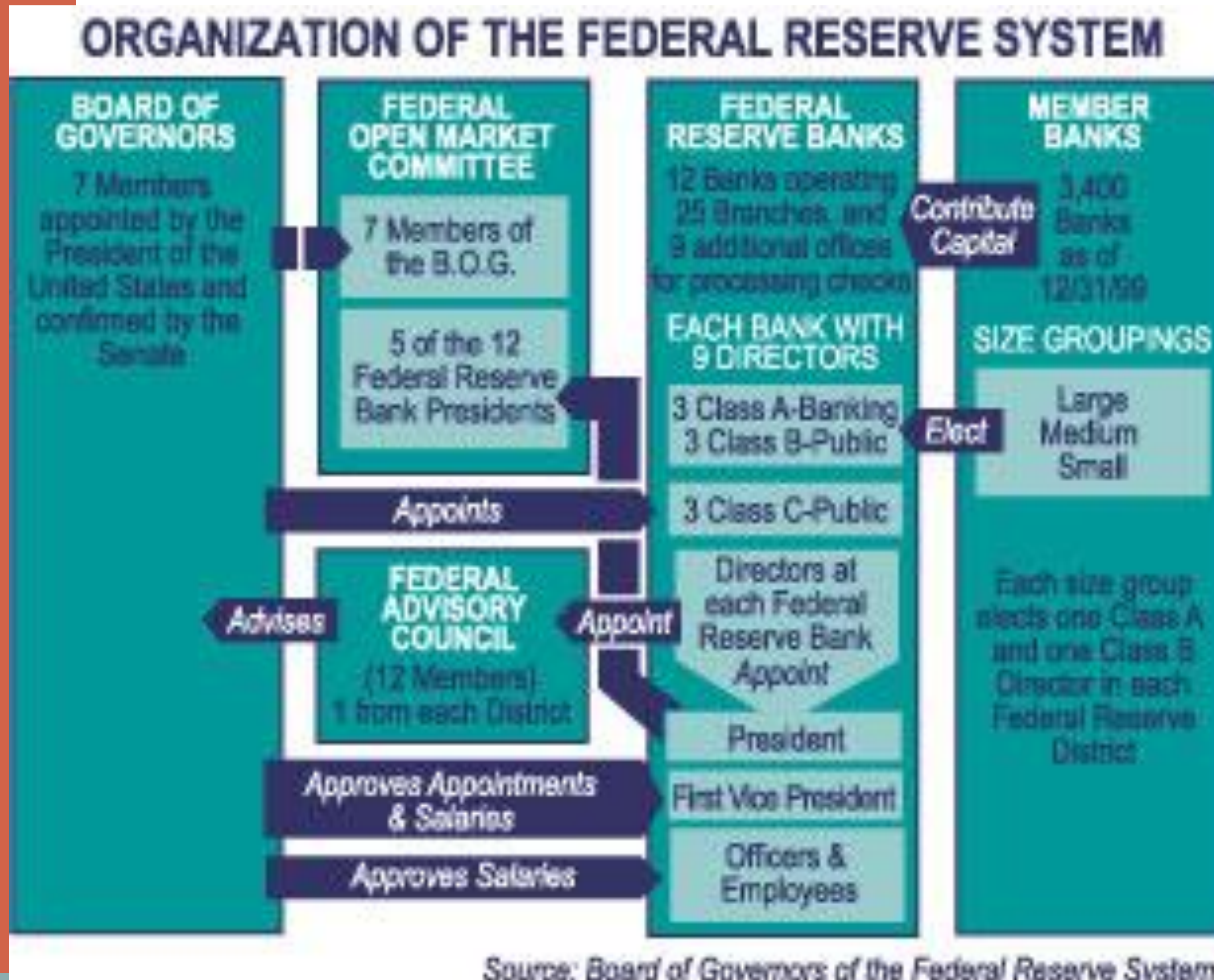
# The Federal Reserve and Monetary Policy

# The Federal Reserve System or FED

- 1913 Congress creates the Federal Reserve System
  - The Fed is privately owned by member banks
  - All banks must be a member of the system
- 1935 a seven-member Board of Governors is created
  - Appointed by President, approved by Senate, serve 14-year staggered terms
  - There are also 12 Reserve District Banks and 25 regional banks and they handle the deposits of member banks
  - Federal Open Market Committee (FOMC)
    - Makes the monetary policy decisions of the country
  - There are several advisory committees that meet with the FED and discuss the economy in its various regions

