

Topic 2 – Who controls Money? What are central banks?

<https://www.investopedia.com/articles/investing/053115/how-central-banks-control-supply-money.asp> (Source)

<https://www.investopedia.com/terms/m/monetarypolicy.asp>

How Central Banks Regulate Money Supply: Key Tools and Effects

Central banks play an important role in maintaining a nation's economic health. By adding or removing money from circulation, they help stabilize growth, control inflation, and manage employment levels.

In the U.S., this role is carried out by the [Federal Reserve](#). In other countries, it is the [European Central Bank](#), the Swiss National Bank, the Bank of England, the People's Bank of China, and the Bank of Japan.

[Central banks](#) influence the money supply through tools like interest rate adjustments, reserve requirements, open market operations, and quantitative easing, all of which shape GDP, inflation, and unemployment across the economy.

(Monetary Policy: Meaning, Types, and Tools

What Is Monetary Policy?

Monetary policy is a set of tools used by a nation's [central bank](#) to control the overall money supply and promote economic growth.

It involves strategies such as adjusting [interest rates](#) and changing [bank reserve requirements](#).

The [Federal Reserve](#) implements monetary policy in the United States to meet its dual mandate from Congress: to achieve maximum employment while keeping inflation in check.)

Key Takeaways

- Central banks regulate money supply to stabilize the economy, impacting interest rates and economic growth.
- Tools for money supply control include setting reserve requirements, conducting open market operations, and engaging in quantitative easing.
- Printing money increases supply but can lead to inflation if excessive.
- Open market operations involve buying or selling government securities to influence money circulation.
- Quantitative easing is used during economic crises to lower long-term interest rates and encourage investment.

Why the Quantity of Money Matters

The quantity of money circulating in an economy affects both micro- and macroeconomic trends. At the micro-level, a large supply of free and easy money means more spending by people and by businesses. Individuals have an easier time getting personal loans, car loans, or home mortgages; companies find it easier to secure financing, too.

At the macroeconomic level, the amount of money circulating in an economy affects things like gross domestic product, overall growth, interest rates, and unemployment rates. The central banks tend to control the quantity of money in circulation to achieve economic objectives and affect monetary policy.

The Role of Money Printing in Economic Policy

Once upon a time, nations pegged their currencies to a gold standard, which limited how much they could produce. But that ended by the mid-20th century, so now, central banks can increase the amount of money in circulation by simply printing it. They can print as much money as they want, though there are consequences for doing so.

Merely printing more money doesn't affect the economic output or production levels, so the money itself becomes less valuable. Since this can cause inflation, simply printing more money isn't the first choice of central banks.

Understanding Reserve Requirements and Their Economic Impact

One of the basic methods used by all central banks to control the quantity of money in an economy is the reserve requirement. As a rule, central banks mandate depository institutions (that is, commercial banks) to keep a certain amount of funds in reserve (stored in vaults or at the central bank) against the amount of deposits in their clients' accounts.¹

Thus, a certain amount of money is always kept back and never circulates. Say the central bank has set the reserve requirement at 9%. If a commercial bank has total deposits of \$100 million, it must then set aside \$9 million to satisfy the reserve requirement. It can put the remaining \$91 million into circulation.

When the central bank wants more money circulating into the economy, it can reduce the reserve requirement. This means the bank can lend out more money. If it wants to reduce the amount of money in the economy, it can increase the reserve requirement. This means that banks have less money to lend out and will thus be pickier about issuing loans.

Central banks periodically adjust the reserve ratios they impose on banks.

IMPORTANT

On March 26, 2020, in response to the coronavirus pandemic, the Fed reduced reserve requirement ratios to 0%—eliminating reserve requirements for all U.S. depository institutions, in other words.

How Central Banks Impact Interest Rates

In most cases, a central bank cannot directly set interest rates for loans such as mortgages, auto loans, or personal loans. However, the central bank does have certain tools to push interest rates towards desired levels. For example, the central bank holds the key to the policy rate—the rate at which commercial banks get to borrow from the central bank (in the United States, this is called the federal discount rate).

When banks get to borrow from the central bank at a lower rate, they pass these savings on by reducing the cost of loans to their customers. Lower interest rates tend to increase borrowing, and this means the quantity of money in circulation increases.

Open Market Operations: A Tool for Monetary Control

Central banks affect the quantity of money in circulation by buying or selling government securities through the process known as open market operations (OMO). When a central bank is looking to increase the quantity of money in circulation, it purchases government securities from commercial banks and institutions. This frees up bank assets: They now have more cash to loan. Central banks do this sort of spending as part of an expansionary or easing monetary policy, which brings down the interest rate in the economy.

The opposite happens in a case where money needs to be removed from the system. In the United States, the Federal Reserve uses open market operations to reach a targeted federal funds rate, the interest rate at which banks and institutions lend money to each other overnight. Each lending-borrowing pair negotiates their own rate, and the average of these is the federal funds rate. The federal funds rate, in turn, affects every other interest rate. Open market operations are a widely used instrument as they are flexible, easy to use, and effective.

Quantitative Easing: Stimulating Economies During Crises

In dire economic times, central banks can take open market operations a step further and institute a program of quantitative easing. Under quantitative easing, central banks create money and use it to buy up assets and securities such as government bonds. This money enters into the banking system as it is received as payment for the assets purchased by the central bank. The banks' reserves swell up by that amount, which encourages banks to give out more loans, it further helps to lower long-term interest rates and encourage investment.

After the financial crisis of 2007–2008, the Bank of England and the Federal Reserve launched quantitative easing programs. More recently, the European Central Bank and the Bank of Japan have also announced plans for quantitative easing.

The Bottom Line

Central banks regulate money circulation through tools such as setting reserve requirements, influencing interest rates, conducting open market operations, and using quantitative easing. These measures help manage liquidity, control inflation, and support economic growth. Ensuring the right quantity of money in circulation is necessary to stabilize the economy and promote sustainable long-term development.