

## 16.9: How a Central Bank Executes Monetary Policy

### Learning Objectives

- Explain how the Federal Reserve System implements monetary policy

The most important function of the Federal Reserve is to conduct the nation's monetary policy. Article I, Section 8 of the U.S. Constitution gives Congress the power “to coin money” and “to regulate the value thereof.” As part of the 1913 legislation that created the Federal Reserve, Congress delegated these powers to the Fed. Monetary policy involves managing interest rates and credit conditions, which influence the level of economic activity, as described in more detail below.

A central bank has the following three traditional tools to implement monetary policy in the economy:

1. Open market operations
2. Changing reserve requirements
3. Changing the discount rate

In discussing how these three tools work, it is useful to think of the central bank as a “bank for banks”—that is, each private-sector bank has its own account at the central bank. We will discuss each of these monetary policy tools in the sections below.

### Open Market Operations

The most commonly used tool of monetary policy in the U.S. is open market operations. **Open market operations** take place when the central bank sells or buys U.S. Treasury bonds in order to influence the quantity of bank reserves and the level of interest rates. The specific interest rate targeted in open market operations is the federal funds rate. The name is a bit of a misnomer since the federal funds rate is the interest rate charged by commercial banks making overnight loans to other banks. As such, it is a very short-term interest rate, but one that reflects credit conditions in financial markets very well.

The **Federal Open Market Committee (FOMC)** makes the decisions regarding these open market operations. The FOMC is made up of the seven members of the Federal Reserve's board of governors. It also includes five voting members who are drawn, on a rotating basis, from the regional Federal Reserve Banks. The New York district president is a permanent voting member of the FOMC and the other four spots are filled on a rotating, annual basis, from the other eleven districts. The FOMC typically meets every six weeks, but it can meet more frequently if necessary. The FOMC tries to act by consensus; however, the chairman of the Federal Reserve has traditionally played a very powerful role in defining and shaping that consensus. For the Federal Reserve, and for most central banks, open market operations have, over the last few decades, been the most commonly used tool of monetary policy. The following video explains how these operations work.



You can [view the transcript for “Segment 406: Open Market Operations”](#) (opens in new window).

Is it a sale of bonds by the central bank that increases bank reserves and lowers interest rates, **or** is it a purchase of bonds by the central bank? The easy way to keep track of this is to treat the central bank as being *outside* the banking system. When a central bank buys bonds, money is flowing from the central bank to individual banks in the economy, increasing the supply of money in

circulation. When a central bank sells bonds, then money from individual banks in the economy is flowing into the central bank—reducing the quantity of money in the economy.

### Changing Reserve Requirements

A second method of conducting monetary policy is for the central bank to raise or lower the **reserve requirement**, which is the percentage of each bank's deposits that it is legally required to hold either as cash in their vault or on deposit with the central bank. If banks are required to hold a greater amount in reserves, they have less money available to lend out. If banks are allowed to hold a smaller amount in reserves, they will have a greater amount of money available to lend out. The following video will explain how changing the reserve requirement alters the money supply.



You can [view the transcript for “Segment 409: Reserve Requirements” \(opens in new window\)](#).

In early 2015, the Federal Reserve required banks to hold reserves equal to 0% of the first \$14.5 million in deposits, then to hold reserves equal to 3% of the deposits up to \$103.6 million, and 10% of any amount above \$103.6 million. Small changes in the reserve requirements are made almost every year. For example, the \$103.6 million dividing line is sometimes bumped up or down by a few million dollars. In practice, large changes in reserve requirements are rarely used to execute monetary policy. A sudden demand that all banks increase their reserves would be extremely disruptive and difficult to comply with, while loosening requirements too much would create a danger of banks being unable to meet the demand for withdrawals.

### Changing the Discount Rate

The Federal Reserve was founded in the aftermath of the Financial Panic of 1907 when many banks failed as a result of bank runs. As mentioned earlier, since banks make profits by lending out their deposits, no bank, can withstand a bank run. As a result of the Panic, the Federal Reserve was founded to be the “lender of last resort.” In the event of a bank run, sound banks could borrow as much cash as they needed from the Fed’s discount “window” to cover the bank run. The interest rate banks pay for such loans is called the **discount rate**. They are so named because loans are made against the bank’s outstanding loans “at a discount” of their face value. Once depositors became convinced that the bank would be able to honor their withdrawals, they no longer had a reason to make a run on the bank. In short, the Federal Reserve was originally intended to provide credit passively, but in the years since its founding, the Fed has taken on a more active role with monetary policy.

So, the third traditional method for conducting monetary policy is to raise or lower the discount rate. If the central bank raises the discount rate, then commercial banks will reduce their borrowing of reserves from the Fed, and instead call in loans to replace those reserves. Since fewer loans are available, the money supply falls and market interest rates rise. If the central bank lowers the discount rate it charges to banks, the process works in reverse.

The following video explains the impact of changes to the Fed’s discount rate.



You can [view the transcript for “Investopedia Video: Fed’s Discount Rate”](#) (opens in new window).

In recent decades, the Federal Reserve has made relatively few discount loans. Before a bank borrows from the Federal Reserve to fill out its required reserves, the bank is expected to first borrow from other available sources, like other banks. This is encouraged by the Fed charging a higher discount rate than the federal funds rate. Given that most banks borrow little at the discount rate, changing the discount rate up or down has little impact on their behavior. More important, the Fed has found from experience that open market operations are a more precise and powerful means of executing any desired monetary policy.

#### ? Practice Question

<https://assessments.lumenlearning.co...essments/14324>

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