LECTURE FOUR - PART SIX

The U.S. Fed's Peculiar Structure

- The U.S. Fed is NOT one big bank directly controlled by the Federal government like in Germany or Japan.
  - – Instead, the Fed is both decentralized and privately owned.
- The Fed consists of 12 regional banks spread throughout the country, and they are owned by the commercial banks.
- In reality, the Fed behaves as a government agency.

The Fed's Structure

- This regional structure of the Fed was originally designed in an age of populism.
- The populist goal was to avoid too great a concentration of central-banking powers in the hands of eastern establishment bankers or Washington bureaucrats.


PRESIDENT'S SIGNATURE ENACTS CURRENCY LAW

Wilson Declares It the First of Series of Constructive Acts to Aid Business.

Makes Speech to Group of Democratic Leaders.

Conference Report Adopted by Senate by Vote of 43 to 25.

Banks All Over the Country Hasten to Enter Federal Reserve System.

WILSON SEES DAWN OF NEW ERA IN BUSINESS

HOME VIEWS OF CURRENCY ACT

FOUR PENS USED BY PRESIDENT

Structure of the Federal Reserve

The Federal Reserve Chairman

The "second most powerful individual in American government behind the President"

Exerts enormous control over monetary policy

Regional Reserve Banks and Branches

- 12 regional Federal Reserve banks.
- 25 branches of Federal Reserve banks.

Board of Governors of the Federal Reserve System

- 7 members nominated by the President and confirmed by the Senate to serve overlapping terms of 14 years.
- Chairman and vice chairman designated by the president and confirmed by the Senate.

Federal Open Market Committee (FOMC)

- 7 members of the Fed's Board of Governors.
- The President of the New York Federal Reserve District Bank.
- Four rotating members from the other eleven Federal Reserve District Banks.

Major Functions of the U.S. Federal Reserve

1. Issue currency
2. Lender of last resort
3. Regulate financial institutions
4. Provide banking services to the Federal government
5. Provide financial services to the nation's banks
6. Conduct monetary policy!!!!!!!!!!

The Objectives of Monetary Policy

- Promote economic growth in line with the economy's potential to expand.
- Provide a high level of employment.
- Insure stable prices.
- Provide moderate long-term interest rates.

The Fed's Open Market Committee

- The Federal Reserve conducts monetary policy through its Federal Open Market Committee.
- The FOMC meets periodically to conduct monetary policy using three major policy instruments.

