How the Federal Reserve Manages Money Supply

Throughout history, free market societies have gone through boom-and-bust cycles. While everyone enjoys good economic times, the downturns are often painful. The Federal Reserve was created to help reduce the injuries inflicted during the slumps and was given some powerful tools to affect the supply of money. Read on to learn how the Fed manages the nation's money supply.

The Evolution of the Federal Reserve

When the Federal Reserve (Fed) was established in 1913, it was not to pursue an active monetary policy to stabilize the economy. Economic stabilization policies were not introduced until John Maynard Keynes' work in 1936. Instead, the founders viewed the Fed as a way to prevent the supply of money and credit from drying up during economic contractions, which happened often in the pre-1914 period.

One of the principal ways in which the Fed was to provide such insurance against financial panics was to act as the lender of last resort. That is, when risky business prospects made commercial banks hesitant to extend new loans, the Fed would lend money to the banks, thus inducing banks to lend more money to their customers. (To learn more, see: *The Federal Reserve*.)

The function of this central bank has grown and today, the Fed primarily manages the growth of bank reserves and money supply to allow a stable expansion of the economy. The Fed uses three main tools to accomplish these goals:

1. A change in reserve requirements,
2. A change in the discount rate, and
3. Open market operations.

Reserve Ratio

A change in reserve ratio is seldom used, but is potentially very powerful. The reserve ratio is the percentage of reserves a bank is required to hold against deposits. A decrease in the ratio will allow the bank to lend more, thereby increasing the supply of money. An increase in the ratio will have the opposite effect. (For related reading, see: *Which nations' economies have reserve ratios?*)

Discount Rate

The discount rate is the interest rate the central bank charges commercial banks that need to borrow additional reserves. It is an administered interest rate set by the Fed, not a market rate; therefore, much of its importance stems from the signal the Fed is sending to the financial markets (if it's low, the Fed wants to encourage spending and vice versa). As a result, short-term market interest rates tend to follow its movement. If the Fed wants to give banks more reserves, it can reduce the interest rate it charges, thereby tempting banks to borrow more. Alternatively, it can soak up reserves by raising its rate and persuading the banks to reduce borrowing.

Open Market Operations

Open market operations consist of the buying and selling of government securities by the Fed. If the Fed buys back issued securities (such as Treasury bills) from large banks and securities dealers, it increases the money supply in the hands of the public. Conversely, the money supply decreases when the Fed sells a security. The terms "purchase" and "sell" refer to actions of the Fed, not the public.

For example, an open market purchase means the Fed is buying, but the public is selling. Actually, the Fed carries out open market operations only with the nation's largest securities dealers and banks, not with the general public. In the case of an open market purchase of securities by the Fed, it is more realistic for the seller of the securities to receive a check drawn on the Fed itself. When the seller deposits it in his or her bank, the bank is automatically granted an increased reserve balance with the Fed. Thus, the new reserves can be used to support additional loans. Through this process, the money supply increases. (For related reading, see: *Open Market Operations vs. Quantitative Easing*.)

The process does not end there. The monetary expansion following an open market operation involves adjustments by banks and the public. The bank in which the original check from the Fed is deposited now has a reserve ratio that may be too high. In other words, its reserves and deposits have gone up by the same amount; therefore, its ratio of reserves to deposits has risen. To reduce this ratio of reserves to deposits, it chooses to expand loans.

When the bank makes an additional loan, the person receiving the loan gets a bank deposit, increasing the money supply more than the amount of the open market operation. This multiple expansion of the money supply is called the multiplier effect.

The Bottom Line

Today, the Fed uses its tools to control the supply of money to help stabilize the economy. When the economy is slumping, the Fed increases the supply of money to spur growth. Conversely, when inflation is threatening, the Fed reduces the risk by shrinking the supply. While the Fed's mission of "lender of last resort" is still important, the Fed's role in managing the economy has expanded since its origin.

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