[9.4] Monetary Policy Options

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Learning Objectives

- Describe the process of money creation.
- Analyze how the Federal Reserve uses reserve requirements to implement U.S. monetary policy.
- Analyze the three primary tools the Federal Reserve uses to implement monetary policy, including open market operations.
- Explain why the Federal Reserve prefers open market operations as a means to implementing monetary policy.

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Key Terms

- money creation
- required reserve ratio
- money multiplier formula
- excess reserves
- discount rate
- federal funds rate
- prime rate
- Open market operations
- security

Creating Money

Suppose you have a checkbook that allows you to write as many checks as you wish for any amount you desire. You don’t need to worry about the balance in your account, and the checks will always be cashed, no matter how much you spend. Of course, no person has an account like that. However, the Federal Reserve comes close. By using its monetary policy tools, the Federal Reserve System affects the nation’s money supply. The Fed has the power to increase or decrease the amount of money in the United States. The Fed manipulates the money supply in order to stabilize the American economy.

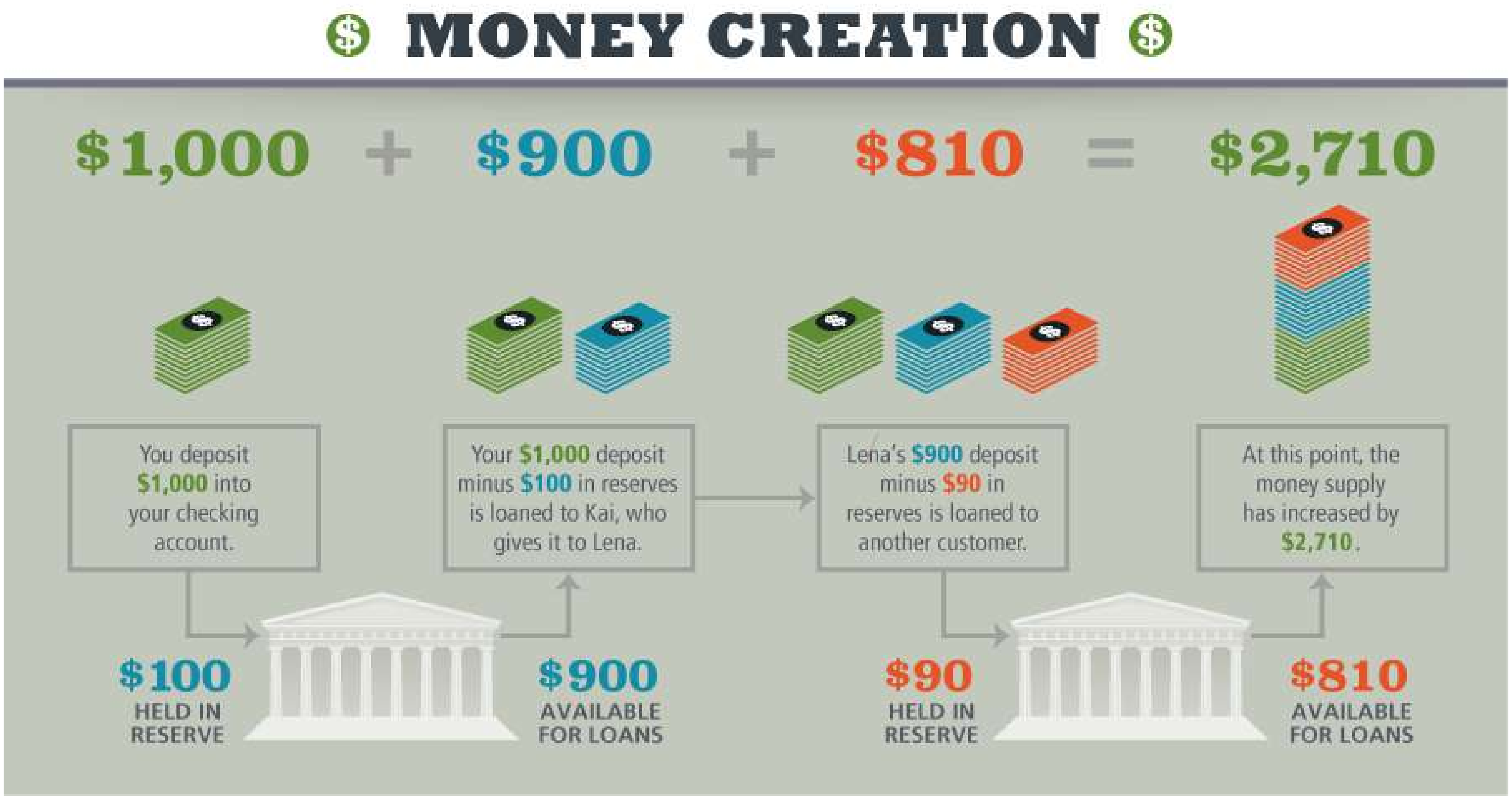
Creating Money

- Money Manufacture vs. Money Creation
- How Banks Create Money
- The Money Multiplier

Creating Money

Coins and paper bills are manufactured in facilities like this. But it is the Federal Reserve that puts money in circulation through the process of money creation.

Creating Money



Money is created as banks loan out money not kept in reserve. Analyze Charts How would an increase in the reserve requirement affect money creation in this example?

Monetary Tool #1: Reserve Requirements

The simplest way for the Fed to adjust the amount of reserves in the banking system is to change the required reserve ratio. (See Figure 9.25.) The Fed's Board of Governors has sole responsibility over changes in reserve requirements. However, changing the reserve requirement is not the Fed's preferred tool.

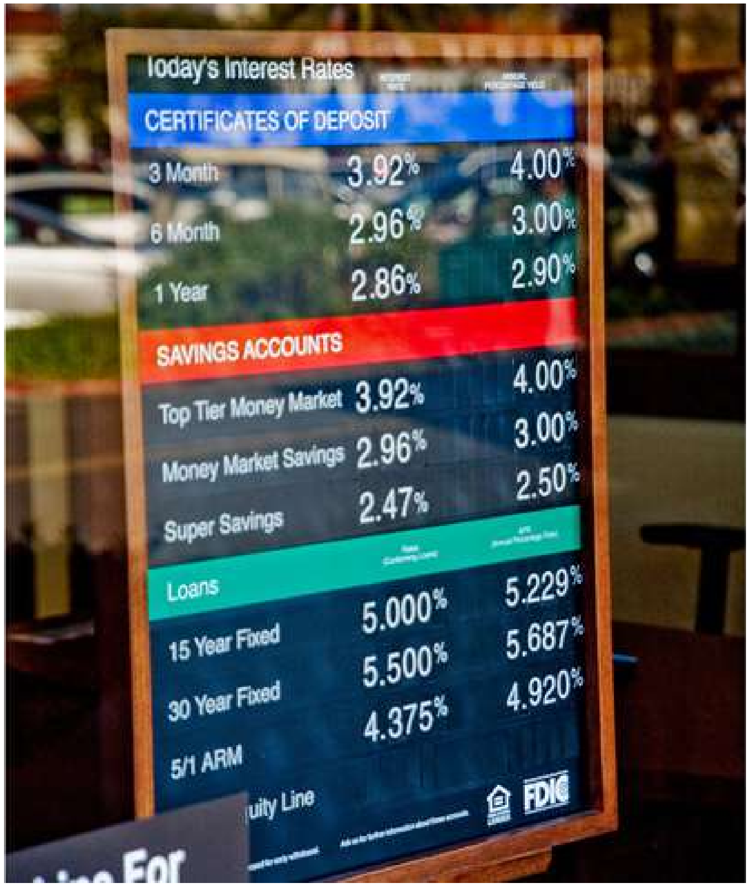
Monetary Tool #1: Reserve Requirements

The Fed uses reserve requirements to influence the money supply. Express Ideas Clearly Who or what is directly affected by a change in reserve requirements?

