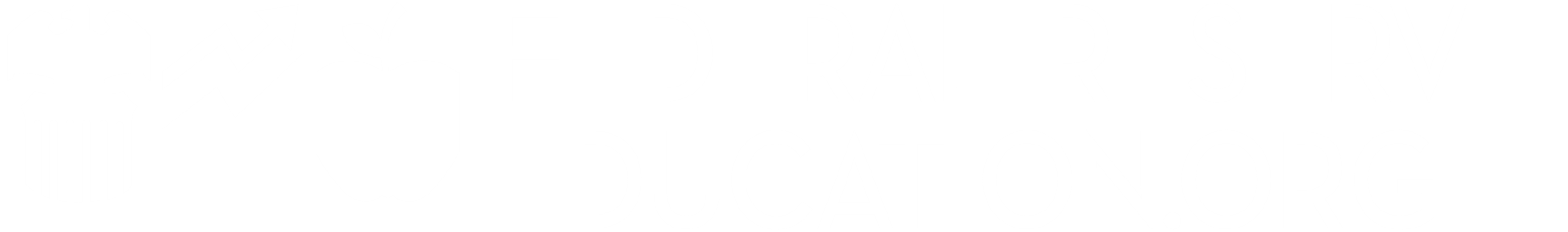
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## **Monetary Policy Basics**

### **Introduction**

The term "monetary policy" refers to what the Federal Reserve, the nation's central bank, does to influence the amount of money and credit in the U.S. economy. What happens to money and credit affects interest rates (the cost of credit) and the performance of the U.S. economy.

Test your knowledge about monetary policy through this [**quiz**](https://www.federalreserveeducation.org/about-the-fed/structure-and-functions/monetary-policy/quiz). Additional [**quizzes**](https://www.federalreserveeducation.org/about-the-fed/quizzes) are also available.

### **What is inflation and how does it affect the economy?**



Inflation is a sustained increase in the general level of prices, which is equivalent to a decline in the value or purchasing power of money. If the supply of money and credit increases too rapidly over time, the result could be inflation.

### **What are the goals of monetary policy?**

The goals of monetary policy are to promote maximum employment, stable prices and moderate long-term interest rates. By implementing effective monetary policy, the Fed can maintain stable prices, thereby supporting conditions for long-term economic growth and maximum employment.

### **What are the tools of monetary policy?**

The Federal Reserve’s three instruments of monetary policy are open market operations, the discount rate and reserve requirements.

Open market operations involve the buying and selling of government securities. The term “open market” means that the Fed doesn’t decide on its own which securities dealers it will do business with on a particular day. Rather, the choice emerges from an “open market” in which the various securities dealers that the Fed does business with – the primary dealers – compete on the basis of price. Open market operations are flexible, and thus, the most frequently used tool of monetary policy.

The discount rate is the interest rate charged by Federal Reserve Banks to depository institutions on short-term loans.

Reserve requirements are the portions of deposits that banks must maintain either in their vaults or on deposit at a Federal Reserve Bank.

### **What are the open market operations?**

The Fed uses open market operations as its primary tool to influence the supply of bank reserves. This tool consists of Federal Reserve purchases and sales of financial instruments, usually securities issued by the U.S. Treasury, Federal agencies and government-sponsored enterprises. Open market operations are carried out by the Domestic Trading Desk of the Federal Reserve Bank of New York under direction from the FOMC. The transactions are undertaken with primary dealers.

When the Fed wants to increase reserves, it buys securities and pays for them by making a deposit to the account maintained at the Fed by the primary dealer’s bank. When the Fed wants to reduce reserves, it sells securities and collects from those accounts. Most days, the Fed does not want to increase or decrease reserves permanently, so it usually engages in transactions reversed within several days. By trading securities, the Fed influences the amount of bank reserves, which affects the federal funds rate, or the overnight lending rate at which banks borrow reserves from each other.

The federal funds rate is sensitive to changes in the demand for and supply of reserves in the banking system, and thus provides a good indication of the availability of credit in the economy.

### **What is the role of the Federal Open Market Committee (FOMC)?**



he FOMC formulates the nation’s monetary policy. The voting members of the FOMC consist of the seven members of the Board of Governors (BOG), the president of the Federal Reserve Bank of New York and presidents of four other Reserve Banks who serve on a one-year rotating basis. All Reserve Bank presidents participate in FOMC policy discussions whether or not they are voting members. The chairman of the Board of Governors chairs the FOMC meeting.

The FOMC typically meets eight times a year in Washington, D.C. At each meeting, the committee discusses the outlook for the U.S. economy and monetary policy options.

### **What occurs at a FOMC meeting?**

First, a senior official of the Federal Reserve Bank of New York discusses developments in the financial and foreign exchange markets, along with the details of the activities of the New York Fed's Domestic and Foreign Trading Desks since the previous FOMC meeting. Senior staff from the Board of Governors (BOG) present their economic and financial forecasts. Governors and Reserve Bank presidents (including those currently not voting) present their views on the economic outlook. The BOG’s director of monetary affairs discusses monetary policy options (without making a policy recommendation.) The FOMC members then discuss their policy preferences. Finally, the FOMC votes.

### **How is the FOMC's policy implemented?**

At the conclusion of each FOMC meeting, the Committee issues a statement that includes the federal funds rate target, an explanation of the decision, and the vote tally, including the names of the voters and the preferred action of those who dissented. To implement the policy action, the Committee issues a directive to the New York Fed’s Domestic Trading Desk that guides the implementation of the Committee’s policy through open market operations. Before conducting open market operations, the staff at the Federal Reserve Bank of New York collects and analyzes data and talks to banks and others to estimate the amount of bank reserves to be added or drained that day. They then confer with Fed officials in Washington who do their own daily analysis and reach a consensus about the size and terms of the operations. Then, a New York Fed official sends a message to the primary dealers to indicate the Fed’s intention to buy or sell securities, and the dealers submit bids or offers as appropriate.

The minutes of each FOMC meeting are published three weeks after the meeting and are available to the public. Occasionally, the FOMC makes a change in monetary policy between meetings.

While the Federal Reserve Bank presidents discuss their regional economies in their presentations at FOMC meetings, they base their policy votes on national, rather than local, conditions.

### **Why does the Fed typically conduct open market operations several times a week?**

The vast majority of open market operations are not intended to carry out changes in monetary policy. Instead, open market operations are conducted on a daily basis to prevent technical, temporary forces from pushing the effective federal funds rate too far from the target rate.

* About the Fed

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