Monetary Policy: A Brief Guide

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What is monetary policy?

It's defined as "The actions of a central bank, currency board, or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affect interest rates." Put simply, it's manipulation of how much money is in circulation, done by some regulatory committee. If you want to know why this is done, please read my other guide, "How the Economy Works: A (Kind of) Brief Guide." Much of this guide will be understood without too much prior knowledge about the economy, but you'll much better understand this guide and connect it to other concepts if you read the other guide first.

Ok, so why is this done?

Inflation (an increase in prices) and deflation (a decrease in prices) can have severe effects on the health of an economy. These effects are explained in depth in the other guide. To combat this, the government has two types of policies that they used based on the situation: expansionary policy and contractionary policy. **Expansionary policy increases the amount of money in the system, while contractionary policy decreases the amount of money in the system.**

How does the government do this?

There are actually quite a few ways to go about this, which I've listed below.

1. **Buying and selling government bonds.** This is the most common form of monetary policy in the United States, and is also known as **open market operations**. But first, what's a government bond? A **government bond** is pretty much a piece of paper that you buy for a certain amount of money. They can be bought by financial institutions, firms, other countries, and individuals. After some years (it varies based on the bond), you will be paid back an amount of money greater than what you put into the bond. The period of time you wait for your bond to increase in value is known as the **period of maturation**. There's a **common misconception** that you have to hold onto a bond until it's fully matured - this is false. Government bonds are also also known as **treasury bonds** or **treasury bills**. So how is this used to control the market? Well, when the government buys bonds, they're taking back their piece of paper and giving out cash. This process puts more money into the system, which is **expansionary**. When the government sells bonds, they're essentially absorbing money, so this is an example of **contractionary** policy because they are decreasing the amount of money that is circulating in the economy.

To summarize:

Expansionary Monetary Policy: FED buys bonds → Money Supply Increases → Interest Rates Decrease → Investment Spending Increase → GDP Increases

Contractionary Monetary Policy: FED sells bonds → Money Supply Decreases → Interest Rates Increase → Investment Spending Decreases → GDP Decreases

2. **Increasing or decreasing required reserves ratio.** This deals with deciding how much cash a bank is required to have for the amount of money that they are lending. This is done by deciding what percentage must be kept as cash. If banks are required to keep a higher percentage of money that they have lent in the form of cash, this is an example of **contractionary policy**, because there'll be less money circulating in the economy. **This also decreases the odds that the banks will end up failing.** If the required reserves ratio is decreased, banks aren't required to keep as much money in the form of cash (though they certainly are allowed to if they want to). As a result, there is more money circulating in the economy, meaning this is an example of **expansionary policy**.

To summarize:

Expansionary Monetary Policy: Decreasing required reserve ratio → Money Supply Increases → Interest Rates Decrease → Investment Spending Increase → GDP Increases

Contractionary Monetary Policy: Increasing required reserve ratio → Money Supply Decreases → Interest Rates Increase → Investment Spending Decreases → GDP Decreases

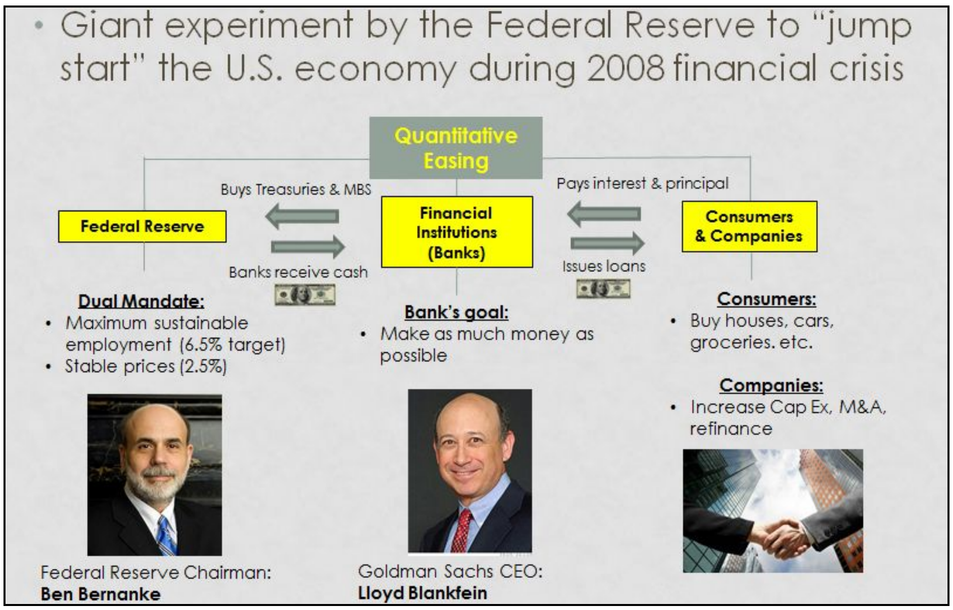
3. **Increasing or decreasing the discount rate.** The discount rate essentially controls how much commercial banks have to pay to borrow money from the federal reserve. This rate is reviewed once every two weeks. Decreasing the discount rate makes it easier for commercial banks to borrow money, as they'll have to pay less to do so. Because they'll be able to borrow more money, more money will circulate in the economy, meaning this is an example of **expansionary policy**. If the discount rate is increased, banks will have to pay more to borrow money, disincentivizing them from doing so. Therefore, banks will borrow less money, decreasing the amount of money circulating in the economy. As I'm sure you can guess at this point, this is an example of **contractionary policy**.

To summarize:

Expansionary Monetary Policy: Decreasing discount rate → Money Supply Increases → Interest Rates Decrease → Investment Spending Increase → GDP Increases

Contractionary Monetary Policy: Increasing discount rate → Money Supply Decreases → Interest Rates Increase → Investment Spending Decreases → GDP Decreases

4. **Quantitative Easing.** This is generally seen as a **last resort**, and is used only when the previous three methods don't work. This is typically during recessions, when interest rates approach 0%. Quantitative easing is the buying of **securities** (such as bonds) with electronic money that didn't actually exist before. So this process **creates money**. Quantitative easing increases the size of bank reserves, meaning it is **expansionary**. This extremely unconventional strategy was used during the 2008 recession.



NOTE: Janet Yellen is actually the chairman of the Federal Reserve now, but the rest of the picture is accurate.

So the Federal Reserve does all this? Can you tell me a little more about them?

The Federal Reserve, also called "The Fed" by its friends and people who are generally lazy, controls the the money supply in the United States. It came into existence in 1913 with the creation of the Federal Reserve Act. It consists of the Board of Governors, the Federal Open Market Committee, and a dozen Federal Reserve Banks. It's challenged with what's known as the **dual mandate**: It must balance inflation and employment levels. **Expansionary policies are associated with high levels of employment, but also high levels of inflation. Contractionary policies on the other hand, lower inflation, but also decrease employment**. The job of The Fed (we're all friends here) is to attain a happy medium, in which we have low level of inflation and high levels of employment.