Session 4: How The Fed Works

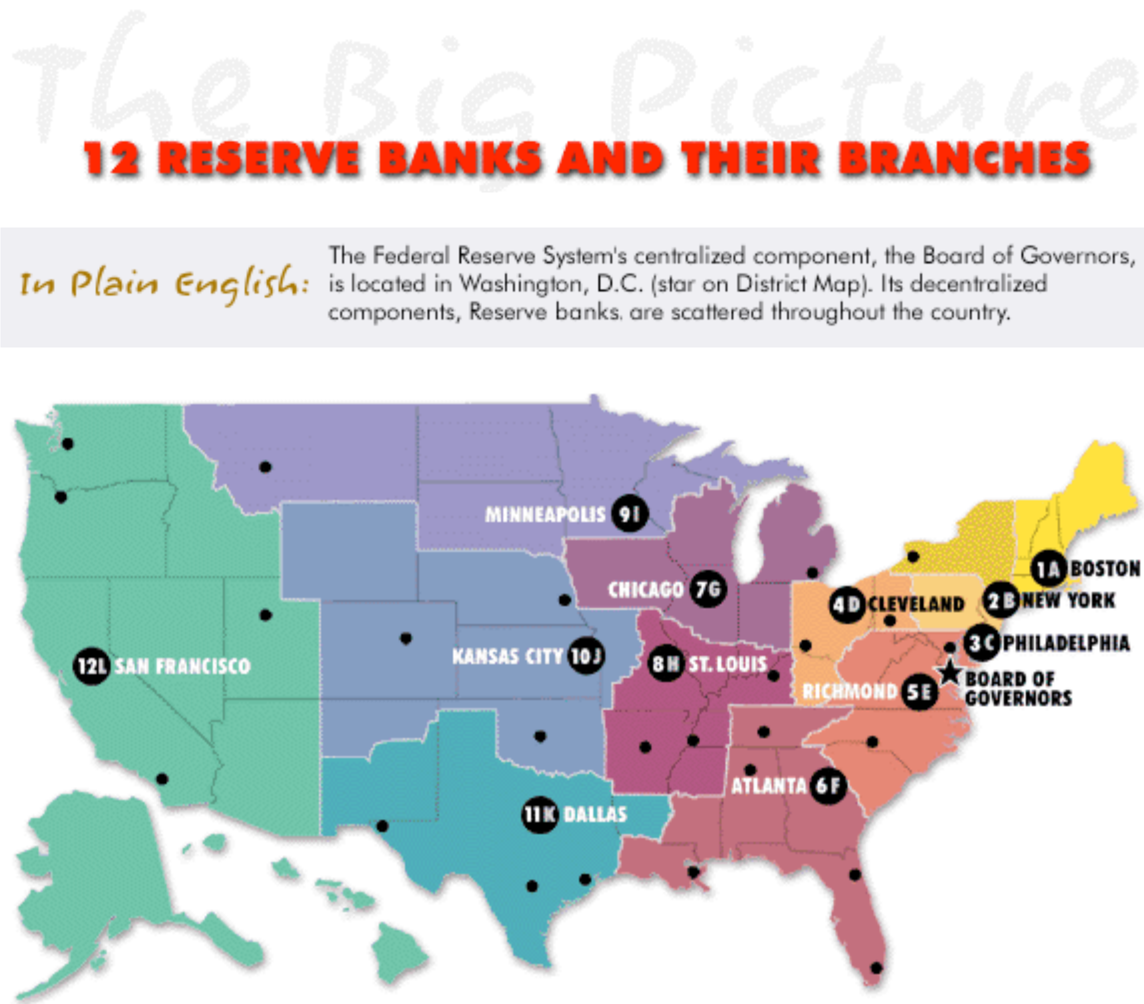

Figure 2: How The Fed operates

Graphic Provided By The St Louis Federal Reserve Bank

The FOMC holds regular meetings, at which it decides to loosen, tighten, or not change monetary policy, and issues a “Risk Statement” indicating current economic conditions. These Risk Statements are considered a reliable indicator of what the Fed plans to do in the future. As mentioned above, the relative tightness or looseness of Monetary Policy determines the rate of borrowing, which influences the rate of economic growth.

To translate its policy decision about the money supply into action, the FMOC authorizes the New York district bank to trade securities on the open market. While the Fed is authorized to conduct open market operations in any type of security, such as stock or corporate bonds, it traditionally trades only U.S. government bonds.

What that means, in practice, is that to enter into open market operations, the Fed either buys or sells government bonds from banks and investors. The Fed buys to loosen the money supply and sells to tighten the money supply. When it buys, it credits the reserve account of the bank that sells the bonds, increasing the reserves that bank has available to lend. When subsequent lending occurs, more money goes into circulation (this can be thought of in terms of newly printed Federal Reserve Notes, although most of the money in circulation is in the form of checkable deposits that are really only electronic data recording the contents of accounts as will be discussed in the context of the banking system as a whole below). As borrowers spend what is loaned to them, the money is deposited and redeposited in other banks, which then have additional reserves to make loans themselves. When the Fed sells in order to tighten the money supply, the reverse is true: it debits the cost of the bonds a bank buys from the bank's reserve account, reducing the amount the bank has available to lend.