The prevailing commercial bank rates research paper

Sociology, Shopping

Introduction

A discount rate is the interest rate that is used in cash flow discounting so as to determine future cash flows’ present value. This discount rate caters for the time value of money and uncertainty or risks of expected cash flows in future, which could be less or more than expected. Time value of money is an idea that the value of money currently is worth much more than that amount in future since it may be earning interests. A discount rate could also be defined as a rate of interest which an eligible depository organ or institution is charged when borrowing short term finances from a central bank or Federal Reserve bank.

The Federal Reserve Bank offers different kinds of loans. Each kind of credit or loan has its own corresponding discount rate. The discount rate borrowing from the Federal Reserve is usually regulated and limited depending on the prevailing economic conditions. Usually, institutions seek for alternative means of achieving their liquidity needs for the short term period. The discount rate of the Federal Reserve is determined using the mean rate which commercial banks charge each other when lending overnight finances. The Federal Reserve usually adjusts the discount rate basing on various factors. These are economic related factors.

These are the overnight lending rates that American commercial banks are willing to charge each other. Banks can borrow from each other on short term basis so as to maintain their required liquidity levels. Since the Federal Reserve is the Central bank of the United States, it is the lender of last resort to the commercial banks. Therefore, the Federal Reserve will adjust its

discount rates to be at par with those of the inter-commercial bank rates. This is done by setting the discount rate as the average of all the rates that banks charge each other during the discount window. The discount rate is usually reviewed every two weeks.

The amount of funds in the economy

The Federal Reserve controls the supply of funds in the economy using the discount rate. This extends on to influence the overall rates of interest and the inflation rates. If there is too much money supply in the economy, there are high chances of inflation occurring. Therefore, to solve this problem, the Federal Reserve sets high discount rates to discourage commercial banks from borrowing funds (if banks borrow a lot of money in overnight windows, money supply in the economy increases further causing inflation).

Similarly, when there is a low supply of money in the economy, the Federal Reserve reduces the discount rates. This will encourage borrowing by financial institutions which in turn increase the money supply in the economy. Once the Federal Reserve reduces the discount rates, the overall interest rates in the economy go down. This can be attributed to the low costs of borrowing that banks can access from the central bank.

The discount rate has two different ways in which it affects the way commercial banks set their individual rates of interest. The commercial banks tend to mimic the Federal Reserve’s discount rate. An increase in the discount rate will imply that the Federal Reserve wants to reduce the money supply in the economy and may be curb inflation. The commercial banks will

also set their specific rates of interest high. This is because the cost of borrowing funds in the short term is slightly higher than before; the bank sets a high interest rate to accommodate the high cost of borrowing. Another reason for the increased interest rate of the commercial banks is that there could be inflation in the economy prompting the commercial banks to set high interest rates so that they do not make losses.

When the discount rates are low, the commercial banks will tend to set their discount rates low. This is because the cost of borrowing funds in the economy by the financial institutions is low. Since the cost of borrowing funds is low, commercial banks, which compete amongst themselves, will try to set as low interest rates as possible to attract customers. The high monetary supply will also influence the banks to set a low rate of interest. Usually, when the Federal Reserve sets the discount rate low, it is trying an expansionary economic policy. To expand the economy, the commercial banks are encouraged to set relatively low.

Inflation has been common over the recent years. Currently, the inflation rates in the American economy are said to be 2%. Normally, inflation rates below 3% are advantageous to the economy and they create employment opportunities to the economy. However, inflation also has detrimental effects on any economy. The Federal must always deal with the inflation rates from increasing beyond uncontrollable levels. The central bank can either use the monetary policy or the fiscal policy in dealing with inflation. Using the monetary policy, the Federal Reserve uses three main tools.

Open Market Operations

The government through the Federal Reserve issues and sells financial securities such as bonds and T bills with the objective of attaining a bank reserve of desired level. During inflation or when inflation is likely to occur, the government issues these financial securities to the public and the commercial banks. The objective is to reduce the money supply in the economy which usually results in inflation. When the private institutions, individuals and commercial banks purchase the bonds, they give money to the Federal Reserve. In this case, the money supply in the economy is reduced hence curbing inflation.

Discount Window Operations

The Federal Reserve can control the inflation rates using the discount window operations. This is where the Federal Reserve lends money to the financial institutions in the short term, overnight to be precise. Being the lender of last resort, the Federal Reserve can set a high level of discount rate so that the commercial banks are discouraged from borrowing a lot of money in the short term. Once the commercial banks borrow fewer funds, the money supply in the economy reduces hence; inflation is reduced or avoided.

Reserve Requirements

The law empowers the Federal Reserve to retain or hold a given proportion of the deposits from the commercial banks as non-interest bearing reserves in the Federal Reserve. To curb inflation rates, the Federal Reserve would simply increase the reserve requirement. This would restrict commercial

banks capability to give credit to the public because most of their finances will be with the central bank. This will reduce money supply in the economy hence reducing inflation.

The monetary policy regulates the money supply in the economy using the same tools by the Federal Reserve. The mostly used tools are the open market operations, the minimum reserve requirement and the discount rate window. The operations are done similarly as the case of curbing inflation because they are all contractionary techniques. This will reduce the supply in the economy to the Federal Reserve's desired level.

