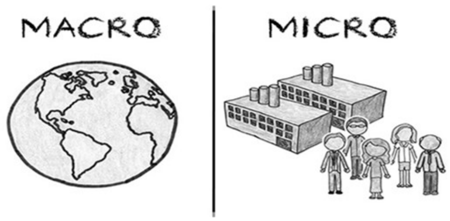
UNIT 5



MACROECONOMICS

MONETARY POLICY

Standard SSEMA2

Explain the role and functions of the Federal Reserve System.

a. Explain the roles/functions of money as a medium of exchange, store of value, and unit of account/standard of value.

<u>What is Money?</u>

Money in the United States economy primarily refers to the coins, currency, and checkable (demand) deposits available to consumers and producers to make purchases. This is known as M1 definition of the money supply which is the definition of money used for the money function "medium of exchange."

There are 3 main functions of money.

<u>Medium of exchange</u>: something accepted by all parties as payment for goods and services. This is the most basic function, it must be accepted.

There are 3 main functions of money.

<u>Standard of Value</u>: a common denominator that can be used to express worth in terms that most people can understand.

There are 3 main functions of money.

<u>Store of Value</u>: allows purchasing power to be saved until needed in the future.

Describe the last transaction in which you used money as a medium of exchange.	Using money as the standard, explain the value of one hour of your time.	Describe your preferred method of storing the value of your money.

Standard SSEMA2

Explain the role and functions of the Federal Reserve System.

b. Describe the organization of the Federal Reserve System (12 Districts, Federal Open Market Committee (FOMC), and Board of Governors).

c. Define monetary policy.

d. Define the tools of monetary policy including reserve requirement, discount rate, open market operations, and interest on reserves.

e. Describe how the Federal Reserve uses the tools of monetary policy to promote its dual mandate of price stability and full employment, and how those affect economic growth.

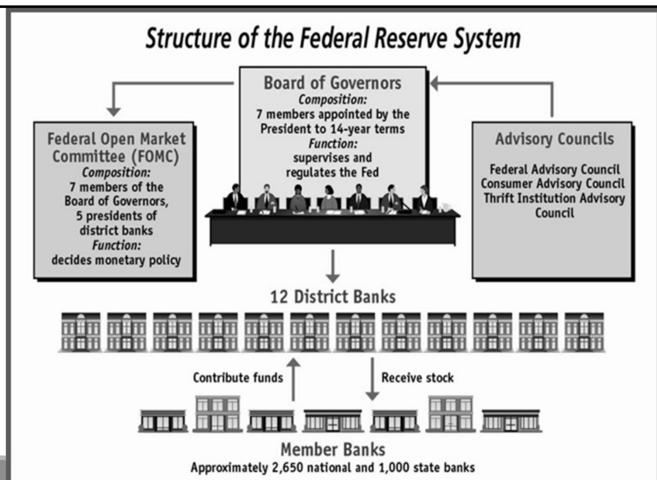
Federal Reserve System

The Federal Reserve System (The Fed) acts to help achieve the economic goals of price stability, full employment, and economic growth. It maintains the currency and the payments system, regulates and supervises banks, protects consumers and encourages financial literacy, acts as the government's bank, and conducts monetary policy.

Key functions

Federal Reserve System

The Fed controls the size of the money supply through reserve requirements, open market operations, the discount rate, and interest on reserves. Changes to the money supply can also affect inflation. Because of different situations and changing political opinions, economic policies have moved in and out of favor, but we needed all three policies in the Great Recession.



