# Chapter 15 THE FEDERAL RESERVE AND MONETARY POLICY

## Chapter in a Nutshell



1. The Federal Reserve System, often simply called the Fed, is the central bank of the Untied States. It was created through an act signed by President Woodrow Wilson in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system.

2. The Fed has a structure designed by Congress to give it a broad perspective on the economy. At the head of the Fed’s formal organization is the Board of Governors. The 12 regional Federal Reserve Banks make up the next level. The organization of the Fed also includes the Federal Open Market Committee and three advisory councils. The Federal Reserve has as stockholders the commercial banks that are members of the Fed.

3. The Fed, as the overseer of the nation’s monetary system has many important duties: lender of last resort, regulating and supervising banks, supplying services to banks and to the government, foreign exchange operations, and controlling the money supply and interest rates.

4. The main responsibility of the Fed is that of formulating and implementing monetary policy which consists of changing the economy’s money supply to help the economy in achieving maximum output and employment and also stable prices. The Fed uses three policy instruments to influence the money supply: open market operations, the discount rate, and the reserve requirement.

5. In the short run, when prices are temporarily fixed, the Fed has the ability to affect the level of interest rates in the economy. When the Fed increases the money supply in order to reduce interest rates, aggregate demand increases, which results in an increase in output and employment. Conversely, a decrease in the money supply that increases interest rates will decrease aggregate demand, output, and employment. In the long run a change in the money supply by the Fed affects only prices and not output and employment.

6. Although monetary policy is employed essentially to attain price stability and full employment the domestic economy, its use also influences, and is influenced by, international developments.

7. One strength of monetary policy is that it is highly impersonal: monetary policy interferes very little with the freedom of the market. Monetary policy is also flexible and can be implemented quickly in response to changing economic circumstances. Finally, the Fed is insulated from day-to-day political pressures so it can act in the best interests of the economy. This allows the Fed to engage in unpopular policies that might be necessary for the long-run health of the economy.

8. Critics of the Fed, however, argue that active changes in the money supply by the Fed can and do destabilize the economy. They note that the Fed does not have up-to-the-minute reliable information about the state of the economy and prices. Timing lags also limit the effectiveness of monetary policy. As a result, critics call for the elimination of activism in monetary policy in favor of a law requiring a fixed rate of increase in money each year.

### Chapter Objectives

After reading this chapter, you should be able to:

1. Describe the structure and operation of the Federal Reserve System.

2. Identify the services that the Federal Reserve System provides for the U.S. economy.

3. Explain the purpose and operation of monetary policy.

4. Describe the instruments that the Federal Reserve uses to control the money supply and interest rates.

5. Explain how monetary policy influences, and is influenced by, international developments.

6. Assess the advantages and disadvantages of monetary policy.

7. Evaluate whether Congress should reduce the independence of the Federal Reserve.

### Key Concept Quiz

## Knowledge Check



|  |  |
| --- | --- |
| 1. Federal Open Market Committee 2. monetary policy 3. discount rate 4. discount window 5. moral hazard 6. exchange rate 7. Federal funds rate 8. Board of Governors 9. Federal Reserve System | \_\_\_\_\_ a. consists of changing money supply to achieve macroeconomic goals  \_\_\_\_\_ b. the rate at which one currency trades for another  \_\_\_\_\_ c. an incentive to take risks on the assumption that intervention will occur in case of failure  \_\_\_\_\_ d. the Fed’s most important policy making body for controlling the money supply  \_\_\_\_\_ e. the rate Federal Reserve banks charge for loans to banks  \_\_\_\_\_ f. refers to Fed loans which are repaid with interest at maturity  \_\_\_\_\_ g. consists of seven members appointed by the President of the United States  \_\_\_\_\_ h. the central bank of the United States  \_\_\_\_\_ i. the rate at which banks lend to each other |

