

Monetary Policy

A. The Money Supply's Effect on the Economy

1. The bulk of the nation's money supply is created by the lending activities of banks & other financial institutions
 - a. When the banking system makes loans to individuals, businesses, & governments, the money supply increases, & when these loans are paid off, the money supply decreases
 - (1)
 - (2)
 - (3)
 - b. Policies that change the size of the money supply can be used to promote price stability, maximum employment, & reasonable economic growth
2. Monetary policy – refers to actions by the Federal Reserve System (the central banking system of the U.S.) that lead to changes in the supply of money & the availability of credit
 - a. There are 2 types of monetary policies that the Federal Reserve (the Fed) can adopt
 - (1) Easy-money policy
 - (2) Tight-money policy
 - (3)
 - b. Too easy a policy causes high inflation & too tight a policy causes high unemployment, so a good balance must be struck
3. The Federal Reserve's ability to control the total amount of money in the economy is not complete as the actions of individuals, firms, & foreign investors all influence the money supply

B. The Federal Reserve (the Fed)

1. The fear of a single central bank dominated by a few wealthy financiers led to the decision to create the Federal Reserve System that was split into national, district, & local levels
 - a. At the national level, the Fed is made up of the ***Board of Governors & the Federal Open Market Committee (FOMC)***
 - (1) Board of Governors

(2) Federal Open Market Committee (FOMC)

- b. At the district level, the Fed is made up of 12 district Federal Reserve banks
 - (1)
 - (2)
 - c. At the local level, the Fed is made up of member banks
 - (1)
 - (2)
2. Aside from guiding the U.S. monetary policy, the Fed performs several other services
- a. The Fed provides services to banks
 - (1)
 - (2)
 - b. The Fed provides services to the government
 - (1)
 - (2)
 - (3)
3. The Fed performs its monetary policies by using 3 tools – changing reserve requirements, changing discount rates, & buying or selling government securities on the open-market
- C. The Fed's Tools of Monetary Policy
- 1. The Fed determines the percentage of a bank's total deposits that must be held on reserve as either cash in their vaults or as deposits in their district Federal Reserve Bank (known as the *reserve requirement*)
 - a. Banks may lend its deposits to individuals & businesses that it is not required to keep as reserves by the Fed
 - (1)
 - (2)
 - b. Changes in the reserve requirement thus affect AD & influence the levels of both unemployment & inflation
 - (1)

- (2)
 - c. The Fed does not often make frequent or dramatic changes to reserve requirements because such changes would create uncertainty in the banking system
- 2. At times, a financial institution may not have enough reserves to meet its reserve requirement, & in such a circumstance, that bank must get a loan either from the Fed or from another bank
 - a. In these situations, the Fed can stimulate the money supply by lowering the **discount rate** (the rate of interest that the Fed charges to a bank for a loan)
 - (1)
 - (2)
 - (3)
 - b. The Fed can also restrain the money supply by raising the discount rate
 - (1)
 - (2)
 - (3)
- 3. The main tool of the Fed to affect the money supply is **open-market operations**, or the buying & selling of government securities
 - a. The FOMC decides to buy or sell government securities (like Treasury bonds, notes, & bills) in conjunction with the monetary policy set by the Board of Governors
 - (1)
 - (2)
 - b. The Fed can stimulate the money supply by buying government securities, which physically pumps new reserves into the economy
 - (1)
 - (2)

- c. The Fed can restrain the money supply by selling government securities, which physically takes reserves out of the economy
 - (1)
 - (2)

D. Limitations of Monetary Policy

- 1. Policies cannot be immediately determined, implemented, or evaluated, but instead there exist long & variable lags associated with each stage of the process
 - a.
 - b.
- 2. Disagreements among economists about the effectiveness of monetary policy can be evaluated using the *equation of exchange* ($MV = PQ$), which relates the money supply & its velocity to the nominal GDP
 - a. MV (money supply x velocity of circulation) represents the total amount spent by buyers in the economy, & PQ (prices x quantity) represents the total amount received by sellers, so the two must be equal
 - (1)
 - (2)
 - b. The *equation of exchange*'s ability to track inflation makes it very useful for economists