SESSION 11:
The Role of the Federal Reserve System and Monetary Policy

Session Description

The Federal Reserve System's monetary policy works to stabilize and promote the growth of the U.S. economy. This session will provide students with an overview of the Federal Reserve System and its monetary policy.

Talking Points

The Federal Reserve System (the Fed)

1. The Federal Reserve System is the central bank of the United States. "Central bank" is the generic name given to a country's primary monetary authority. Generally, a nation's central bank is responsible for determining the money supply, supervising and regulating banks, providing banking services for the government, and lending to banks.

2. Congress created the Federal Reserve System in 1913. Congress oversees the entire Federal Reserve System. The Fed must work within the objectives Congress established, yet Congress gave the Federal Reserve autonomy to carry out its responsibilities without political pressure. The Federal Reserve System is a central bank under public control, with many checks and balances.

3. The nation's periodic episodes of banking panics were one of the most serious concerns that led Congress to create the Federal Reserve and establish the following as its responsibility: safe, sound, and competitive practices in the nation's banking system. To accomplish this, Congress included the Fed among those responsible for regulating the banking system and supervising financial institutions.
    a. Regulation refers to the written rules that define acceptable behavior and conduct for financial institutions. These regulations help establish safe, sound banking practices and protect consumers in financial transactions.
    b. The nation's banking system is only as safe and sound as the banks within the system. The Federal Reserve examines banks regularly to identify and contain bank risks.

4. The Fed has three main parts: (1) the Board of Governors, (2) 12 regional Reserve Banks, and (3) the Federal Open Market Committee (FOMC).

5. The Board of Governors, also called the Federal Reserve Board, is an agency of the federal government and located in Washington, D.C. It is the Fed's centralized component. The Board of Governors consists of seven members who are appointed by the

president of the United States and confirmed by the Senate to staggered, 14-year terms, which expire every two years. Fed governors guide the Federal Reserve's policy actions. Longer, staggered terms ensure the Fed's political independence as a central bank.

a. The president of the United States appoints two Fed governors to serve four-year terms as Chairman and Vice Chairman of the Board.

b. The Chairman reports to Congress twice a year regarding the Fed's monetary policy objectives, testifies before Congress on numerous other issues, and meets periodically with the Secretary of the Treasury.

6. The structure of the Federal Reserve is complex, yet effective. Reserve Banks operate somewhat independently but under the general oversight of the Board of Governors.

7. Federal Reserve Banks are often called the "bankers' banks" because they provide services to commercial banks similar to the services commercial banks provide to their customers. Federal Reserve Banks authorize or distribute currency and coin to banks, lend money to banks, and process electronic payments.

8. Reserve Banks also serve as fiscal agents for the U.S. government. They maintain accounts for the U.S. Treasury, process government checks, and conduct government securities auctions.

9. Economists at Reserve Banks conduct regional, national, and international research; prepare Reserve Bank presidents for their participation on the FOMC; and distribute information about the economy through publications, speeches, educational workshops, and websites.

10. The FOMC is the Fed's chief body for monetary policy.

    a. By tradition, the chairman of the FOMC is also the Chairman of the Board of Governors. The FOMC includes the 7 Fed governors and the 12 Reserve Bank presidents.

    b. At any time, only 12 of the members vote on policy decisions. These include the 7 members of the Board of Governors, the president of the Federal Reserve Bank of New York, and 4 other Reserve Bank presidents. Although Reserve Bank presidents vote on a rotating basis, all of them attend and participate in deliberations at FOMC meetings even when they are not voting members.

    c. The FOMC typically meets eight times a year in Washington, D.C. If economic conditions require additional meetings, the FOMC can and does meet more often.

Monetary Policy

1. Keeping our economy healthy is one of the most important jobs of the Federal Reserve. The Federal Reserve System has a dual mandate. By law, the Fed must pursue the economic goals of price stability and maximum employment. It does this by managing the nation's system of money and credit—in other words, conducting monetary policy. The Fed can pursue expansionary and/or contractionary policies.

