The image shows the Federal Reserve Building in Washington, D.C., a large, classical-style stone building with a prominent portico and columns. The building is set against a clear blue sky and a green lawn in the foreground.

Chapter 16: The Federal Reserve and Monetary Policy Section 2

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ECONOMICS

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Objectives

1. **Describe** how the Federal Reserve serves the federal government.
2. **Explain** how the Federal Reserve serves banks.
3. **Describe** how the Federal Reserve regulates the banking system.
4. **Explain** the Federal Reserve's role in regulating the nation's money supply.



Key Terms

- **check clearing:** the process by which banks record whose account gives up money and whose account receives money when a customer writes a check
- **bank holding company:** a company that owns more than one bank
- **federal funds rate:** the interest rate that banks charge each other for loans
- **discount rate:** the interest rate that the Federal Reserve charges commercial banks for loans

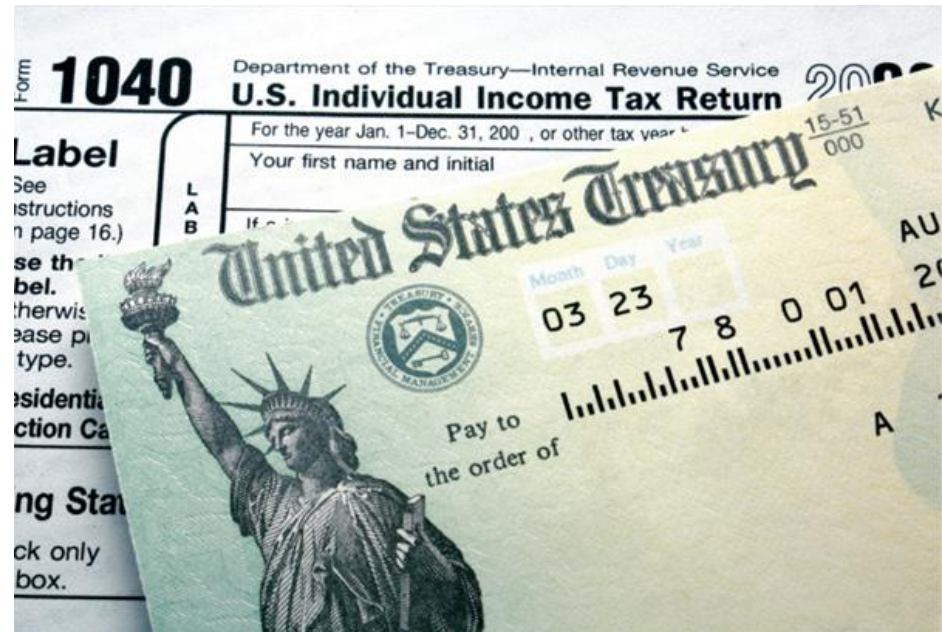


- What does the Federal Reserve do?
 - The Federal Reserve:
 - Serves as banker and financial agent for the U.S. government
 - Issues currency
 - Clears checks
 - Supervises lending practices
 - Acts as a lender of last resort
 - Regulates the banking system through reserve requirements and bank examinations
 - Regulates the money supply



Serving Government

- Among the most important functions of the Fed is to provide banking and fiscal services to the federal government.
- The U.S. government pays out about \$1.2 trillion each year to support social insurance programs.
 - To handle its banking needs when dealing with such large sums, the federal government turns to the Federal Reserve.



- Checkpoint: What does the Federal Reserve do in its role as the government's banker?
 - The Federal Reserve maintains a checking account for the Treasury Department that is used to process Social Security checks, income tax refunds, and other government payments.



Agent

- The Fed also sells, transfers, and redeems securities, such as government bonds, bills, and notes.
- Under the Federal Reserve System, only the federal government can issue currency, which takes place at the United States Mint.



Supervising Lending Practices

- To ensure stability, the Federal Reserve monitors bank reserves throughout the banking system.
- The Fed Board studies proposed bank mergers and bank holding company charters to ensure competition in banking and financial industries.
- The Fed also protects consumers by enforcing truth-in-lending laws, which require sellers to provide full and accurate information about loan terms.
 - Checkpoint: How does the Fed protect consumers who take out bank loans?