### Multiple Choice Questions

1. The Fed is independent in the sense that its actions do not require the endorsement of
2. The U.S. House of Representatives
3. The U.S. Senate
4. The President
5. All of the above
6. The Federal Reserve system was
7. created to provide the nation with a stable monetary system
8. signed into law by President Theodore Roosevelt
9. not legislated by Congress
10. all of the above
11. The Federal Reserve system consists of
12. 12 regional banks
13. 10 regional banks
14. 15 regional banks
15. 20 regional banks
16. The Fed’s most important policy making body for controlling the growth of the money supply is the
17. Federal Open Market Committee
18. Board of Governors
19. Advisory Councils
20. Organization of Policy Committee
21. The Federal Reserve banks
22. are not motivated by profit
23. charge commercial banks for check collection and other services
24. receive no funding from the government
25. all of the above
26. The Federal Reserve banks are owned by
27. the banks that are members of the federal reserve system
28. the U.S. Treasury
29. all citizens of the U.S.
30. state and local governments
31. All of the following are important functions of the Fed *except*
32. controlling the money supply
33. reducing the government debt
34. regulating and supervising banks
35. supplying services to banks
36. The Fed supplies the following services to the U.S. government, *except*
37. a checking account at the Fed
38. issuing and redeeming treasury bills, notes and bonds, including savings bonds
39. helping the congress and the president negotiate a tax cut
40. destroying currency that is no longer usable
41. Open market operations
42. refer to the purchase or sale of securities to the Fed
43. are only undertaken to slow down the growth of money supply in the economy
44. are always undertaken on explicit orders from Congress
45. refer to foreign exchange operations of the Fed
46. When a commercial bank uses the Fed’s discount window it
47. is availing of the Fed’s service as a lender of last resort
48. is attempting to improve its profits by securing a low interest loan
49. is acquiring additional reserves to help improve the profits of another bank
50. decreases its reserve holdings
51. Monetary policy that attempts to increase employment and output in the short run involves
52. increasing the money supply
53. increasing the discount rate
54. increasing the required reserve ratio
55. selling securities to banks
56. An increase in the required reserve ratio
57. leads to an increase in the monetary supply
58. leads to an increase in the discount rate
59. may lead to an expansion in aggregate demand
60. may be part of a contractionary monetary policy package.
61. The interest rate that commercial banks charge each other for short-term loans is called
62. the commercial interest rate
63. the discount rate
64. the prime rate
65. the federal funds rate
66. When the Fed decreases the discount rate, it may be pursuing
67. contractionary fiscal policy
68. contractionary monetary policy
69. expansionary monetary policy
70. anti-inflationary policy
71. Critics of the Fed’s intervention in the case of the bailing out of Long-Term Capital Management maintain that such actions create
72. moral hazard problems
73. money hazard problems
74. risky venture problems
75. growth hazard problems
76. If the Fed decreases the money supply, which of the following will occur in the short run
77. the interest rate will increase, the price level will decrease, and real output will decrease
78. the interest rate will increase, the price level will increase, and real output will decrease
79. the interest rate will decrease, the price level will decrease, and real output will increase
80. the interest rate will decrease, the price level will increase, and real output will decrease
81. The timing lag required by the Fed to correctly analyze economic data for policy decisions is the
82. administrative lag
83. execution lag
84. operation lag
85. recognition lag
86. If the Fed desires to increase the exchange value of the dollar relative to the Japanese yen, it would
87. initiate an expansionary monetary policy
88. initiate a contractionary monetary policy
89. initiate an expansionary fiscal policy
90. initiate a contractionary fiscal policy
91. Suppose the Fed purchases a $100,000 Treasury bill from Pioneer Bank. If the required reserve ratio is 25 percent, the maximum amount that the bank can safely lend is
92. $50,000
93. $75,000
94. $100,000
95. $125,000
96. When the Fed buys securities on the open market, the securities it purchases are usually
97. bonds issued by private corporations
98. securities issued by foreign governments
99. securities issues by state and local governments
100. securities issued by the U.S. Treasury
101. The independence of the Federal Reserve from the federal government is reinforced by the fact that the Federal Reserve
102. does not depend on the federal government for its operating budget
103. controls all economic policy making in the United States
104. is able to nominate and elect its own Board of Governors
105. provides 7 year terms for the members of it Board of Governors
106. Concerning the Federal Reserve, decisions to buy or sell government securities are made by the
107. presidents of the 12 Federal Reserve banks
108. Board of Governors of the Federal Reserve system
109. Federal Open Market Committee
110. Federal Advisory Council
111. The most important function of the Federal Reserve is
112. the control of the nation’s money supply
113. the issuing of checks for the federal government
114. lender of funds to U.S. stock brokers
115. providing of a means of check clearance for banks
116. Economists widely agree that the Fed’s monetary policy is
117. equally effective in combating inflation and recession
118. not effective in combating inflation and recession
119. better at combating inflation than recession
120. better at combating recession than inflation
121. To help stabilize the U.S. economy following the terrorist attack against the United States in 2001, the Federal Reserve adopted
122. an expansionary monetary policy
123. a contractionary monetary policy
124. an expansionary fiscal policy
125. a contractionary fiscal policy
126. The monetary tool that is used least by the Federal Reserve System is
127. bonds issued by private corporations
128. securities issued by foreign governments
129. securities issues by state and local governments
130. securities issued by the U.S. Treasury

