After a series of banking crises, Congress passed the Federal Reserve Act in 1913. The Federal Reserve System, often referred to as “the Fed,” is a group of twelve regional independent banks. During the Great Depression, the regional banks did not always agree on what kind of action to take. In response, Congress reformed the Fed in 1935, giving it more centralized power to deal with crises such as the Great Depression.

Member banks own the Federal Reserve System. Members include all nationally-chartered banks, which are required to join, and some state-chartered banks, which may join if they wish. A Board of Governors, appointed by the President, oversees the Fed. To prevent the board from being influenced by politics, no one President may appoint all the governors.

The President also appoints the Board’s chair. The chair is the main spokesperson for the nation’s monetary policy, the actions the Fed takes to influence the level of real GDP and the rate of inflation.

The Federal Reserve System is divided into twelve regional Federal Reserve Districts, with one regional Federal Reserve Bank in each. They monitor and report on district economic and banking conditions. The Federal Open Market Committee (FOMC) makes key decisions about interest rates and the growth of the U.S. money supply. Its members are drawn from the Board of Governors and the twelve district banks.

**The Big Idea**

The Federal Reserve System was founded in 1913 to stabilize the nation’s money supply and conduct monetary policy.

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**Text Summary**

The Federal Reserve and Monetary Policy

**Section 1**

**The Federal Reserve System**

**Text Summary**

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**Graphic Summary: Federal Reserve Districts**

The Federal Reserve System is made up of 12 districts, each with its own Federal Reserve Bank. The Board of Governors of the Fed meet in Washington, D.C.

**Review Questions**

1. Why did Congress adjust the Federal Reserve structure in 1935?

2. Map Skills: What city is home to the Federal Reserve bank of District 1?
**SECTION 2  FEDERAL RESERVE FUNCTIONS**

**TEXT SUMMARY**

The Fed provides banking services to the federal government. It maintains a checking account for the Treasury Department and processes payments, such as Social Security checks and IRS refunds. It helps the government finance its activities. When the Treasury Department auctions government bonds, the funds gained from such sales are deposited into the Federal Reserve Bank of New York. The Fed also issues paper currency and takes worn or damaged bills out of circulation.

The Fed provides banking services to banks. One service is check clearing, the process by which banks record whose account gives up money and whose account receives money when someone writes a check. The Fed sends out bank examiners to supervise lending practices and other activities of member banks. The Fed also protects consumers by enforcing truth-in-lending laws.

The Fed acts as a lender of last resort, making emergency loans to commercial banks so that they can maintain required reserves. The interest rate the Fed charges for these loans is called the **discount rate**.

The Federal Reserve is best known for its role in regulating the nation’s money supply. The law of supply and demand affects money as well as the rest of the economy. Too much money in the economy leads to inflation. Ideally, the Fed tries to increase the money supply by the same rate as the growth in the demand for money.

**GRAPHIC SUMMARY: Functions of the Federal Reserve System**

The twelve banks that make up the Federal Reserve system carry out functions that are critical to the health of the nation’s economy and banking system.

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**REVIEW QUESTIONS**

1. What is the discount rate?

2. **Diagram Skills** What are the four main functions of the Federal Reserve System?
Money enters the economy by a process called **money creation**. Banks create money making loans. When a bank makes a loan of $1000 and deposits money in the borrowers checking account, it increases the money supply by $1,000. The bank can loan out all but the **required reserve ratio (RRR)**, the ratio of reserves to deposits required of banks by the Fed. If the RRR is 10 percent, the bank may loan out $900 of the original $1,000 deposit. The bank can then lend out 90 percent of that $900, and so on.

The Fed has three tools for adjusting the amount of money in the economy. The simplest is to change reserve requirements. Reducing the RRR means that banks can lend out more money, increasing the money supply. Increasing RRR has the opposite effect.

A second tool is to adjust the discount rate. Reducing the discount rate lets banks borrow from the Fed at a low rate. Banks then have more money available for loans which increase the money supply. Increasing the discount rate will decrease the amount loaned.

The Fed’s third and most important monetary policy tool is **open market operations**, the buying and selling of government securities such as bonds. When the Fed wants to increase the money supply, it purchases government securities. The bond seller deposits money from the sale into the bank, starting the money creation process. To decrease the money supply, the Fed sells government securities. The money paid for the bond is taken out of circulation, and reserves are reduced.

### The Big Idea

By lending money, banks increase the money supply. The Fed uses several tools to make the money supply increase or decrease.

### Graphic Summary: Tools of the Fed

<table>
<thead>
<tr>
<th>Changing the Required Reserve Ratio (RRR)</th>
<th>Changing the Discount Rate</th>
<th>Open Market Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>To INCREASE the money supply, the Fed can...</td>
<td>Reduce the RRR, freeing up reserves for banks, allowing them to make more loans.</td>
<td>Decrease the discount rate, encouraging banks to borrow from the Fed, increasing reserves for loans.</td>
</tr>
<tr>
<td>To DECREASE the money supply, the Fed can...</td>
<td>Increase the RRR, reducing reserves for banks, making less money available for loans.</td>
<td>Increase the discount rate, discouraging banks from borrowing from the Fed, decreasing reserves for loans.</td>
</tr>
</tbody>
</table>

The Fed has three major tools for regulating the nation’s money supply. The preferred tool is open market operations, which has the least disruptive effect on the banking system.

