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HOW THE FED WORKS

by Lee Badgett

Each week the Federal Reserve Board (popularly known as the "Fed") releases figures stating the current money supply to an anxiously waiting public of economists and other economy-watchers. Analysts scrutinize the figures, speculating on their implications and looking behind and between the lines of the Fed's report for signals of changing monetary policy. But for people who are not fluent in the obscure language of the economist, the interest in the Fed and its money supply numbers may seem unwarranted. What would an increase in the money supply of $3.7 billion in one week mean other than that the Fed's printing presses were unusually busy? Actually, such a change means something quite different--its meaning depends on what the Fed calls money and on the actions that the Fed takes given its powers and responsibilities.

Changes in the money supply, as a result of either the Fed's policies or some other event, affect the economy primarily through the interest rate. When the interest rate falls, the cost of borrowing money falls, so people who must borrow money to finance investments are more likely to invest. For example, a decrease in interest rates on mortgages stimulates the building of new homes, an important part of investment spending in the economy. Such spending creates jobs and increases demand for many related goods, so the Fed's power to change the interest rate has enormous implications for the health of our economy.

Who Decides What The Fed Will Do? -- In response to several banking panics in the late nineteenth and early twentieth centuries, the Federal Reserve System was established in 1914. The system consists of twelve Federal Reserve district banks, each one a corporation with member banks as "stockholders." The member banks receive a small part of Fed profits and have no decision-making authority. Authority over the Fed is held by the Board of Governors whose seven members are appointed by the President of the United States for fourteen year terms. The most influential member of the Board is its Chair, currently Paul Volcker. The governors and five district bank presidents make up the Federal Open Market Committee (FOMC) that controls the money supply. Once the governors are appointed and receive Senate approval, their autonomy is considerable, not to mention controversial. Since the governors are relatively insulated from national politics and public opinion, they can respond quickly when they perceive a need to change the money supply. This independence has made monetary policy a much more powerful tool for stabilizing the economy than fiscal policy (government spending and taxation), which is subject to lengthy time lags.

The FOMC uses "open market operations"--the buying or selling of U.S. government bonds on the open market--as the Fed's primary instrument for changing the money supply. The definition of the money supply that the Fed calls "M1" counts currency and money in checking accounts, including those that pay interest. If the FOMC wants to increase M1, the Fed will buy bonds (usually Treasury bills) on the open market and will pay for them by crediting a member bank's Fed account with the purchase price. The member banks use the new deposits in their accounts to lend money to their own customers. These loans become additions to M1, either as cash or as checking account deposits. Thus the Fed does not create money by printing, but by creating reserves (money in the banks' Fed accounts) out of nothing. Similarly, if the Fed decides to decrease the money supply, it will sell securities. Banks pay for the securities with the reserves in their accounts at the Fed. The Fed takes this "money" out of circulation, thereby decreasing M1.

The Fed's incluence on the interest rate comes through this open market operation. When the Fed decides to increase the money supply by buying bonds, the demand for bonds increases. The increase in demand causes the price of bonds to rise, which causes the interest rate of the bonds to fall. (A bond's fixed interest payment is set when the bond is issued. If the price of the bond goes up, the proportion of the price that is paid in interest, the interest rate, decreases.) Another way to think about the relationship between the money supply and the interest rate is that, in a sense, the interest rate is the price of money. For a consumer, the price of holding money in cash is the interest that he or she could earn by putting the money in a bank account. For a bank, which supplies money in the form of loans, the price that a borrower must pay is the interest rate. When banks suddenly have more money, as after an open market purchase by the Fed, they have to lower the price of the money to get people to borrow it.

How Should The Fed Focus Its Policy? -- Economists who believe the interest rate has a strong effect on the level of investment spending believe that the Fed should focus its policies on the interest rate. Some other economists believe that in the long run an increase in the money supply will result in inflation because of an equal proportional increase in prices. Since the economy has one long-run potential level of output regardless of prices, as the argument goes, an increased money supply will "chase after" the same number of goods and cause prices to rise. Economists who believe in this position ("monetarists" such as Milton Friedman) argue that the Fed should keep the money supply growing at a low but constant rate. Unfortunately, since each level of the money supply corresponds to a particular interest rate at which people will want to hold that quantity of money, the Fed cannot set both the interest rate and the money supply. Historically, the Fed's monetary policy goal was targetting money supply growth.

Not surprisingly, then, monetary policy is as controversial as fiscal policy. The Fed's actions will become increasingly important for the health of the economy if the Gramm-Rudman budget law, which aims at a balanced budget by 1991, causes a big cut in government spending. Even though the legal status of the Gramm-Rudman is still up in the air, the sentiment that led to the act's passage will certainly cause some decrease in spending. The Fed may respond to counteract contractionary spending cuts with a new policy of "easy money" (increasing M1 growth to lower the interest rate)--a monetary policy that at least theoretically falls into the Fed's realm of power and modern responsibility.

-- Lee Badgett