Monetary Policy

An Introduction to the Federal Reserve Bank and its Economic Role.

Learning Targets

- I can explain what monetary policy is, and discuss the different policy options available.
- I can explain the role of the Federal Reserve.
- I can discuss the details and merits of both expansionary (easy) and contractionary (tight) monetary policy.

What is the Federal Reserve?

- A collection of 12 central banks throughout the US.
- 7 member board of governors, appointed to long terms.
- Controls the nations monetary policy.

Who Runs the Federal Reserve?

- The Chairman of the Board of Governors. (the Fed Chairman)
- Appointed by the president, alternating with election cycle.
- Can't be fired, answers to no one. Why?

Janet L.Yellen

What does “the Fed” do?

- In simplest terms:
  - Operate as a bank for banks in the private sector.
  - Operate as a bank for the Federal government.
  - Regulate US Currency.

What else does the Fed do?

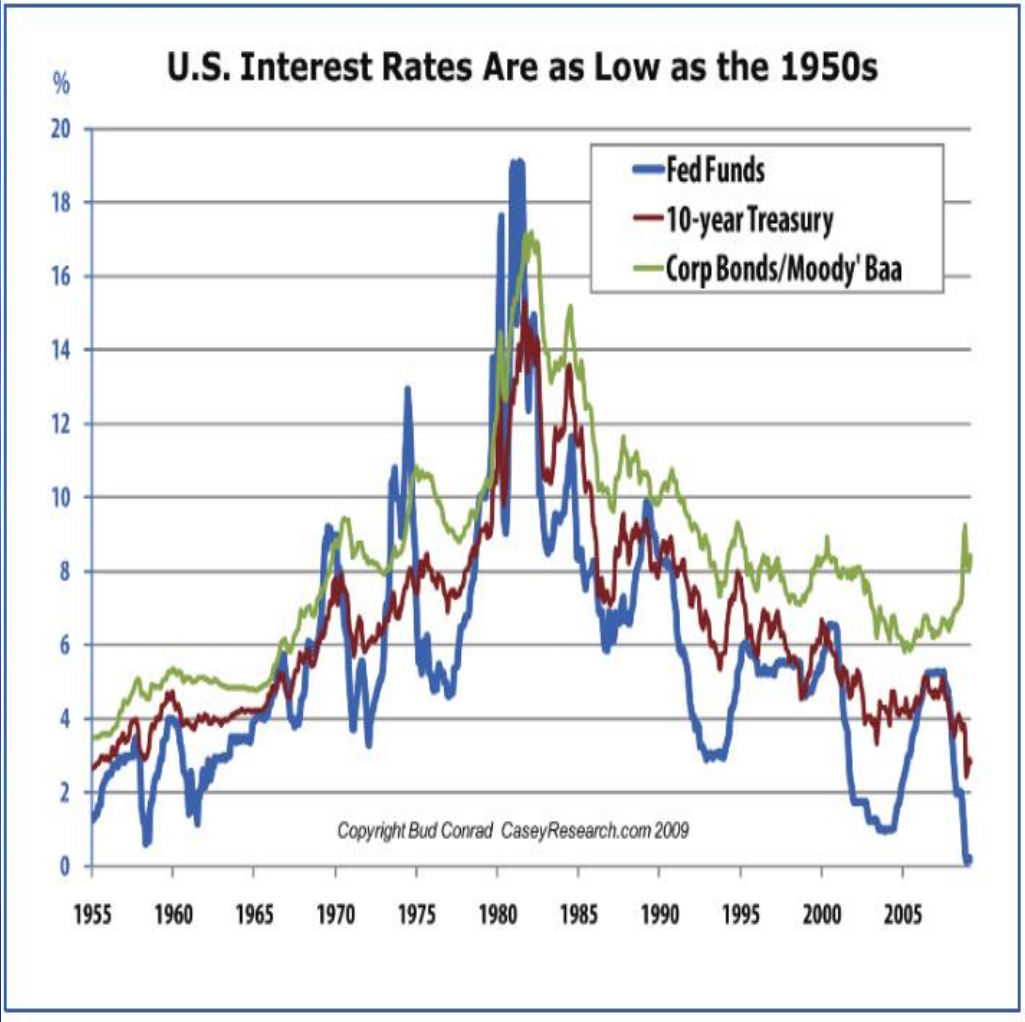
- They can also use monetary policy to influence the economy.
  - They can adjust the reserve ratio
  - They can adjust interest rates.
  - They have “open market” operations as well.

The Reserve Ratio

- The Fed tells banks how much cash they have to keep on hand.
  - If they raise the reserve ratio, banks have less available to loan. This reduces the amount of money in circulation.
  - The opposite is also true.
  - This makes accounting tricky for banks.

Interest Rates

- The Fed can adjust the interest rate they charge on loans to banks.
  - This should affect the interest rates those banks charge/pay you.



Open Market Operations

- The Fed can buy and sell securities and government bonds.
  - To banks or private citizens.
  - Buying puts money into circulation, selling takes it out.
  - Primary way the Fed influences the economy.
  - Literally adding or removing currency from the free market.

Why would the Fed want to ease the money supply? (expansionary policy)

- If they were concerned about declining GDP.
- If they were concerned about unemployment.
- If we had a problem with deflation.

Why would the Fed want to tighten the money supply? (contractionary policy)

- If they were concerned about the value of the US dollar.
- If they were concerned about inflation.

How would the Fed do it?

- Expansionary?
  - Lower the reserve ratio.
  - Lower interest rates.
  - Buy bonds and securities on the open market.
- Contractionary?
  - Raise the reserve ratio.
  - Raise interest rates.
  - Sell bonds and securities on the open market.

The Good and the Bad

- Monetary policy is a good tool to use in that:
  - Immediate impact.
  - Sheltered from "mob rule."
  - No direct deficit or debt issues.
- Monetary policy has some weaknesses in that:
  - Uncertain impact. (The fed can create incentives. How will people respond to those incentives?)
  - Answer to nobody.
  - Could lead to serious currency issues.

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