2. Expansionary policy actions are intended to increase economic activity, and contractionary policy actions are intended to moderate or decrease economic activity.
   a. Expansionary monetary policy refers to actions taken by the Federal Reserve to increase the growth of the money supply and the amount of credit available.
   b. Contractionary monetary policy refers to actions taken by the Federal Reserve to decrease the growth of the money supply and the amount of credit available.

3. The Fed has three main tools to achieve its monetary policy goals: the discount rate, reserve requirements, and open market operations. All three affect the amount of funds in the banking system.
   a. The Discount Rate
      i. The discount rate is the interest rate Reserve Banks charge commercial banks for short-term loans. The discount rate influences other interest rates. Federal Reserve lending at the discount rate complements open market operations in achieving the target federal funds rate and serves as a backup source of liquidity for commercial banks. Reserve Banks and the Board of Governors make changes to the discount rate.
      ii. Lowering the discount rate is expansionary because lower interest rates encourage lending and spending by consumers and businesses.
      iii. Raising the discount rate is contractionary because higher interest rates discourage lending and spending by consumers and businesses.
   b. Reserve Requirements
      i. A reserve requirement is the portion of deposits the Fed requires banks to hold in cash, either in their vaults or on deposit at a Reserve Bank. The Board of Governors has sole authority over changes to reserve requirements. The Fed rarely changes reserve requirements.
      ii. A decrease in reserve requirements is expansionary because it increases the funds available in the banking system to lend to consumers and businesses.
      iii. An increase in reserve requirements is contractionary because it reduces the funds available in the banking system to lend to consumers and businesses.
   c. Open Market Operations
      i. Open market operations refers to the Fed buying and selling government securities from its portfolio. It is the most frequently used tool, by far.

ii. Buying and selling securities affects an important interest rate called the federal funds rate. The federal funds rate is the interest rate that banks charge one another for overnight loans. It is an important rate because it influences other interest rates in the economy. For example, if the federal funds rate rises, home loan rates and car loan rates will likely rise as well. The FOMC establishes a target for the federal funds rate and then uses open market operations to move the rate toward the target.

iii. The Fed holds government securities, as do individuals, banks, and other financial institutions, such as brokerage companies and pension funds. After FOMC participants have deliberated the options, members vote on a policy that is given to the Federal Reserve Bank of New York's Trading Desk. The policy directive informs the Desk of the FOMC's objective for open market operations—whether to maintain or alter the current policy. The Desk then buys or sells U.S. government securities on the open market to achieve this objective.

iv. The term "open market" means that market forces and not the Fed itself decides with which securities dealers the Fed will buy and sell government securities—that is, various securities dealers compete against each other in the government securities market based on price.

4. The Fed's purchase of government securities is referred to as expansionary monetary policy and its sale of government securities as contractionary monetary policy.

a. Expansionary Monetary Policy

i. Purchases of government securities increase bank reserves, making more funds available for lending. This puts downward pressure on the federal funds rate. Policymakers call this easing, or expansionary monetary policy.

ii. When the Fed buys government securities through the securities dealers in the bond market, it deposits the payments into the bank accounts of the banks, businesses, and individuals who sold the securities.

iii. Those deposits become part of the funds in commercial bank accounts and thus part of the funds that commercial banks have available to lend.

iv. Because banks want to lend money, to attract borrowers they decrease interest rates, including the rate they charge each other for overnight loans (the federal funds rate).

b. Contractionary Monetary Policy

i. Sales of government securities reduce bank reserves. Less money available for lending tends to raise the federal funds rate. Policymakers call this tightening, or contractionary monetary policy.

ii. When the Fed sells government securities, buyers pay from their bank accounts, which reduces the amount of funds held in bank accounts.

iii. Because there is less money in bank accounts, banks have less money available to lend.

iv. When banks have less money to lend, the price of lending that money—the interest rate—goes up, and that includes the federal funds rate.

Session 11: Standards and Benchmarks

Arkansas Economic Standards

Strand: National Economy

Content Standard 6: Students will analyze monetary and fiscal policies for a variety of economic conditions.