Federal Reserve System

Board of Governors

- The Fed is privately owned by member banks and is run by a seven-member Board of Governors. The Board sets general policy for the Fed
- 7 members, each serving 14 year terms
- Members are appointed by the president and confirmed by the Senate

Federal Reserve System

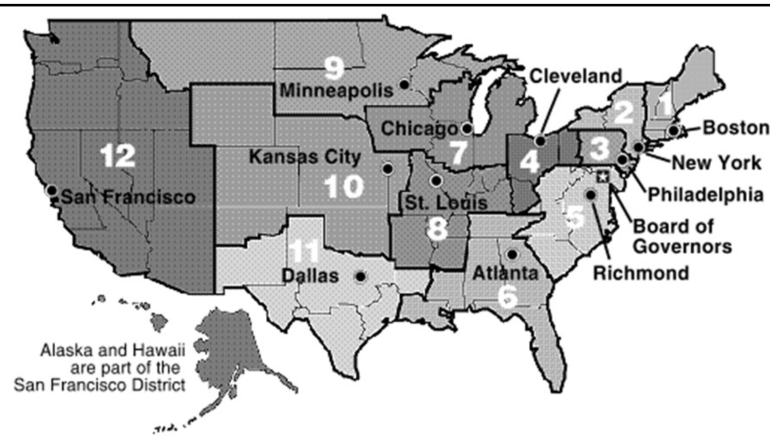
Federal Open Market Committee

- The Federal Open Market Committee (FOMC) is the primary monetary policy arm of the Fed. It has the power to raise or lower interest rates.
- The committee has 12 members and meets 8 times a year
- Makes decisions about the growth of money supply and interest rates

Federal Reserve System

District Banks

- There are twelve district Fed banks in different regions of the country. District banks provide many of the same functions for banks and depository institutions that banks provide to us.
- District banks accept deposits from and make loans to other banks



Federal Reserve System

Member Banks

- Commercial banks that are members of the Fed bank in their district.
- These are the banks we use.

Bank of America.

SunTrust

Bank of North Georgia

Fidelity Bank

Fifth Third Bank

Federal Reserve System

- The Fed is also responsible for the money supply, for regulating banks, for preparing certain consumer legislation, and serves as the federal government's bank.
- The Fed determines how much currency is in circulation, and the Bureau of the Mint makes new bills and coins.

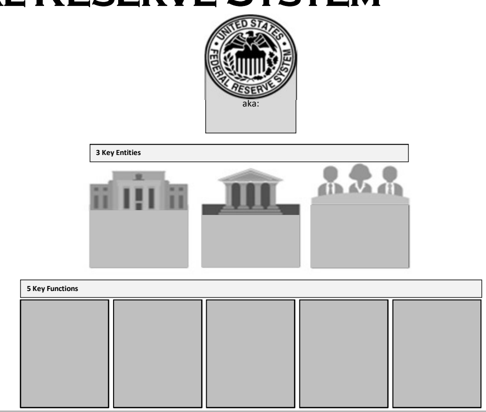
Federal Reserve System

- The Fed controls the payment system, which controls the electronic transfer of funds. It is also the clearinghouse for all checks written in the United States.
- The Fed makes sure that all banks operate in accordance with banking laws and regulations.

Federal Reserve System

- The Fed provides some guidance for consumers, and oversees certain consumer related issues, such as mortgages and foreclosures.
- The Fed raises money for the federal government by selling bonds and other securities that have the backing of the faith and credit of the U.S. government.

Federal Reserve System



Federal Reserve System

The most important role of the Federal Reserve is in controlling the money supply — the total amount of money in an economy. By controlling the money supply, the Fed influences the growth of the GDP, and the rate of inflation.

Federal Reserve System

Monetary Policy: the expansion or contraction of the money supply to influence the cost and availability of credit.

The cost of credit = Interest

Federal Reserve System

- The Fed controls the money supply to create greater stability within the economy.
- It's goal is to promote economic growth, stable prices, and full employment.

Federal Reserve System

Easy Money Policy

- The Fed allows the money supply to expand and interest rates to fall, which normally stimulates the economy. This policy is used when the economy is in a recession.

AKA: Expansionary Money Policy

Federal Reserve System

Tight Money Policy

- The Fed restricts the money supply which increases interest rates and slows the economy down. This is used when the economy is experiencing inflation.

AKA: Contractionary Money Policy

Federal Reserve System

Fractional Reserve System: a system that requires banks and other depository institutions to keep a fraction of their deposits in the form of legal reserves.