A meeting of the FOMC

Setting The Reserve Requirement

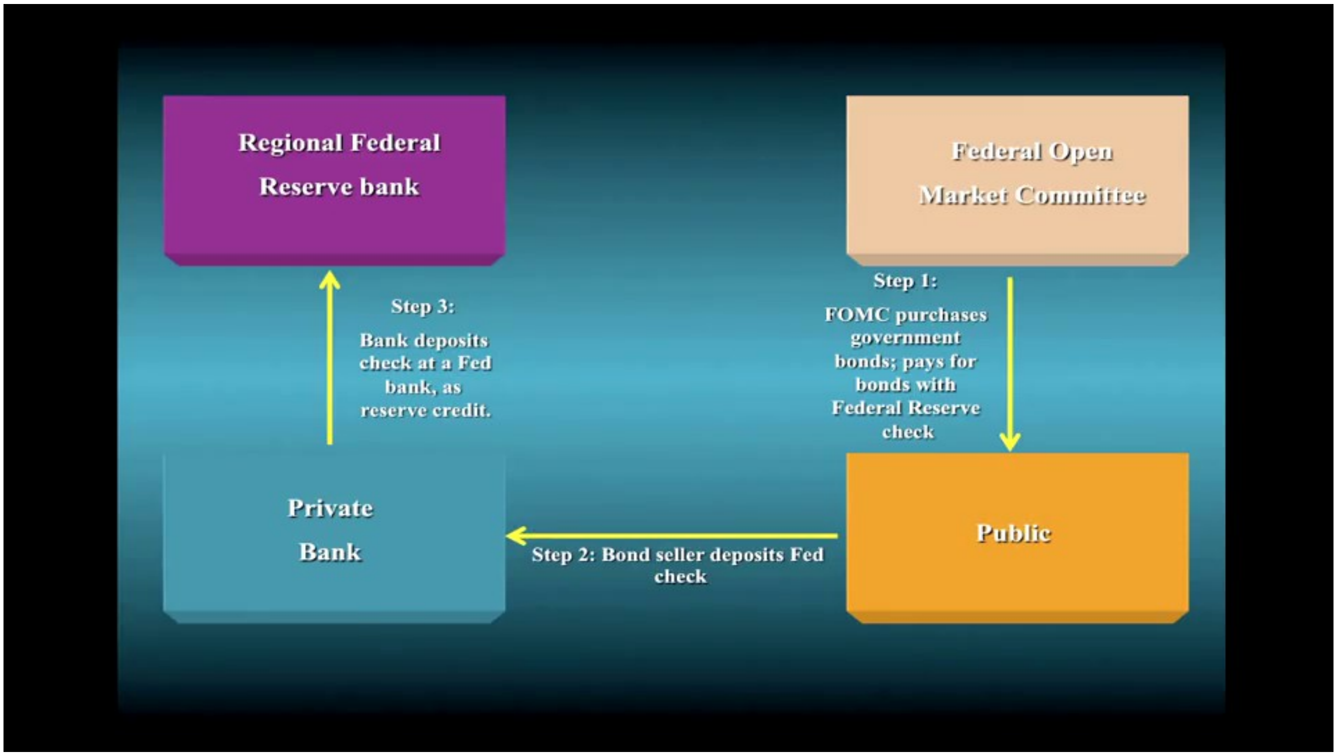
- Setting the reserve requirement RR is the least used of the Fed's monetary policy tools.
- The Fed can increase M by lowering the RR or decrease M by raising the RR.
- The Fed rarely uses changes in the reserve requirement to conduct monetary policy.
- The Fed's primary function is to insure that banks don't fall below a safe level of reserves and thereby undermine the stability of the system.

Setting the Discount Rate

- The discount rate is the interest rate the Fed charges to banks when they borrow money.
- Lowering the discount rate makes it cheaper for banks to borrow money and expand M.
- Raising the discount rate makes it more expensive for banks to borrow from the Fed and is contractionary.

Open Market Operations

- The most important instrument of monetary policy.
- Involves the buying and selling of government securities to expand or contract M.
- The Fed BUYS government securities to expand the money supply.
- The Fed SELLS government securities to contract the money supply.



Open Market Operations a Potent Tool!

- By buying or selling bonds, the Fed can expand or contract the money supply.
- Such open market operations allow the Fed to determine the total supply of money.
- Open market operations thereby represent the Fed's most potent traditional monetary policy tool!!!

Example: The Fed Fights Inflation

- Suppose the Fed thinks the economy is overheating and starting to generate demand-pull inflation.
- The Keynesian solution is to contract the economy.
- So the Federal Open Market Committee votes to sell $1 billion of Treasury bills.
- This reduces the money supply and thereby drives up interest rates and slows the economy.

Who Are The Bonds Sold To?

- The bonds are sold to the “open market – hence “open market operations.”
- This open market includes dealers in government bonds who resell them to commercial banks, big corporations, other financial institutions, and even individuals.
- The purchasers buy bonds by writing checks to the Fed, drawn from an account in a commercial bank.
- In this way, the Fed reduces the money supply!

An Example

- Suppose the Fed sells $10,000 worth of bonds to Linda Smith.
- Smith will write a check on the Coyote Bank of Santa Fe to pay for the bonds.
- The Fed then presents this check at the Coyote Bank.