Monetary Tool #2: The Discount Rate

In the past, the Fed lowered or raised the discount rate to increase or decrease the money supply. The discount rate is the interest rate the Federal Reserve charges on loans to financial institutions. Today, the discount rate is primarily used to ensure that sufficient funds are available in the economy. For example, during a financial crisis, there may not be enough funds in the banking system to provide the necessary loans to businesses and individuals. In that case, the ability of banks to borrow from the Federal Reserve at the discount rate provides a key safety net.

Monetary Tool #2: The Discount Rate



Interest rates determine the return bank customers earn on money they deposit and the cost they pay for money they borrow.

Monetary Tool #3: Open Market Operations

Open market operations are the buying and selling of government securities in order to alter the supply of money. (See Figure 9.26.) A security is a financial document, such as a stock certificate or bond, that represents ownership of corporate shares or the promise of repayment by a company or government. Today open market operations are by far the most important—and most often used—tool employed by the Fed to implement U.S. monetary policy.

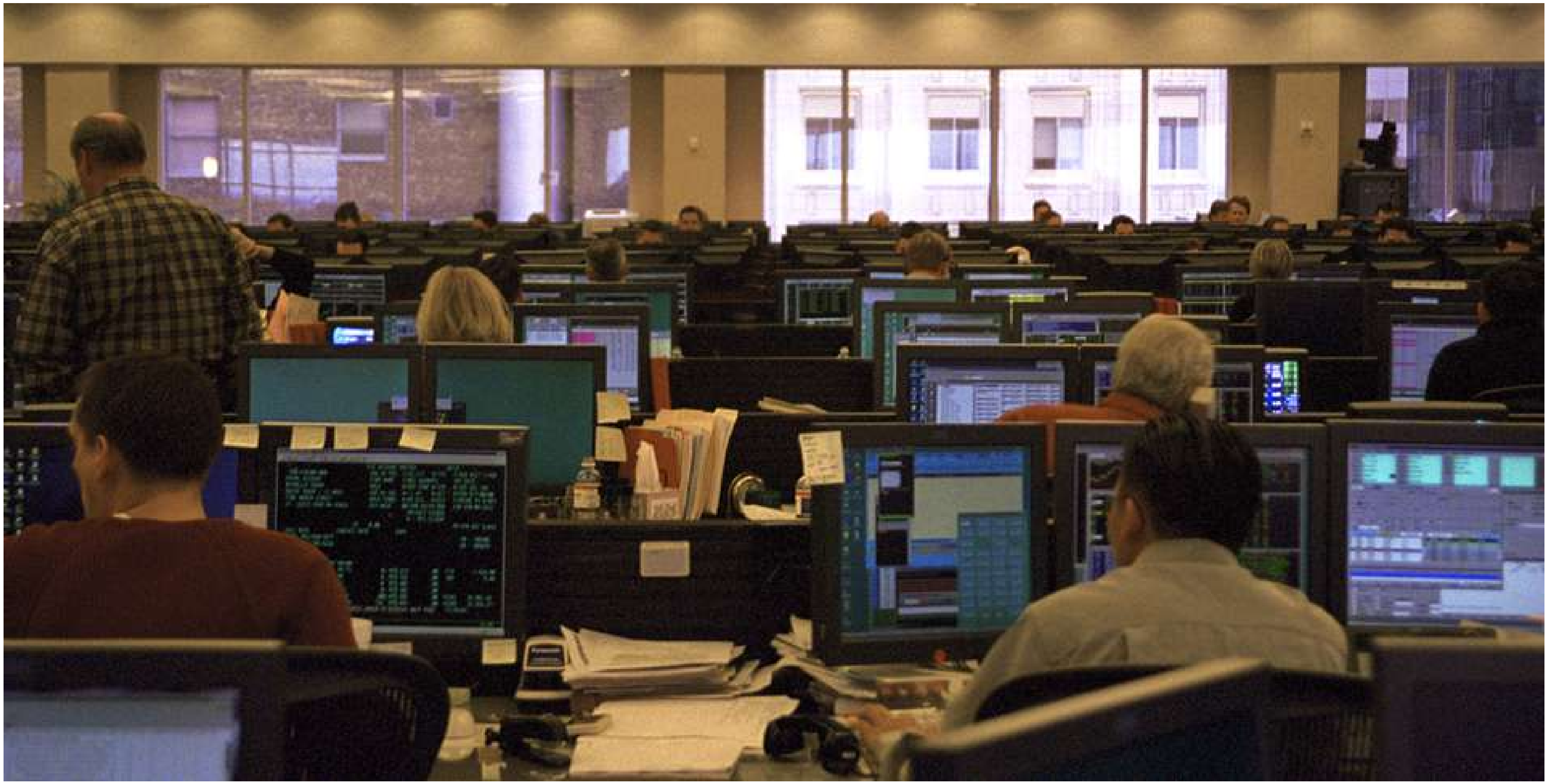
Monetary Tool #3: Open Market Operations

