**What is the Fed: Monetary Policy**

**Introduction**

The Fed is the nation’s monetary policy authority. Monetary policy involves influencing the availability and cost of money and credit to promote a healthy economy. For the Fed, Congress has mandated two policy goals: one, maximum sustainable output and employment; and two, stable prices, meaning low, stable inflation. These dual policy goals imply moderate long-term interest rates. The Fed works to fulfill its dual mandate primarily by setting a target for a key interest rate, the federal funds rate, which is what financial institutions charge each other for loans in the overnight borrowing market. The federal funds rate serves as a benchmark for many other short-term interest rates and consequently broadly influences credit conditions. The Fed uses a number of tools to keep the federal funds rate near its target.

**Setting Monetary Policy: The Federal Funds Rate**

The federal funds rate is the interest rate banks charge each other for overnight loans of reserve balances.

The Fed cannot directly control inflation, output, or employment, nor can it set long-term interest rates. It affects these vital economic variables indirectly, mainly through its control over the federal funds rate. All depository institutions, including banks, credit unions, and thrifts, are required to hold minimum reserve balances in accounts at Federal Reserve Banks. The federal funds rate is the interest these institutions charge one another for overnight loans of reserves, balances that are sometimes needed to meet minimum requirements. Fed monetary policy actions alter the supply of reserves in the banking system. When more reserves are available in the banking system, the federal funds rate goes lower, reflecting an excess of supply over demand. In this way, the Fed is able to keep the federal funds rate close to its target. Changes in the federal funds rate are intended to cause changes in other short-term interest rates. Indirectly, the federal funds rate also affects long-term interest rates, the total amount of money and credit in the economy, and ultimately, employment, output, and inflation.

To keep inflation in check, the Fed can use its monetary policy tools to raise the federal funds rate. Monetary policy in this case is said to be “tight” or “contractionary.” To fight recessions, the Fed can use its monetary policy tools to lower the federal funds rate. Monetary policy is then said to be “easy,” “expansionary,” or “accommodative.”

The Fed has traditionally used three tools to conduct policy: open market operations; the discount rate; and reserve requirements. More recently, it has added other instruments to its monetary policy toolkit, such as paying interest on reserve balances held at Reserve Banks. The Fed has also used a number of temporary nontraditional tools over the past few years to fight economic weakness.

**Implementing Monetary Policy: The Fed’s Policy Toolkit**

Because the recent recession was so severe, the Fed used a number of extraordinary monetary policy tools that are not part of its traditional toolkit.

**Open Market Operations**

The Fed’s most frequently used monetary policy tool is open market operations. This consists of buying and selling U.S. government securities on the open market with the aim of aligning the federal funds rate with a publically announced target set by the FOMC. The Federal Reserve Bank of New York conducts the Fed’s open market operations through its trading desk. If the FOMC lowers its target for the federal funds rate, then the trading desk in New York will buy securities on the open market. The Fed pays for these securities by crediting the reserve accounts of the banks that sell the securities. In essence, when the Fed buys securities through open market operations, it is creating money. Additional money in these bank reserve accounts puts downward pressure on the federal funds rate according to the basic principle of supply and demand. In turn, short-term market interest rates directly or indirectly linked to the federal funds rate also tend to fall. Lower interest rates encourage consumer and business spending, thereby stimulating economic activity.

On the other hand, if the FOMC raises its target for the federal funds rate, then the New York trading desk will sell government securities, collecting payments from banks by withdrawing money from their reserve accounts. Less money in these reserve accounts means a smaller supply of money in the banking system, putting upward pressure on the federal funds rate. That typically causes market interest rates to rise, which damps consumer and business spending, slowing economic activity and reducing inflationary pressure.

**The Discount Rate**

The discount rate is the interest rate a Reserve Bank charges eligible financial institutions to borrow funds on a short-term basis, transactions known as borrowing at the “discount window.” Unlike open market operations, in which the federal funds rate is determined by the supply and demand for money in the banking system, the discount rate is set by the Reserve Bank boards of directors, subject to Board of Governors approval. The level of the discount rate is set above the federal funds rate target. As such, the discount window serves as a back-up source of funding for depository institutions. The discount window can also become the primary source of funds under unusual circumstances. An example is when normal functioning of financial markets, including borrowing in the federal funds market, is disrupted. In such a case, the Fed serves as lender of last resort, one of the classic functions of a central bank. This took place during the recent financial crisis (see Financial Stability section).

**Reserve Requirements**

By law, all depository financial institutions must set aside a percentage of their deposits as reserves to be held either as cash on hand or as account balances at a Reserve Bank. The Fed sets reserve requirements for all commercial banks, savings banks, savings and loans, credit unions, and U.S. branches and agencies of foreign banks. Depository institutions use their reserve accounts to process many financial transactions through the Federal Reserve, such as check and electronic payments, and currency and coin services.

Altering reserve requirements is potentially a monetary policy tool, but is rarely used. Nonetheless, reserve requirements support monetary policy by creating a relatively predictable demand for loans in the federal funds market. In many cases, banks borrow in that market specifically to meet reserve requirements. The relatively predictable nature of the market for bank reserves better enables the Fed to influence the federal funds rate through open market operations.

**Interest on Reserves**

In October 2008, Congress granted the Fed authority to pay depository institutions interest on reserve balances. The interest rate paid on reserves is effectively a floor beneath the federal funds rate because banks are not willing to loan to each other at rates significantly below what they can earn by leaving their reserves on deposit with the Fed.

Because of the Fed’s efforts to stimulate the economy, a very large volume of reserves is currently in the banking system and the federal funds rate is effectively at zero. As the economy recovers, the ability to pay interest on reserves gives the Fed another tool to tighten policy without having to significantly or suddenly reduce the supply of reserves in the banking system. By increasing the interest rate paid on reserves, the Fed will be able to put upward pressure on market interest rates because banks will not want to lend to the public at rates significantly below what they can earn by holding reserves with the Fed.