Federal Reserve System

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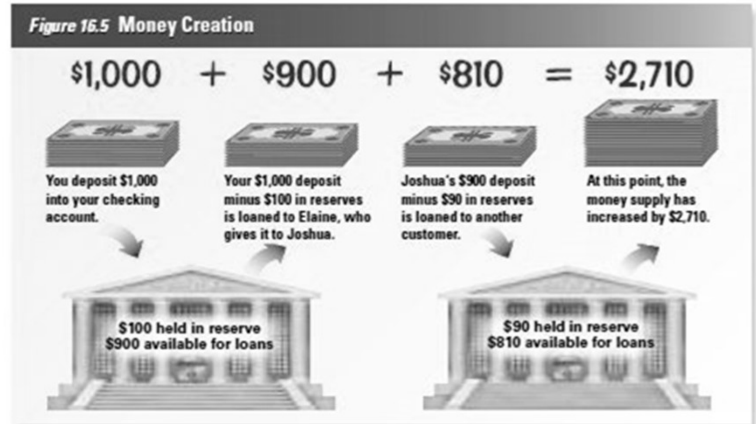
Federal Reserve System

Initial Deposit: $1000		Reserve Requirement: 15%	
Year	**Deposit**	**Reserves**	**Loan Amount**
1	$1,000	$150.00	$850.00
2	$850.00		
3			
4			
5			
Total			

Federal Reserve System

Reserve Requirement: a rule stating that a percentage of every deposit be set aside as legal reserves.

- Deposit $100 with a reserve requirement of 10%.
- The bank must set side $10 as a required reserve.
- And then may loan the remaining $90, which is called excess reserves.
- It is logical to assume the bank will want to loan that money because banks earn interest on the loan.



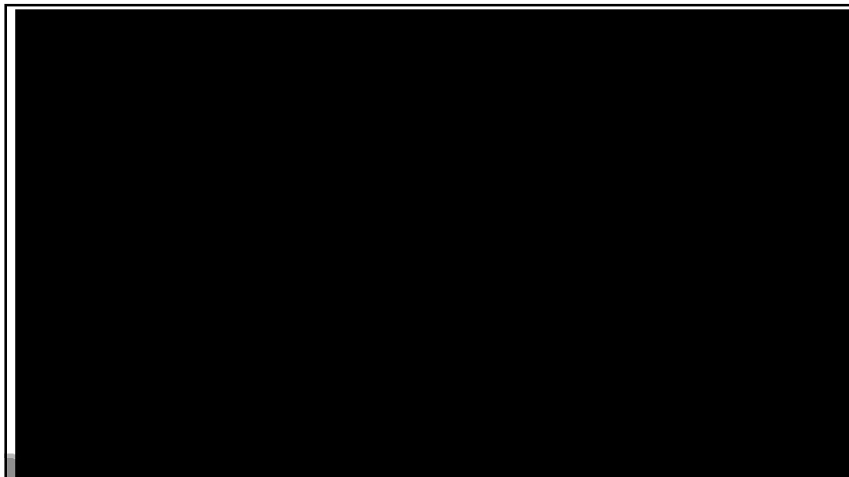
Federal Reserve System

The fractional reserve system will allow the money supply to grow to several times the size of the excess reserves the banking system keeps.

Fred deposits $1,000 in a bank.

How much will the money supply expand?

- $1,000 ÷ .10 = $10,000 (money supply)
- $1,000 ÷ .20 = $ 5,000 (money supply)
- $1,000 ÷ .25 = $ 4,000 (money supply)



Monetary Policy Review

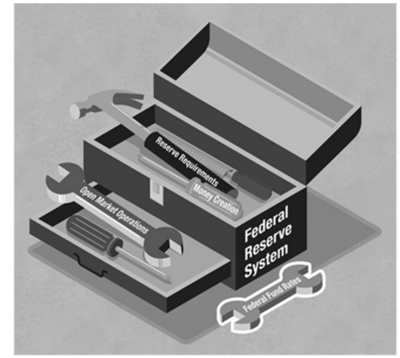
EOC Quick Review

Federal Reserve System

Tools of the Fed

- Reserve Requirement
- Discount Rate
- Open Market Operations
- Interest on Reserves

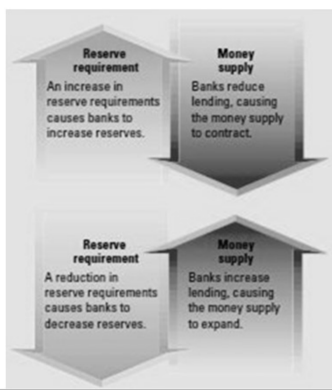
Each tool affects the amount of excess reserves in the banking system.