- Purchasing Government Securities
- Selling Government Securities
- Targets

Monetary Tool #3: Open Market Operations

Open market operations involve the buying and selling of government securities. Identify Steps in a Process What steps would lead to a reduction in the money supply through open market operations?

Monetary Tool #3: Open Market Operations

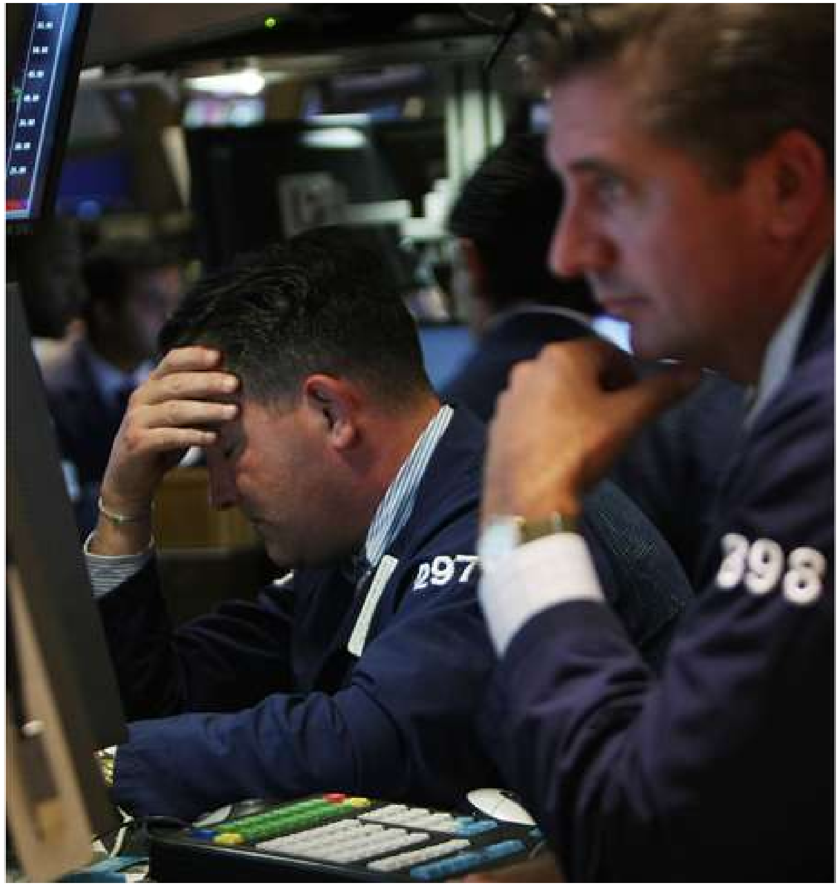


As the name implies, open market operations occur when the Fed buys and sells securities on the open market, trading with buyers and sellers like the people shown here.

Using Monetary Policy Tools

Open market operations are the most often used of the Federal Reserve's monetary policy tools. They can be conducted smoothly and on an ongoing basis to meet the Fed's goals. The Fed changes the discount rate less frequently. It usually follows a policy of keeping the discount rate in line with other interest rates in the economy in order to prevent excess borrowing by member banks from the Fed, which might threaten economic stability.

Using Monetary Policy Tools



The economic crisis that occurred from 2007 to 2009 shook financial markets and prompted the Fed to take action.