36 The Federal Reserve and Monetary Policy

MODULE 36

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	
Federal Reserve	Treasury bills	+ $100 million	Monetary base	+ $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

Federal Reserve	Assets		Liabilities	
	Treasury bills	− $100 million	Monetary base	− $100 million

Commercial banks	Assets		Liabilities	
	Treasury bills	+ $100 million		
	Reserves	− $100 million		