Federal Reserve System

Tools of the Fed

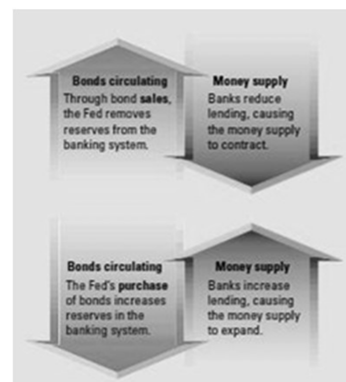
- **Reserve Requirement**: The amount that banks must set aside for every dollar deposited.
- Lowering the RR will expand the money supply.
- Raising the RR will shrink the money supply.



Federal Reserve System

Tools of the Fed

- **Open Market Operations**: This is the most popular tool of monetary policy. It involves the buying and selling of government securities/bonds.
- When the Fed buys bonds, the money supply expands.
- When the Fed sells bonds, the money supply shrinks.



Federal Reserve System

Tools of the Fed

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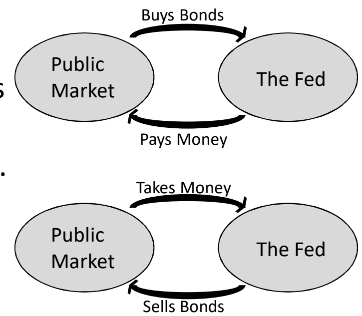
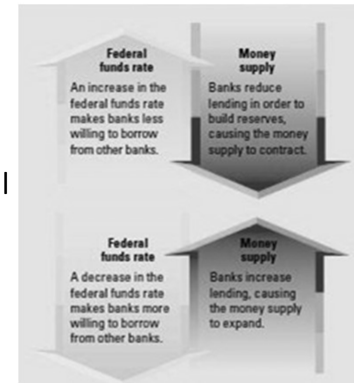


Federal Reserve System

Tools of the Fed

- **Discount Rate**: this is the interest rate the Fed charges on loans to other banks.
- Lowering the discount rate will expand the money supply.
- Raising the discount rate will reduce the money supply.



Problem	Solution		
	Open Market Operations	Reserve Requirement	Discount Rate
Inflation			
Recession and High Unemployment			

Federal Reserve System

Tools of the Fed

- **Interest on Reserves**: The Federal Reserve pays interest on the required reserves as well as the excess reserves of financial institutions. These financial institutions must determine whether they can earn more profit by loaning this money out to customers or by earning interest from the Fed by keeping the excess reserves. If the Fed changes the amount of interest earned on reserves it changes the incentives for institutions to keep or to loan out the money.

Fred deposits $1,000 in a bank with a reserve requirement of 10%.

- $100 Required Reserve
- $900 Available to Loan
- $800 Actual Loans

Tool	Fed Action	Effect on Excess Reserves	Money Supply
Reserve Requirement	Lower	Frees excess reserves because fewer are needed to back existing deposits in the system.	Expands
	Raise	More reserves are required to back existing deposits in the system. Excess reserves contract.	Contracts
Open Market Operations	Buy	Checks written by the Fed add to reserves in the banking system	Expands
	Sell	Checks written by buyers are subtracted from bank reserves. Excess reserves in the system contract	Contracts
Discount Rate	Lower	Additional reserves can be obtained at lower cost. Excess reserves expand.	Expands
	Raise	Additional reserves through borrowing are now more expensive. Excess reserves are not added.	Contracts
Interest on Reserves	Lower	Banks increase loans. Excess reserves contract.	Expands
	Raise	Banks increase reserves on deposit, decreasing loans. Excess reserves expand.	Contracts