- NE.6.E.2 Examine monetary policy tools used by the Federal Reserve System (e.g., open market operations, discount rate, reserve requirement, interest on reserves)

Common Core State Standards

- CCSS.ELA-Literacy.RH.9-10.1 Cite specific textual evidence to support analysis of primary and secondary sources, attending to such features as the date and origin of the information.
- CCSS.ELA-Literacy.RH.9-10.2 Determine the central ideas or information of a primary or secondary source; provide an accurate summary of how key events or ideas develop over the course of the text.
- CCSS.ELA-Literacy.RH.9-10.4 Determine the meaning of words and phrases as they are used in a text, including vocabulary describing political, social, or economic aspects of history/social science.
- CCSS.ELA-Literacy.SL.9-10.1 Initiate and participate effectively in a range of collaborative discussions (one-on-one, in groups, and teacher-led) with diverse partners on grades 9–10 topics, texts, and issues, building on others' ideas and expressing their own clearly and persuasively.
- CCSS.ELA-Literacy.SL.9-10.1d Respond thoughtfully to diverse perspectives, summarize points of agreement and disagreement, and, when warranted, qualify or justify their own views and understanding and make new connections in light of the evidence and reasoning presented.
- CCSS.ELA-Literacy.L.9-10.4 Determine or clarify the meaning of unknown and multiple-meaning words and phrases based on *grades 9–10 reading and content*, choosing flexibly from a range of strategies.
- CCSS.ELA-Literacy.L.9-10.6 Acquire and use accurately general academic and domain-specific words and phrases, sufficient for reading, writing, speaking, and listening at the college and career readiness level; demonstrate independence in gathering vocabulary knowledge when considering a word or phrase important to comprehension or expression.
- CCSS.ELA-Literacy.RH.11-12.1 Cite specific textual evidence to support analysis of primary and secondary sources, connecting insights gained from specific details to an understanding of the text as a whole.

- CCSS.ELA-Literacy.RH.11-12.2 Determine the central ideas or information of a primary or secondary source; provide an accurate summary that makes clear the relationships among the key details and ideas.
- CCSS.ELA-Literacy.SL.11-12.1 Initiate and participate effectively in a range of collaborative discussions (one-on-one, in groups, and teacher-led) with diverse partners on grades 11–12 topics, texts, and issues, building on others' ideas and expressing their own clearly and persuasively.
- CCSS.ELA-Literacy.SL.11-12.1d Respond thoughtfully to diverse perspectives; synthesize comments, claims, and evidence made on all sides of an issue; resolve contradictions when possible; and determine what additional information or research is required to deepen the investigation or complete the task.
- CCSS.ELA-Literacy.L.11-12.4 Determine or clarify the meaning of unknown and multiple-meaning words and phrases based on *grades 11–12 reading and content*, choosing flexibly from a range of strategies.
- CCSS.ELA-Literacy.L.11-12.6 Acquire and use accurately general academic and domain-specific words and phrases, sufficient for reading, writing, speaking, and listening at the college and career readiness level; demonstrate independence in gathering vocabulary knowledge when considering a word or phrase important to comprehension or expression.

Session 11: Resources

The Federal Reserve System

1. Online Course: In Plain English (Federal Reserve Bank of St. Louis)
   a. Go to https://www.stlouisfed.org/education.
   b. Choose 

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   c. Register or, if you already have an account, log in.
   d. Register your class for the course as follows:
      i. Choose the "COURSES" tab.
      ii. In the "COURSE NAME" column choose "In Plain English."
      iii. Choose "ADD TO CLASSROOM" and follow the prompts.