### True-False Questions

1. T F Monetary policy interferes significantly with the freedom of the private sector of the economy.

2. T F Monetary policy is highly effective, and unlike fiscal policy does not suffer from timing lags.

3. T F Some critics of the Fed would prefer to see the money supply increase at a fixed rate each year.

4. T F The Fed has the ability to affect interest rates in the long run.

5. T F Monetary policy enjoys the unique benefit of not being subject to changes due to international developments.

6. T F A decrease in the money supply also reduces interest rates and employment.

7. T F The Fed uses four policy instruments to change the money supply: open market operations, the money market rate, the discount window, and the reserve requirement.

8. T F Monetary policy is never used to attain full employment and is essentially used to achieve price stability.

9. T F Some believe that the Fed does not have up-to-the-minute reliable information about the state of the economy and prices.

10. T F The stockholders of the Fed are the commercial banks that are members of the Fed.

11. T F The Fed operates as a profit-making venture, and when it runs at a loss, Congress authorizes funds to cover such losses.

12. T F An increase in the money supply increases interest rates and aggregate demand.

13. T F The Fed, unlike commercial banks, is not involved in foreign exchange operations.

14. T F The Fed is insulated from day-to-day political pressures.

15. T F The Fed, which is the central bank of the United States, is guaranteed by the constitution of the United States.

16. T F There are a total of 13 regional Federal Reserve banks.

17. T F Open market operations are directed by the FOMC.

18. T F The Fed has three advisory councils.

19. T F The Federal Open Market Committee usually meets about every six weeks.

20. T F The Fed can initiate a tight monetary policy by selling government securities.

21. T F The discount rate is the most important and widely used monetary tool of the Fed.

22. T F It is widely agreed that the Fed is better at combating recession than inflation.

23. T F The Fed will loan reserves to troubled banks for virtually any reason.

24. T F An expansionary monetary policy tends to decrease interest rates in the short run and thus stimulate aggregate demand.

25. T F The administrative lag for monetary policy is shorter than for fiscal policy.

26. T F The fact that the Fed is a self‑financing institution supports its independence from the federal government.

27. T F Immediately following the 2001 terror attack against the United States, the Fed enacted a contractionary monetary policy designed to reduce inflationary expectations.

28. T F A main argument for making the Federal Reserve largely independent from the federal government is that politicians may put reelection, rather than the long‑run health of the economy, first in their decision making.

### Application Questions

1. The Central Bank of Mammon purchases $1,000 in government bonds from a commercial bank. Assume this commercial bank is the only bank in Mammon and thus constitutes the entire commercial banking system.
2. If the legal reserve requirement in Mammon is 25 percent, what is the money multiplier?
3. If this commercial bank was fully loaned up before this transaction, how much does it have in excess resources now?
4. What is the maximum amount of money that can be created due to this transaction?
5. What happens to the money supply if the Central Bank of Mammon sells $1,000-worth of treasury securities to the commercial bank?
6. What are the transactions described in questions *1* and *2* commonly called? What do you suppose are the differences in the policy objectives of the Central Bank of Mammon in pursuing these two different transactions?



## Answers to Knowledge Check Questions

### Key Concept Answers

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| --- | --- | --- |
| 1. d | 4. f | 7. i |
| 2. a | 5. c | 8. g |
| 3. e | 6. b | 9. h |

### Multiple Choice Answers

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 1. d | 6. a | 11. a | 16. a | 21. a | 26. b |
| 2. a | 7. b | 12. d | 17. d | 22. c |  |
| 3. a | 8. c | 13. d | 18. b | 23. a |  |
| 4. a | 9. a | 14. c | 19. c | 24. c |  |
| 5. d | 10. a | 15. a | 20. d | 25. a |  |

### True-False Answers

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 1. F | 6. F | 11. F | 16. F | 21. F | 26. T |
| 2. F | 7. F | 12. F | 17. T | 22. F | 27. F |
| 3. T | 8. F | 13. F | 18. T | 23. F | 28. T |
| 4. F | 9. T | 14. T | 19. T | 24. T |  |
| 5. F | 10. T | 15. F | 20. T | 25. T |  |

### Application Question Answers

1. a. The money multiplier is 4.

1. The bank has $1,000 in excess reserves.
2. The maximum amount of money that can be created is $4,000.
3. The money supply decreases.
4. These are called open market operations. The central bank is possibly attempting to increase output and employment when it purchases bonds. The central bank may be combating inflation when it sells bonds.