Lender of Last Resort

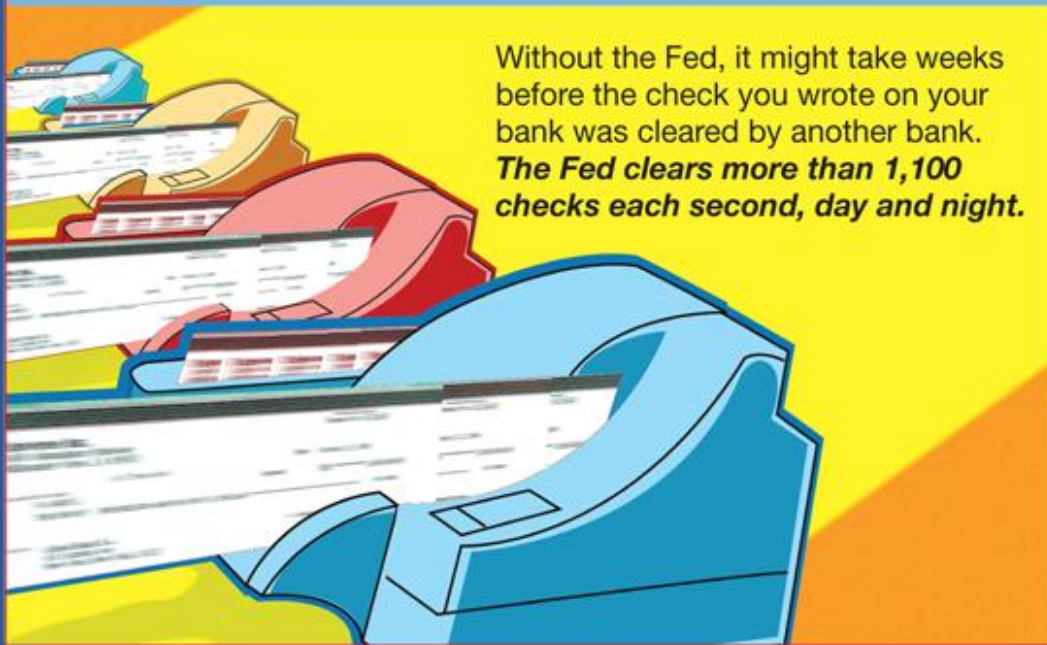
- Banks lend each other money on a day-to-day basis, using money from their reserve balances.
- Banks can also borrow money from the Fed. They do this routinely and especially during financial emergencies.
 - The Fed acts as a lender of last resort, making emergency loans to commercial banks so that they can maintain required reserves.



The Fed and You

Only the Federal Reserve can issue money in the United States. As a result, people in every state use the same money. *If bills become worn or torn, the Fed destroys them and issues crisp, new money.*

Without the Fed, it might take weeks before the check you wrote on your bank was cleared by another bank. *The Fed clears more than 1,100 checks each second, day and night.*



Regulating the Banking System

- The Fed coordinate the regulating activities of banks, savings and loan companies, credit unions, and bank holding companies.
- Each financial institution that holds deposits for customers must report daily to the Fed about its reserves and activities.
 - The Fed uses these reserves to control how much money is in circulation at any one time.



Bank Examinations

- The Fed and other regulatory agencies also examine banks periodically to make sure that each institution is obeying laws and regulations.
- Bank examiners can force banks to sell risky investments or to declare loans that will not be repaid as losses.
 - They can also classify an institution as a problem bank and force it to undergo more frequent examinations.



Regulating the Money Supply

- The Federal Reserve is best known for its role in regulating the nation's money supply.
 - The Fed's job is to consider various measures of the money supply and compare those figures with the likely demand for money.
 - The more money held as cash, the easier it is to make economic transactions.
 - But, as interest rates rise, people and firms will generally keep their wealth in assets that pay returns.
 - The general level of income also influences money demand.



Stabilizing the Economy

- Too much money in the economy leads to inflation. It is the Fed's job to prevent this by keeping the money supply stable.
- In an ideal world, where real GDP grew smoothly and the economy stayed at full employment, the Fed would increase the money supply just to match the growth in the demand for money.



Review

- Now that you have learned what the Federal Reserve does, go back and answer the Chapter Essential Question.
 - How effective is monetary policy as an economic tool?