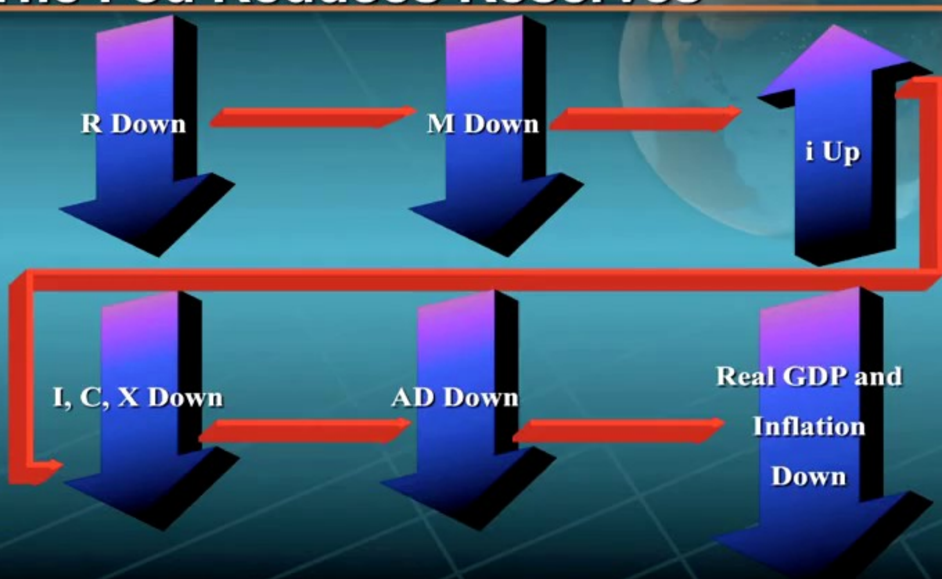
The Important Point

- When the Coyote Bank pays the check, it will reduce its balance of reserves with the Federal Reserve.
- This, in turn, reduces the reserves in the entire commercial banking system by $10,000.

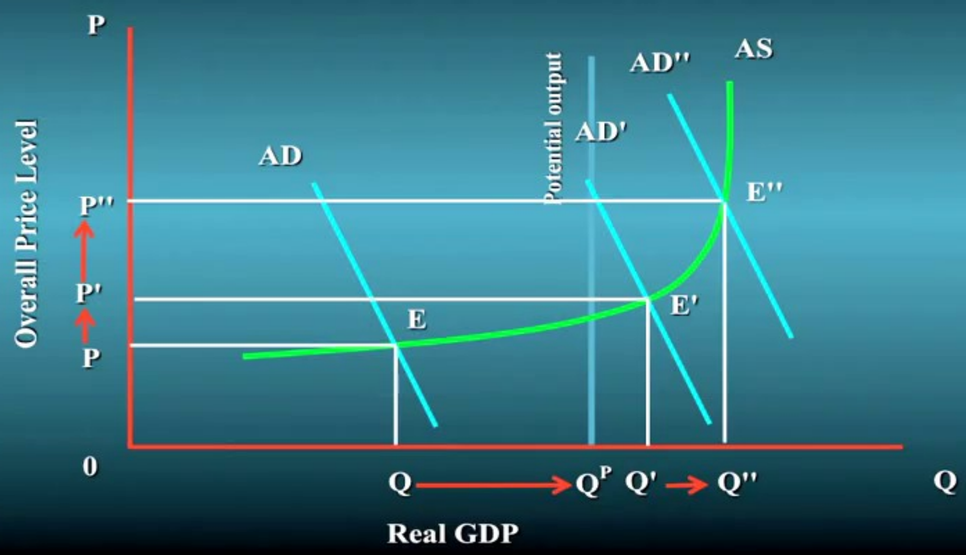
Closing a Recessionary Gap With Monetary Policy

- You should now see how open market operations can be used to close a recessionary or an inflationary gap.
- This process is illustrated with the help of a five-step monetary policy sequence called the <u>monetary transmission mechanism</u>.

The Fed Reduces Reserves



Monetary Policy in the AD-AS Framework



(1)
Easy money policy

Problem: Unemployment and recession

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Federal Reserve buys bonds, lowers reserve ration, or lowers the discount rate

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Excess reserves increase

↓

Money supply rises

↓

Interest rates fall

↓

Investment spending increases

↓

Aggregate demand increases

↓

Real GDP rises by a multiple of the increase in investment

(2)
Tight money policy

Problem: inflation

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Federal Reserve sells bonds, increases reserve ratio, or increases the discount rate

↓

Excess reserves decrease

↓

Money supply falls

↓

Interest rate rises

↓

Investment spending decreases

↓

Aggregate demand decreases

↓

Inflation declines