

# Example of the federal reserve essay

[Economics](#), [Money](#)



**The main duties of the Federal Reserve are;**

Formulating, implementing, and supervising the monetary policy of the country with a view to influence credit and monetary conditions in the economy, ensuring stable prices.

Regulation and supervision of important financial institutions including banks. It ensures that the banking system is safe and that credit consumers are protected.

**Ensuring that the financial system is stable.**

Providing essential financial services to U. S government and its institutions and also taking care of the government's payment activities.

The Fed increases the money supply in three ways. The Fed can buy Treasury bond, bills or and notes thereby releasing money into the economy. It can also increase the money supply by reducing the percentage of the reserve requirement. Finally, it can also increase the money supply by reducing the discount rate for banks so that the banks can issue loans at lower rates.

**Inflation**

The costs of high levels of inflation are numerous, and they include;

The cost of uncertainty - There are a lot of uncertainties during high inflation periods, and people are normally uncertain of where they should spend their money. It leads to lost opportunities since firms are reluctant to invest.

**Menu costs – These are costs associated with frequent changing of price lists due to changing inflation levels.**

Declined competitiveness internationally - High levels of inflation makes a country's exports expensive in instances where exchange rates are not affected hence, making it less competitive.

**Fiscal drag – These are inflation costs associated with increased taxation by the government as a result of high inflation levels.**

Redistribution of income - During inflation lenders loose because the amounts they lend out get diminished in purchasing power when it is paid back. The borrowers gain during inflation.

The cost of decreasing inflation - High levels of inflation are undesirable and, therefore, governments implement several policies to reduce it. One of the policies usually implemented is raising the discounting rates that raise the rates at which banks issue loans.

**Nominal and Real Exchange Rates**

Nominal exchange rate refers to the exchange rate of currencies. For example, \$1 can be exchanged for 124 Japanese Yen. Real exchange rate, on the other hand, refers to the quantity of goods from a domestic country that can be exchanged for goods in a foreign country. The two are related by the following formula for real exchange rate;

**Nominal Exchange Rate x Domestic Price Foreign Price**

If you require more Yens to acquire a unit dollar than you did before, the dollar will have appreciated. For instance, if the nominal exchange rate

changes from 100 Yen to 120 Yen for a unit dollar, then the dollar will have appreciated.

## **Aggregate Demand and Supply**

In the short run, the economy is normally more unstable, and slight changes in main economic factors are likely to shift aggregate demand and supply.

The long run, on the other hand, is more stable and can sustain small economic dynamics. The figure below represents aggregate demand and supply curves. The variables on the axes are price levels and output as can be seen below.

When the government reduces spending on highway construction by \$10 billion, the aggregate demand curve shifts towards the left-hand side. The left shift is due to reduced government purchases. The shift is likely to be more than \$10 billion if the multiplier effect is greater than the crowding-out effect. On the other hand, it is likely to be less than \$10 billion if the vice versa was true.

## **Money Supply**

When the Federal Reserve's Open Market Committee purchases \$1 million worth of bonds in the market, they will have released \$1 million into the economy. The money supply in the economy is expected to, therefore, increase. Given that the required reserve ratio is 20%, the money multiplier will be given by  $1/0.2 = 5$ . The money supply will, therefore, expand by;  $5 \times \$1 \text{ million} = \$5 \text{ million}$ .

## **Creation and Destruction of Money**

FIRST BANK ACCOUNT

SECOND NATIONAL BANK

The above answer has ignored the shareholders' equity that the two banks have in their accounts. George deposits \$100 into his First National Bank account. The bank keeps 10% as per required reserve ratio and lends out \$90 to Jack, who also deposits the money into his Second National Bank account.