### Review Questions

1. How does reducing the RRR lead to an increase in the money supply?
2. **Chart Skills** What are the three major tools of the Fed in controlling the money supply?
**TEXT SUMMARY**

**Monetarism** is the belief that the money supply is the most important factor in macroeconomic performance. Monetary policy alters the supply of money, which in turn affects interest rates. When the supply of money is low, the price of money—the interest rate—is high. When the supply of money is high, interest rates are low.

The Fed can use monetary policy to expand or contract the U.S. economy. An **easy money policy** is a monetary policy that increases the money supply. A larger money supply means lower interest rates, which in turn means more money for investment and a boost to the economy. By contrast, a **tight money policy** is a monetary policy that reduces the money supply by raising interest rates, thus decreasing GDP.

Timing is essential in monetary policy. Good timing smooths out fluctuations in the business cycle. Bad timing can make the business cycle worse. For example, an expansionary policy may take effect as the economy is beginning to expand on its own, leading to overexpansion and inflation.

An **inside lag** is a delay in implementing policy. It may occur because it takes time to recognize a problem. An **outside lag** is the time for a policy to take effect. Because of lags and the difficulty of predicting the direction of the economy, it is difficult to use monetary policy effectively. Some recessions are short and correct themselves in time. Policy makers are more likely to want to intervene in the case of a long and severe recession.

**THE BIG IDEA**

The Fed can use monetary policy to tame business cycles, but it must decide if and when it is wise to intervene in the economy.

**GRAPHIC SUMMARY:** *Fiscal and Monetary Policy Tools*

<table>
<thead>
<tr>
<th>Expansionary tools</th>
<th>Fiscal policy tools</th>
<th>Monetary policy tools</th>
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</thead>
<tbody>
<tr>
<td>1. increasing government spending</td>
<td></td>
<td></td>
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<tr>
<td>2. cutting taxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. open market operations: bond purchases</td>
<td></td>
<td></td>
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<tr>
<td>2. decreasing the discount rate</td>
<td></td>
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<tr>
<td>3. decreasing reserve requirements</td>
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</tr>
</tbody>
</table>

<table>
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<th>Contractionary tools</th>
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<tbody>
<tr>
<td>1. decreasing government spending</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. raising taxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. open market operations: bond sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. increasing the discount rate</td>
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</tbody>
</table>

Both fiscal policy and monetary policy can be used to affect the economy.

**REVIEW QUESTIONS**

1. What is the difference on the money supply between an easy-money policy and a tight-money policy?

2. **Chart Skills** If the Fed is pursuing an expansionary policy, would it want to buy or sell bonds?
IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

1. What is monetary policy?
   A. the amount of money the federal government spends
   B. the amount of money that the Federal Reserve banks print up and distribute
   C. actions the Federal Reserve System takes to influence the rate of inflation and real GDP
   D. the decision to have federal or state banks

2. How many Federal Reserve Districts are there?
   A. one
   B. one for each state
   C. three
   D. twelve

3. Who owns the Federal Reserve System?
   A. the federal government
   B. member banks
   C. all banks in the country
   D. all commercial banks in the country

4. What is one service the Fed performs for the Treasury Department?
   A. It processes payments, such as Social Security checks.
   B. It auctions government bills.
   C. It collects federal taxes.
   D. It selects the Secretary of the Treasury.

5. The discount rate is
   A. the rate the Fed charges for loans to commercial banks.
   B. the amount that a bank has to subtract for its reserves.
   C. a special rate that member banks of the Federal Reserve get for their financial operations.
   D. the rate customers of savings banks get for borrowing money.

6. How do banks create money?
   A. by getting permission to print money from the Federal Reserve
   B. by paying interest to their customers
   C. by selling off bank property
   D. by loaning out money that borrowers place in their checking accounts

7. What is the required reserve ratio?
   A. the amount of money that the Fed does not let banks borrow
   B. the reserves that the Fed requires banks to keep from the money deposited
   C. the interest rate banks charge each other
   D. the money kept by the federal government

8. What is the Fed's most important monetary policy tool?
   A. open market operations
   B. changing the discount rate
   C. changing reserve requirements
   D. borrowing money

9. What is the main idea of monetarism?
   A. All money should be issued by the federal government.
   B. The money supply is the most important factor in economic performance.
   C. Interest rates are the most important factor in economic performance.
   D. Money should be minted in gold or silver.

10. Which of the following actions would the Fed take to fight inflation?
    A. increase government spending
    B. raise taxes
    C. increase the money supply
    D. reduce the money supply