

Federal Reserve System

- The Federal Reserve System helps to promote economic stability by regulating the amount of money in circulation. **The Federal Reserve can increase or decrease the amount of money in circulation** through several measures. By increasing or decreasing the amount of money in circulation, the Federal Reserve influences whether there is more spending or saving in general, and therefore can help to avoid recessions and high inflation

Federal Reserve System

- Students need to know how the U.S. government promotes economic stability. Have students review the reason the Federal Reserve System was created and how the Federal Reserve System promotes economic stability.

Federal Reserve System

- The Federal Reserve System has the ability to decrease the discount rate (interest rate), **which can reduce consumer and business spending for two reasons. One** reason is that there would be less money in circulation (which is a responsibility of the Federal Reserve. **Another** reason is that loans would be more difficult to obtain

THE STORY OF THE FEDERAL RESERVE SYSTEM



You're probably familiar with one or more banks in your neighborhood.



Story by: Ed Steinberg
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Art by: Jesse Chen

Perhaps you or someone in your family has a checking or savings account at a local bank...



I'd like to deposit this in my savings account, please.

... or perhaps someone in your family has recently taken out a loan at a bank --- to buy a car, for example.



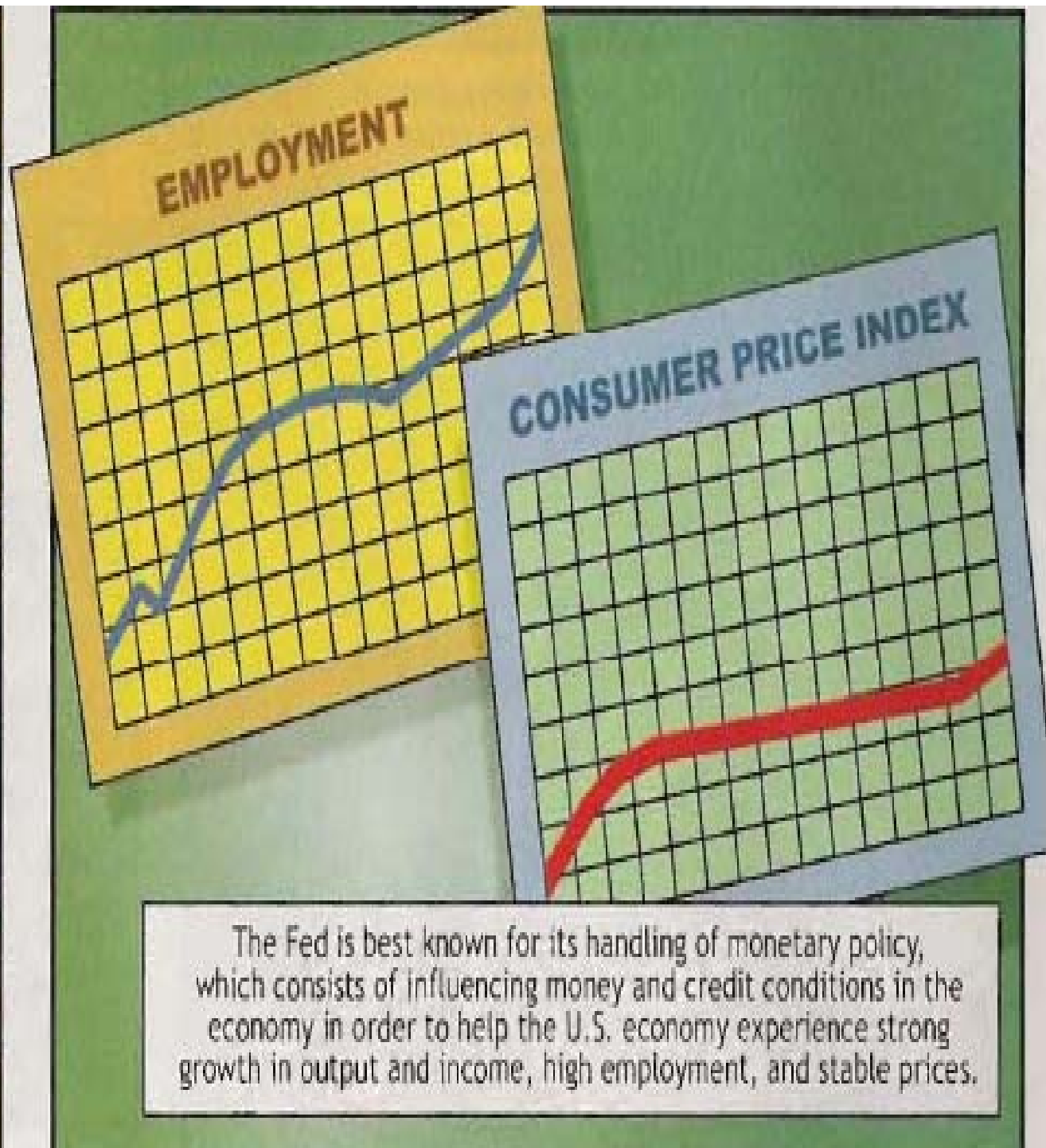
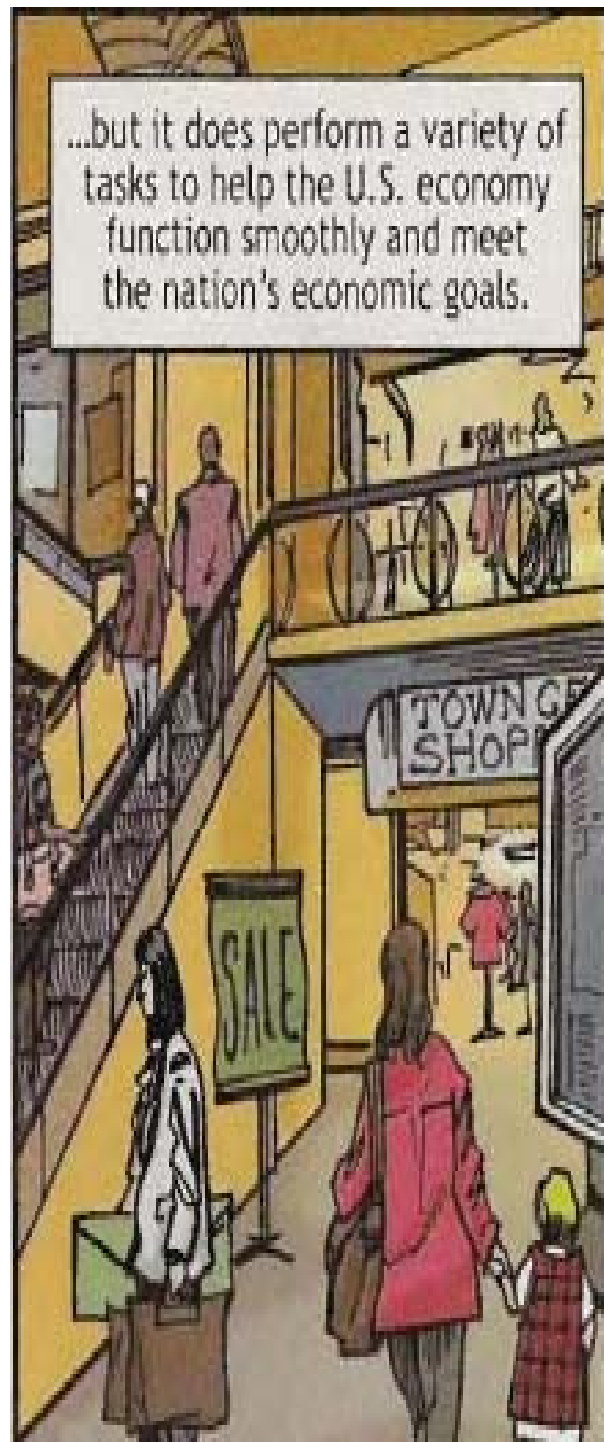
I don't have enough cash to buy a new car, but if I can spread the payments out over four years, I can afford it.




