MONETARY POLICY & FEDERAL RESERVE NOTES

1.) Functions of the Fed

- The Federal Reserve (Fed) serves as the nation's central bank.
- It conducts **MONETARY POLICY**
- It is designed to oversee the banking system.
- It regulates the quantity of money in the economy.

The Fed has **three** tools in its **monetary** toolbox:

1. **Open-market operations**
2. **Changing the reserve requirement**
3. **Changing the discount rate**

2.) The Structure of the Federal Reserve System

The primary elements in the Federal Reserve System are:

1. The Board of Governors

- The Fed is run by a ***Board of Governors***, which has seven members appointed by the President and confirmed by the Senate.
- Among the **seven** members, the most important is the chairman. The chairman directs the Fed staff, presides over board meetings, and testifies about Fed policy in front of Congressional Committees.

2. The 12 Regional Federal Reserve Banks

The Federal Reserve System is made up of the Federal Reserve Board in Washington, D.C., and **twelve** regional Federal Reserve Banks. The New York Fed implements some of the Fed's most important policy decisions.

3. The Federal Open Market Committee *(FOMC):*

- Serves as the main policy-making organ of the Federal Reserve System
- Meets approximately every six weeks to review the economy.
- All actions to regulate the economy by this committee are call **OPEN-MARKET OPERATIONS.**

3.) Tools of the Federal Reserve

TOOL #1: Open-Market Operations

The money supply is the quantity of money available in the economy. The primary way in which the Fed changes the money supply is through **open-market operations** (The Fed purchases and sells U.S. government bonds).

- To **increase** the money supply, the Fed **buys** government bonds from the public.
- To **decrease** the money supply, the Fed **sells** government bonds to the public.

Here's how it works. When the Fed wants to **increase the money supply**, it **buys** securities. The Fed purchases securities from a bank and pays for the securities by adding a credit to the bank's reserve. The bank can lend the excess money to consumers in the market. This **increases the amount of money in the banking system, which speeds the economy up by increasing the amount of money banks have to loan out**. This stimulates the economy by increasing business and consumer spending because banks have more money to lend. When there is MORE money in the economy, interest rates are lowered.

When the Fed wants to **decrease the money supply**, it **sells** securities. That transaction deducts an amount from the bank's reserve. This reduces the amount of money the bank has to lend in the market. This move ultimately **slows the economy down by decreasing the amount of money banks have to loan out**. LESS MONEY in the economy will increase interest rates and typically reduces consumer and business spending.

TOOL #2: Reserve Requirements

The money supply is affected by the amount deposited in banks and the amount that banks loan.
The fraction of total deposits that a bank has to keep as reserves is called the **reserve requirement ratio**. This ratio is controlled by the Federal Reserve (it is also called required reserves)

HERE IS HOW IT WORKS: The reserve requirement is the amount (%) of a bank's total reserves that **CAN NOT** be loaned out. **IT IS SET BY THE FEDERAL RESERVE!!**

- **Increasing** the reserve requirement **decreases** the money supply.
- **Decreasing** the reserve requirement **increases** the money supply.

TOOL #3: Discount Rate

HERE IS HOW IT WORKS: The discount rate is the interest rate the Fed charges smaller banks for loans.

- **Increasing** the discount rate **decreases** the money supply. (because it is MORE expensive for banks to get the money)
- **Decreasing** the discount rate **increases** the money supply. (because it is LESS expensive for banks to get the money)

DISCOUNT RATE ↑ = MONEY DECREASE (INVESTMENT ↓, GDP ↓)
DISCOUNT RATE ↓ = MONEY INCREASE (INVESTMENT ↑, GDP ↑)
RESERVE REQUIREMENT ↑ = MONEY DECREASE (INVESTMENT ↓, GDP ↓)
RESERVE REQUIREMENT ↓ = MONEY INCREASE (INVESTMENT ↑, GDP ↑)
BUY (back) BONDS = MONEY INCREASE (INVESTMENT ↑, GDP ↑)
SELL BONDS = MONEY DECREASE (INVESTMENT ↓, GDP ↓)

4.) <u>Money Supply, Interest Rates, and GDP</u>

1. Money supply impacts interest rates
2. Interest rates impact investment
3. Investment is a component of GDP **(REMEMBER THE FORMULA: C + I + G + (Ex - Im)**
4. GDP is changed as a result
   - So if money supply **<u>increases</u>**, then interest rates **<u>decrease</u>**. (So GDP increases because businesses and consumers are investing MORE). This means that businesses will purchase more loans in order to advance their business. GDP WILL INCREASE AS A RESULT!
   - On the other hand, if money supply **<u>decreases</u>**, then interest rates **<u>increase</u>**. (So GDP decreases because businesses and consumers are investing LESS).
   - This means that businesses will purchase less loans in order to advance their business. GDP WILL DECREASE AS A RESULT!

5.) <u>Functions of Money</u>

WHAT MAKES MONEY, MONEY? It must have these **THREE** functions:

1. **Medium of Exchange** (It must be widely recognized as something with value and must be acceptable as payment for goods)
2. **Unit of Account** (It is a YARDSTICK people use to post prices and compare one good's value to another good's value)
3. **Store of Value** (It can store value to be used at sometime in the future)

6.) <u>Types of the Money</u>

1. **Commodity money** takes the form of a commodity with intrinsic value. Examples: Gold, silver, cigarettes.
2. **Fiat money** is used as money because of government decree. It does **<u>not</u>** have **intrinsic** value. Examples: Present day coins, paper currency, check deposits, credit cards.