2. Lesson: Your Introduction to The Federal Reserve and You; http://www.philadelphiafed.org/education/teachers/resources/fed-today/Your_Introduction_to_The_Federal_Reserve_and_You_Lesson.pdf
   a. Video (viewed during the lesson): The Federal Reserve and You: Chapter 1 (3:50); http://www.phil.frb.org/education/federal-reserve-and-you/index.cfm

3. Complete one of the following, either the lesson or online course:
   a. Lesson: The Great Depression Curriculum Unit (Federal Reserve Bank of St. Louis)
      i. Lesson 6: Could It Happen Again?; https://www.stlouisfed.org/education/great-depression-curriculum-unit
         (1) Choose the PDF and accompanying slides of your choice:
            a. SMART Notebook
            b. PowerPoint
   b. Online Course: The Great Depression (Federal Reserve Bank of St. Louis)
      i. Lesson 6: Could It Happen Again?
         (1) Go to https://www.stlouisfed.org/education.
         (2) Choose 

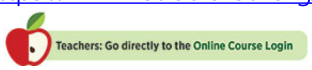
         .
         (3) Register or, if you already have an account, log in.
         (4) Register your class for the course as follows:
            a. Choose the "COURSES" tab.
            b. In the "COURSE NAME" column choose "Could It Happen Again?"
            c. Choose "ADD TO CLASSROOM" and follow the prompts.

Monetary Policy

4. ☑ Ⓢ Visual 11A: Monetary Chain for Expansionary Monetary Policy

5. High School Economics (*Virtual Economics® 4.5*)
    a. Lesson 22: The Case of the Gigantic $100,000 Bill

6. Lesson: The Fed's Toolbox; https://www.stlouisfed.org/education/the-feds-toolbox
    a. Choose the PDF and accompanying PowerPoint slides.

7. Online Course: Monetary Policy (Federal Reserve Bank of St. Louis)
    a. Go to https://www.stlouisfed.org/education.
    c. Choose 

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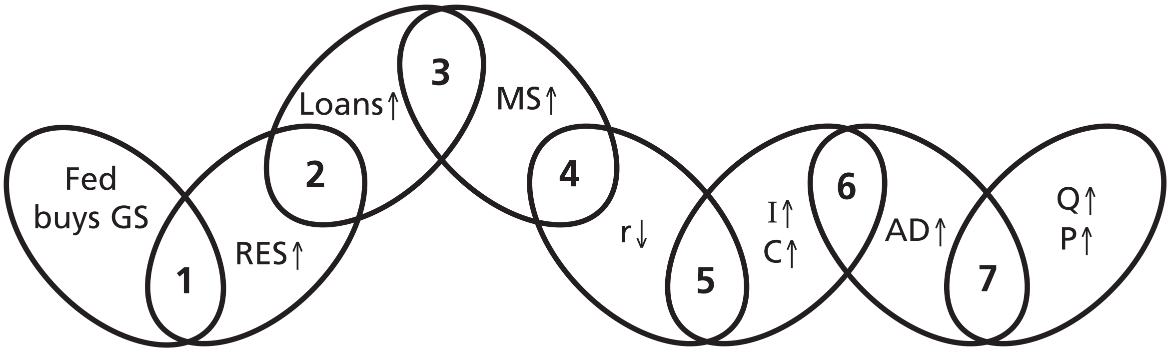
    d. Register or, if you already have an account, log in.
    e. Register your class for the course as follows:
        i. Choose the "COURSES" tab.
        ii. In the "COURSE NAME" column choose "Monetary Policy."
        iii. Choose "ADD TO CLASSROOM" and follow the prompts.

8. Lesson: Crowding Out (Federal Reserve Bank of St. Louis); https://www.stlouisfed.org/education/crowding-out
    a. Choose the PDF and accompanying SMART Notebook slides.

Ⓢ Visual 11A: Monetary Chain for Expansionary Monetary Policy



1. The Federal Reserve buys government securities (GS)—that is, the Fed conducts open market operations. The Fed pays for these securities by making deposits in the sellers' bank accounts.

2. Those deposits increase bank reserves (RES).

3. Banks can use increased reserves to make loans. These loans increase the money supply (MS).

4. When the money supply increases and the demand for loans remains unchanged, interest rates (r) decrease.

5. Lower interest rates encourage increased investment (I) in plants, buildings, equipment, and so on. It also encourages additional consumer spending. (C)

6. Increased investment leads to increased aggregate demand (AD).

7. In the short run, increases in the money supply increase overall demand (Q). In the long run, this may result in increases in the price level (P).