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Functions of the Federal Reserve System

Provide financial services

Supervise and regulate banks

Maintain stability of the financial system

Conduct monetary policy

How the Fed Conducts Policy

 Sets reserve requirements - rules set by the Federal Reserve that determine the minimum reserve ratio for a bank.

- For example, the U.S. minimum reserve ratio for checkable bank deposits is 10%.
 - The federal funds market allows banks that fall short of the reserve requirement to borrow from banks with excess reserves.
 - The federal funds rate is the interest rate determined in the federal funds market.

How the Fed Conducts Policy

- Conducts open-market operations the principal tool of monetary policy.
 - The Fed can increase or reduce the monetary base by buying government debt (U.S. Treasury Bills) from banks or selling government debt to banks.

The Federal Reserve's Assets and Liabilities:

Assets

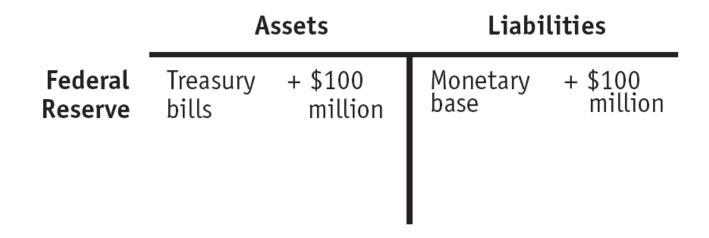
Liabilities

Government debt (Treasury bills)

Monetary base (Currency in circulation + bank reserves)

Open-Market Operations by the Fed

An Open-Market Purchase of \$100 Million



	Assets		Liabilities	
Commercial banks	Treasury bills	– \$100 million		
	Reserves	+ \$100 million		

Open-Market Operations by the Fed

An Open-Market Sale of \$100 Million

	Assets		Liabilities	
Federal	Treasury	– \$100	Monetary	- \$100
Reserve	bills	million	base	million

	Assets		Liabilities
Commercial banks	Treasury bills	+ \$100 million	
	Reserves	– \$100 million	