Session 3: The Money Supply

The primary function of the Fed is to maintain the health of the economy. This ideally means low inflation, high employment, moderate interest rates, strong financial markets, and a stable currency. This is a delicate balance, since high employment can lead to inflation, undermining financial markets; however, ameliorating the effects of inflation may slow down the economy, weakening markets. Some variation is normal; the Fed is responsible for preventing things from getting out of control.

The regulation of the money supply is known as “Monetary Policy”. The primary tool used by the Fed in setting Monetary Policy is the careful manipulation of Short-Term Interest Rates. Banks typically adjust their interest rates in lockstep with short-term rates both in terms of loan rates and interest paid on deposits. Fed actions, or even speculation about future Fed actions, can also influence the pace of trading on securities markets, altering securities prices. In the long term, higher interest rates tend to curb growth and lower stock prices, while making bond and cash equivalent investments more attractive; alternatively, lower rates may boost securities prices, as growth makes more investors become comfortable accepting additional risk