The Federal Reserve System (known as "the Fed") is the nation's central bank.

It doesn't provide services to individuals the way your neighborhood bank does...

...but it does perform a variety of tasks to help the U.S. economy function smoothly and meet the nation's economic goals.



The Fed is best known for its handling of monetary policy, which consists of influencing money and credit conditions in the economy in order to help the U.S. economy experience strong growth in output and income, high employment, and stable prices.



The term **MONEY** refers to cash in circulation and the amounts that people and businesses have in bank accounts, and **CREDIT** means the amounts that banks and other lenders can lend.

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The job of making monetary policy often is a balancing act, as the Fed has to make sure that money and credit don't grow either too slowly or too rapidly.



If they grow too slowly, funds won't be available for loans, and people and businesses will find it harder to borrow to make major purchases.

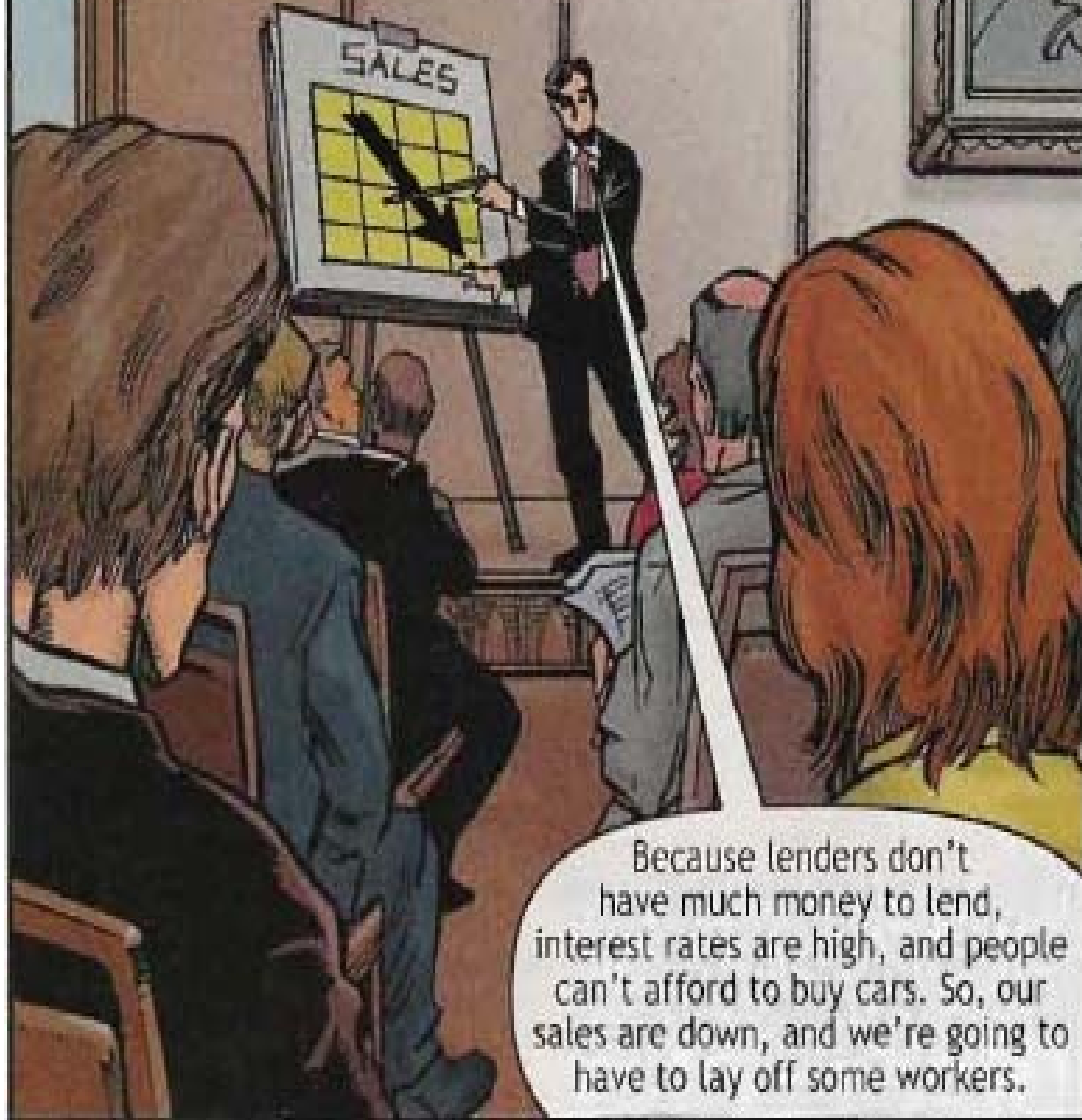


I'm afraid you won't be able to buy the car. Interest rates are way up because there's not much money to lend, and the monthly payments at the higher rates are more than you can afford.



I know you would like to expand your factory, but because we don't have much money to lend, we have to charge a high interest rate. You wouldn't be able to afford the monthly payments.

Insufficient money and credit growth can lead to a recession, a period in which economic activity (such as production and spending) declines and unemployment rises.



Because lenders don't have much money to lend, interest rates are high, and people can't afford to buy cars. So, our sales are down, and we're going to have to lay off some workers.




Nobody's building now, because interest rates are so high, so we have to lay off some workers.

On the other hand, when money and credit grow too much, the result can be inflation – a sustained and rapid increase in the price level.



How can you raise your prices so often?

Well, everyone who comes in to buy seems to have a lot of money to spend, so we figure we can raise prices and still sell the appliances.

A man with a worried expression, wearing a white lab coat over a brown shirt, stands in a grocery store aisle. He is holding a newspaper that has a large red banner across the top that says "SUPER SPECIAL". The aisle is filled with shelves of various products, including boxes of spaghetti and bags of rice. A sign on the wall to the left says "5 SOUP RICE PASTA". A speech bubble from the man explains his financial situation.

Inflation has many bad effects. One is that some people's incomes don't go up as fast as prices, so inflation reduces their purchasing power—what they can afford to buy.

I got a 3% raise but prices are up 8%, so I'm worse off now than I was before. I guess I'll have to eat out less often or cut back on how much clothing I buy.



By making it hard for businesses to plan, inflation also can lead to uncertainty and instability in the economy.

Our costs are way up, and if we raise our prices enough to cover them, our sales may suffer.



Lumber and steel prices have risen, but our customers may not be prepared to pay higher construction fees. They may postpone building until prices settle down.

The uncertainty that inflation causes can lead businesses to cut purchases of new equipment and buildings.



The drop in business investment, in turn, can hurt the economy's ability to produce in the future.



Last year, when inflation created so much uncertainty, we stopped buying machinery and now we're having trouble keeping up with our orders.

So to try to prevent both recessions and inflation, the Fed has three main monetary policy tools: open market operations, reserve requirements, and the discount rate.



Open Market Operations



The **buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system**. Purchases inject money into the banking system and stimulate growth while sales of securities do the opposite.

Discount Rate

- the **interest rate charged by Federal Reserve Banks on loans** to their member banks, usually against government securities as collateral.

Reserve Requirements

- Requirements regarding the **amount of funds that banks must hold in reserve against deposits made by their customers**. This money must be in the bank's vaults or at the closest Federal Reserve Bank.