Recent Federal Reserve Monetary Policy
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Hello, I'm Steve Meyer. I'm an economist here at the Federal Reserve in Washington. The Fed is the central bank of the United States, the Congress created the Fed and made it responsible for monetary policy. I'm going to spend a few minutes discussing monetary policy and recent steps the Fed has taken to support our nation's economic recovery. The Fed adjusts monetary policy to promote maximum sustainable growth in output and employment and to keep inflation low and stable. When the outlook for growth is too slow and unemployment is high the Fed can push interest rates down to make credit less expensive that helps the economy grow more quickly and create more jobs.

If inflation is extremely low, pushing interest rates down can help prevent the dangerous of slide into deflation, meaning a continuing decline in prices in wages. But if inflation is rising and the economy is growing too strongly the Fed can push up interest rates to reign in growth and control inflation. In normal times, before the recent global financial crisis the Fed adjusted short term interest rates such as the rate at which banks lend to each other over night. To make those adjustments the Fed bought and sold U.S. government bonds, notes, and bills. Longer term interest rates including those on home mortgages, auto loans, and business credit generally moved up and down with short term rates, though rarely by the same amount. As the financial crisis intensified the economy began to contract, unemployment started to climb, and the risk of deflation rose so the Fed reduced short term interest rates sharply. By the end of 2008, short term interest rates were close to zero, about as low as possible, even so output and employment continued to shrink. The Fed decided it needed to do more. To push down longer term interest rates the Fed bought a large amount of bonds and other longer term securities issued or guaranteed by the U.S. Government, about 1.7 trillion dollars in total. The Fed spread out its purchases from late 2008 into early 2010 and it conducted competitive auctions to ensure that it paid the lowest prices possible. This monetary policy was effective, longer term interest rates fell, business and households were able to borrow at lower rates, and asset values rose. The Feds actions together with steps taken by other parts of the U.S. government help the economy start growing again in the summer of 2009, and inflation stayed low.

Unfortunately, the recovery slowed in the middle of 2010, unemployment was near 10 percent and the economies expansion became too sluggish to bring unemployment down. Meanwhile inflation continued to trend lower and there was a growing risk of deflation. So in November of 2010, after several months of public discussion, Fed officials decided to start a second round of securities purchases, they announced they intended to buy an additional $600 billion dollars of longer term U.S. Treasury securities, about one-third as much as in the first round. You may wonder how the Fed pays for the bonds and other securities it buys. The Fed does not pay with paper money, instead the Fed pays the sellers bank using newly created electronic funds and the bank adds those funds to the sellers account. The seller can spend the funds or can simply leave them in the bank. If the funds stay in the bank then the bank can increase its lending, purchase more assets or build up the reserves it holds on deposit at the Fed. More broadly, the Feds securities purchases increase the total amount of reserves that the banking system keeps at the Fed. Whether the Feds purchases lead to an increase of the amount of money circulating in the economy depends on what banks do with the new reserves and on what sellers do with the funds they receive. As it happens the money supply has not grown unusually rapidly since the Fed began its first round of asset purchases, if anything the money supply has been growing more slowly than normal and as I noted earlier inflation declined while the Fed was conducting its first round of purchase and is now quite low. Still if the Fed were to continue buying securities even as banks eventually expand their lending then the money supply could increase too rapidly and inflation could become too high, Fed policy makers are determined to avoid that outcome. The Fed will not keep

buying large amounts of securities on and ongoing basis. Its purchases are a temporary measure to help the economy recover. When the economy has recovered sufficiently the Fed will reduce it's holdings of Treasury debt and other securities. That reduction will avoid a large permanent increase in the money supply.

The Fed also has other tools it can use to decrease bank reserves and prevent a large expansion of the money supply, those tools have been tested and are ready to be used if needed. The bottom line is that the Feds asset purchases are an extension of standard monetary policy, right now at the beginning of 2011 monetary policy is helping foster a stronger economic recovery and job creation while keeping the risk of deflation low, later when appropriate the Fed will tighten monetary policy to avoid future inflation, thank you for watching.

If you would like more information about monetary policy you can find it on the Federal Reserve Board website.