- Analyze how the FED carries out monetary policy using the three tools.

The FED has three tools as its disposal to help carry out monetary policy

1. Changing the reserve requirement
2. Changing the discount rate
3. Open market operations.

Changing the reserve requirement

- Reserve requirement- regulation set by the FED requiring banks to banks to keep a certain percentage of their deposits as cash in their own vaults
- They do this in case one or more banking customers decide to withdraw large amounts of cash from their checking accounts
- What happened during the great depression?
- Do you think to reserve requirements is lower or higher during the holidays?
  - In general, the FED has a reserve requirements of 10-20%
  - If a very small bank has deposits of $1000 the bank must keep $100 in its vaults the other $900 is used to loan credit and give loans in order a profit with interest.

- The lower the percentage the FED requires banks to keep the more money that frees up for banks to give credit and loans. The reverse is also true.
- If inflation was high the FED would increase the reserve requirement in order to REDUCE the money supply by making it more expensive to get loans and credit.
- Rarely used because even small changes in the reserve requirement can have a major impact on the economy. As a result some believe that this tool is not precise or accurate enough to make frequent small adjustments and is best saved for major recession inflations.

Change the discount rate

- In certain situation a bank will find itself in a situation without enough cash on hand to meet the reserve requirements such as with unexpectedly large withdrawals or deposits. The bank must then borrow funds from the Federal Reserve, like all other loans the FED charges interest
- Discount Rate- interest rate that the FED charges on loans to member banks

Open Market Operations

- Open market operation- buying and selling of the US securities by the FED to affect the money supply
- This is the Major monetary supply tool the FED uses
- Simple way to think about it- investors like you and I buy bonds for their secured interest rate to make more money. The FED does the same thing with other banks. They can buy/sell bonds to other banks in order to increase/reduce the monetary supply.

- With new forms of saving and investment opportunities in recent years it is more difficult than ever to track the money supply using M1 and M2
- The FED has made mistakes in monetary policy before and is regularly heavily criticized
  - Instances of rising inflation they increased the money supply making it rise even more
  - In instance of contractions/recession the FED decreased the money supply making it worse