Welcome to the Federal Reserve System!
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Today’s key objectives:
1. What is the Federal Reserve?
2. What are some of the basic functions of the Federal Reserve?
3. How does the Federal Reserve use monetary policy to attempt to influence inflation and unemployment?
I. Welcome to the Federal Reserve System, aka, the Fed

A. Definition of the Fed:
   The nation’s central bank

B. Chairperson of the Fed:
   Janet Yellen
   (March 2014)
The Fed makes loans to member banks when banks run low on cash. It is the lender of last resort. It is known as the banker’s bank.

A. Loans are for emergencies only.

B. Loans must be paid back usually within one week.

C. The Fed charges an interest rate called the discount rate. (The Fed also controls the fed funds rate: the interest rate banks use to borrow money from each other.)
The Fed is the government’s bank.

A. Collects and analyzes information on the economy. (Acts as an economic adviser)
B. Deposits tax revenue collected by the federal government into a checking account.
C. Writes checks for tax refunds, payroll, Social Security, etc.
The Fed regulates the country’s money supply.

A. Replaces worn out paper currency.

B. Controls the nation’s money supply. Expands or contracts the money supply as needed.

_This is the most important function of the Fed!!!_
Money Supply – Did You Know?

Components

- M1 = coin and currency in circulation, plus checking accounts
- M2 = M1 plus short term liquid assets

Context

- The Fed uses M1 and M2 as a standardized way of defining money in the economy

Used

- By households and businesses
- To make payments and to be held as short-term investments

M1 and M2

($trillions, seasonally adjusted)

Source: Federal Reserve Board

<table>
<thead>
<tr>
<th>Year</th>
<th>M1</th>
<th>M2-M1</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>$1.54</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>$3.22</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>$4.77</td>
<td></td>
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<tr>
<td>2010</td>
<td>$8.59</td>
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</tbody>
</table>

As a share of the total values shown above, M1 dropped from 26% in 1980 to 20% in 2010.¹

¹ See PowerPoint file for technical note.
Money Supply – Components

**M2**
- Savings Deposits
- Time Deposits
- Certain CDs
- Money Market Deposit Accounts
- Money Market Mutual Funds
- Includes M1

**M1**
- Coin
- Currency
- Demand Deposits
- Travelers Checks

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**February 2014**
($trillions, seasonally adjusted)

Source: Federal Reserve Board

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http://www.frbsf.org/education/teachers/datapost/index.html
FRBSF Economic Education Group
M2 in Detail
February 2014 ($billions, seasonally adjusted)

Source: Federal Reserve Board 4/3/14 data release
Note: Components may not add to totals due to rounding.

http://www.frbsf.org/education/teachers/datapost/index.html
FRBSF Economic Education Group
Trends — M1 and M2
Jan. 1980 to Feb. 2014 ($trillions, seasonally adjusted)

Source: Federal Reserve Board 4/3/14 data release

Graph showing trends in M1 and M2 from Jan. 1980 to Feb. 2014, with M2-M1 and M1 values.

Website: http://www.frbsf.org/education/teachers/datapost/index.html

FRBSF Economic Education Group
The Fed uses open market operations to expand or contract the money supply.

A. To *expand* the money supply:
   The Fed *buys* bonds
   from banks
   (banks get $!!!)

B. To *contract* the money supply:
   The Fed *sells* bonds
   to banks
   (banks lose $)
D. The Federal Open Market Committee

1. Consists of 12 members:
   a. 7 Board of Governors (14 year terms)
   b. President of the New York Federal Reserve
   c. Remaining four seats are filled on a rotating basis for one year from the regional Bank Presidents of each group:
      1- Boston, Philadelphia, Richmond
      2- Cleveland and Chicago
      3- Atlanta, St. Louis and Dallas
      4- Minneapolis, Kansas City and San Francisco

2. Meets 8 times each year, reviews economic and financial conditions, determines Open Market Operations (buying and selling of bonds.)
2013 Members of the FOMC

Janet Yellen, Board of Governors, Chairman
William C. Dudley, New York, Vice Chairman
James Bullard, St. Louis
Charles L. Evans, Chicago
Esther L. George, Kansas City
Jerome H. Powell, Board of Governors
Sarah Bloom Raskin, Board of Governors
Eric S. Rosengren, Boston
Jeremy C. Stein, Board of Governors
Daniel K. Tarullo, Board of Governors
________________, Board of Governors
The Fed uses *monetary policy* in an attempt to influence AD

**A. Easy money policy:**
- As supply of $ increases,
- interest rates *drop*,
- *more* homes and cars are sold = AD increases.
- This tries to keep us out of recession.

**Tight money policy:**
* As supply of $ decreases,
  interest rates *increase*,
*less* homes and cars are sold = AD decreases.
This keeps inflation under control.
Recent Actions Taken by the Fed:

1. Made $260 billion available for financial institutions to borrow, May, 2008. (No stigma attached!)
2. Reduced the discount rate (to .75% from 3.50% in 2008)
3. Assisted the JPMorgan Chase buyout of investment bank Bear Sterns ($30 billion).
4. Reduced the federal funds rate to .25% from 4.25% in 2008).
5. Announced the purchase of $600 billion of bonds, aka QE2, December, 2010.
1. The Fed attempts to influence AD.

2. To increase AD:
   - Buy bonds, lower rates, consumers borrow/spend *more* money.
   - * Unemployment \( \downarrow \), inflation may \( \uparrow \)

3. To lower AD:
   - Sell bonds, increase rates, consumers borrow/spend *less* money.
   - * Unemployment \( \uparrow \), inflation \( \downarrow \)

*The most important function of the Fed is:*

**TO CONTROL THE MONEY SUPPLY!**
Practice Scenario #1:
Slow economic growth
Decreasing jobs.

1. Buy bonds to ↑ the money supply.
2. Easy money policy
3. Interest rates ↓, inflation ↑, unemployment ↓
Scenario #2: Increasing inflation

1. Sell bonds to $\downarrow$ the money supply.
2. Tight money policy
3. Interest rates $\uparrow$, inflation $\downarrow$, unemployment $\uparrow$
Scenario #3: 
*Stagflation...Ouch! Bad news!*  
(↑ unemployment, ↑ inflation)

- Your best guess!
- Just kidding! Bernanke’s choice - fight inflation first...maybe:
  1. Sell bonds to ↓ the money supply.
  2. Tight money policy
  3. Interest rates ↑, inflation ↓, unemployment ↑
Scenario #4: Cost of shoe production ↑

• Do nothing! The Fed is not concerned with the ↑ cost of production of just one item.