Reserve, the reserves lent to the bank are created by the Fed. This process increases the amount of money and credit in the economy. The Federal Reserve does not automatically allow a bank to borrow from it whenever the bank wants to. The Fed can refuse to make such a loan. If the discount rate is low and the Fed does not discourage banks from borrowing from it, the Federal Reserve will foster an expansionary monetary policy. If the discount rate is high and the Fed discourages banks from borrowing from it, the Federal Reserve will foster a tight monetary policy. The discount rate is probably the least strong of the three principal tools of monetary policy, but the Federal Reserve uses changes in it to indicate an overall tightening or loosening of monetary policy.