# What does the Fed do?

- The Federal Reserve is a check clearing service
- The Fed holds the reserves of banks in order to control the money supply
- The Fed issues new currency when needed
- The Fed serves as the bank for the US government with deposits from the IRS to Social Security, and it sells bonds to raise money for the government

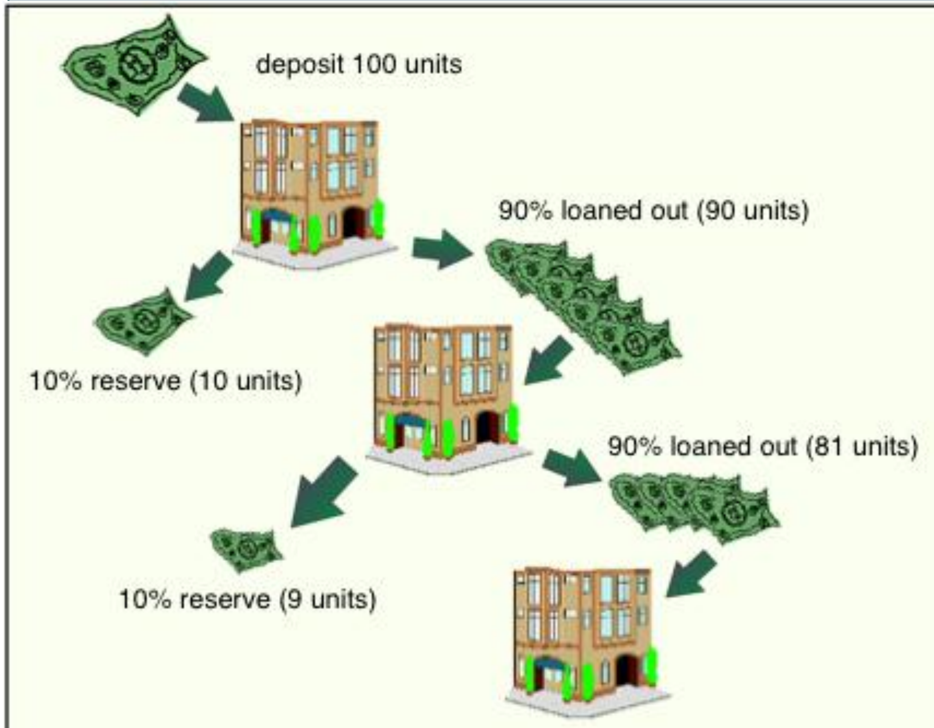


# Monetary Policy

- The most important responsibility of the Federal Reserve is Monetary policy
  - The expansion or contraction of the money supply to influence the availability of credit

- These policies are based on the fractional reserve system
  - Banks are required to keep a fraction of their deposits in reserve at the bank or with the Federal Reserve
    - This fraction is known as the reserve requirement

# How money is created




Banks artificially create money in the economy by making loans based on fractional reserve banking. In this example, what started out as 100 units of money deposited becomes 171 units of money loaned.

- When a deposit is made they are required to keep a portion of it in their vaults, or the FEDs vault
- The excess reserves is then loaned out to people/businesses, which is deposited into another bank, etc…
- The money supply will stop growing at some point, based on the size of the reserve requirement
- Therefore a deposit of $1,000, with a reserve requirement of 20% could increase the money supply to $5,000

# Tools of Monetary Policy

**Easy monetary policy is used to stimulate the economy**

- Money supply grows, causing interest to fall, which encourages more investment
  - Lower reserve requirement
  - Buy government bonds
  - Lower discount rate

**Tight monetary policy is used to slow economic growth and inflation**

- Fed restricts money supply, causing interest rates to rise discouraging more investments
  - Increase reserve requirement
  - Sell government bond
  - Raise the discount rate

# Other issues in Monetary Policy

- Monetary policy is mainly good for controlling inflation
  - when monetary policy is contractionary through high interest rates, this protects the size of the money supply and helps control inflation
  - Easy money is not always good for controlling deficits/recessions
    - Just because interest rates are lower during a recession, doesn't guarantee people will borrow money
- Conflicting goals between Congress and FED (and people)
  - Congress is worried about getting elected, Federal Reserve isn't, so they have conflicting goals and ideas on economy
  - Congress is more interested in the short run, FED cares about the long run
- Too independent of Congress
- The burden of policies on the economy
  - Higher interest rates can slow down investment in other areas of the economy