The economic stimulus program is usually aimed at using expansionary measure or tools to encourage economic growth. The stimulus programs are meant to increase the money supply in the economy when the economy is shrinking or is stagnating. The stimulus can be implemented through the money multiplier. This is by determining a money supply amount that will be pumped into the economy. The multiplier is adjusted so that when the Federal Reserve implements its monetary and fiscal policies, the money supply in the economy is directly affected through the money multiplier effect. If the government wants to increase the money supply in the economy, it will set a large money multiplier so that the money supply in the economy can be easily increased or reduced depending on the objectives of the Federal Reserve on the economy. Similarly, when the government does not want to significantly change the money supply in the economy, it will set a small money multiplier which will not increase or reduce the money supply in the economy significantly.

Currently, there is still little money in the American economy even after the financial crisis has subsided. This is indicated by the high rates of unemployment meaning there is less money that is needed to induce a considerable investment increase that will create jobs for American citizens. Another indicator of little money supply is the relatively high interest rates by commercial banks. Unlike in 2006 during the period when mortgage finances were cheap, the interest rates are relatively high, meaning there are less funds in the economy. The high demand for funds is what drives the interest rates high. One more indicator of few funds in the economy is the efforts by the Federal Reserve to put in place expansionary monetary and fiscal policies that would stimulate and increase money supply in the economy.

Particularly the monetary policy has been used by the Federal Reserve more often than the fiscal policy. Monetary policies that encourage expansionary effects on the economy have been implemented over the recent past. These include the reduction of minimum reserve requirements to encourage banking institutions to advance more loans to the public. The open market operations are being used where the government is buying bonds from institutions with the aim of increasing the money supply in the economy and increasing the economic growth. Finally, the discount rate window of the Federal Reserve has seen the discount rate set at a commercial bank friendly rate. This is meant to ensure that the economy remains vibrant through the injection of money from banking institutions.

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2. WEEKLY REFLECTION

In macro economics, deficits, debts and surpluses are very important influences of the state of any country's economy. Each of the three economic features affects the economy in a unique way. The American macro economy has been influenced by deficits, surpluses and debts at different periods over the years. This paper seeks to analyze the influence of each of these economic aspects on the macro economy of the United States of America.

Deficit

A deficit refers to a revenue shortage in the economy. Once an economy is said to be having a deficit, it implies that the country's total revenue is less than the total expenditure in the economy. In such a case, the national economy will have to operate on a deficit. An economy operates on a deficit

when it has to acquire finds from elsewhere apart from the revenues it collects. Since the economy is in a deficit, the government will have to find ways of financing the deficit. The most common way that the American government finances its deficit is by issuing bonds to the Federal Reserve (the central bank) and to private individuals. The bonds are actually borrowed money which the government promises to pay in future.

Therefore, an economy operating on a deficit is unable to implement its full macroeconomic policies. This is because the economy's budget is too high for the government to finance at that particular period. Over the decades since the 1980s, with the exception of the period between 1998 and 2001, the US economy has been operating on a deficit. The deficit has plunged the nation into debt because not even the issuing of bonds can finance the current deficit. The deficit causes the government to reassess its macroeconomic policies so that they can fit the amount of revenue it collects and the amount of deficit it can finance. This leads to economic stagnation since most macroeconomic policies that are important to the US economy cannot be implemented due to lack of funding. Sometimes, nominal deficits reduce the amount of debt for the macro economy because once inflation increases, the value of money reduces. This makes the debt to reduce in value.

Surplus

A surplus refers to a flow concept where the total revenues in an economy exceed the total expenditures or payments. Surpluses occur in an economy when the economy is experiencing a boom either the entire economy or

some sectors of the economy. In the American economy's case, the only period since 1980 that there has been a surplus is the period between 1998 and 2002. A surplus in the economy is very beneficial and advantageous to any economy. The government can cover all its expenses and still have a remainder of the revenue. In such a case, the government can engage in or initiate other projects that could expand the economy and create even more revenues. The surplus makes it possible for the government and the Federal Reserve to create new macroeconomic policies that will benefit Americans and the economy as a whole. Therefore, a surplus creates a healthy and strong macro economy.

Debt

Debt refers to an accumulation of deficits less the accumulated surpluses. It is a calculated at a particular point in time unlike in deficits. The debts are a liability to the American economy. The economy has to finance its debt, which has been increasing over the recent years, by refinancing bonds due through the sale of new bonds. This is done by the US treasury department continuously. In case the economy has a surplus, some previous bonds could be retired by repurchasing them. Debt has detrimental effects on the macro economy because it hinders the implementation of important policies in the economy. Similarly, debt shrinks the economy since no expansionary measures will be implemented. Most sectors of the economy will not fulfill their potential because the government and the Federal Reserve cannot finance them sufficiently.

Therefore, deficits have negative effects on the American economy; they also result into debt which hinders economic growth as well as implementation of favorable macroeconomic policies. On the other hand, surpluses impact positively on the economy. A surplus creates a favorable opportunity for the creation of a healthy macro economy; the expansion of the economy and implementation of other expansionary macroeconomic policies.

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