

## MONETARY POLICY

The interaction of supply and demand of money determines interest rates (the price of money). The Federal Reserve is the Central Bank of the United States and in charge of monetary policy. The Fed conducts monetary policy through the Federal Open Market Committee (FOMC). Through the FOMC the Fed controls the nation's money supply.

Monetary policy has two primary goals:    1) promote stable prices (keep inflation low)  
  2) promote "maximum" output (GDP) and employment

The FOMC conducts monetary policy using two primary tools:

- 1) Open Market Operations—the Fed's buying and selling of Treasury bonds and bills
- 2) Discount Rate Changes—changing the interest rate that the 12 District banks pay to borrow money directly from the Fed

LOOSE Monetary Policy is a policy that is designed to increase the supply of money. This policy typically involves lowering the discount rate and buying securities (Treasury bonds and bills) in open market operations. This injects money into the banking system, thereby increasing the money supply and placing downward pressure on interest rates (*the federal funds rate*).

End Result: Lower interest rates encourage consumers to spend more money causing aggregate demand to increase which leads to a higher GDP and more employment.

TIGHT Monetary Policy is a policy that is designed to decrease the supply of money. This policy typically involves raising the discount rate and selling securities (Treasury bonds and bills) in open market operations. This takes money out of the banking system, decreasing the money supply and placing upward pressure on interest rates. (*the federal funds rate*).

End Result: Higher interest rates encourage consumers to spend less money causing aggregate demand to fall which leads to a lower GDP and less employment.

Short Term versus Long Term Interest Rates:

Open market operations influence the federal funds rate -- the interest rate that financial institutions pay when they borrow reserves overnight from each other. This is a short term interest rate. The Federal Reserve DOES NOT control long term interest rates which are based on future inflationary expectations. Low inflation will naturally lead to low, long term interest rates. If the Fed simply lowered short term interest rates and inflation rose you would actually have very low short term interest rates and high long term interest rates! Recall that inflation is the enemy of people who "save" money. Therefore, if inflation expectations rise, long term interest rates must rise to compensate investors for the shrinking value of money.

What Sectors of the Economy are stimulated by Monetary Policy:

Any area of the economy that is financed (*where money is borrowed*) such as Housing, Automobiles, Business Investment, etc.... As interest rates fall people are encouraged to spend money which stimulates aggregate demand, raising GDP.

Inflation: The Risk of Monetary policy:

Wages and prices will begin to rise at a faster rate if monetary policy stimulates aggregate demand enough to push labor and capital markets beyond their long-run capacities. In fact, a monetary policy that persistently attempts to keep short-term real rates excessively low will eventually lead to higher inflation and higher nominal interest rates. Once inflation starts---it is very hard to control and will lead to lowering long term GDP. The Fed's inflation target is 1.5%-2.0% and inflation in excess of 3% really worries the Federal Reserve.

FOMC in 2001-2009:

Monetary policy, like Fiscal Policy, has a policy lag (time). You should expect a *6-month to one-year time lag* before the economy demonstrates the effect of a change in monetary policy. When the Federal Reserve decides to change monetary policy it "targets" a new federal funds rate. Usually the FOMC changes the federal funds rate in 25 or 50 basis points increments ( $\frac{1}{4}$  or  $\frac{1}{2}$  of 1% ). During the recession of 2001 the FOMC was very aggressive. It lowered the federal funds rate from 6.0% to 1.00% in 13 separate decreases to help stimulate the struggling economy.

Between June of 2004 and June 2006 the Federal Reserve RAISED interest rates from 1.0% to 5.25% at 17 consecutive FOMC meetings to help keep potential inflationary pressures in check. Starting in September 2007 the Federal Reserve has lowered rates aggressively, bringing the federal funds rate to 0.0% in January 2009, where it has remained.

1) What are the two main responsibilities/goals of the Fed and its monetary policy?

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2) List the 2 primary types of monetary policy & circle the appropriate discount rate and Open Market Operation policy with each type.

\_\_\_\_\_ discount rate (increase , decrease) Securities/U.S. Treasury bonds (buy or sell)

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3) What is the difference between short term and long-term interest rates?

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4) Explain a risk of running long periods of loose monetary policy.

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