Extra Credit a newsletter for educators

## How Does the Fed Seek to Influence Interest Rates? (Answer Key)

This month, *Extra Credit* offers a set of guided reading questions for your students to use as they read the *Economy Matters* article "How the Fed Seeks to Influence Interest Rates." The article by staff writer Charles Davidson discusses how monetary policy is "transmitted" through various channels to influence the federal funds rate. The article contains a wonderful explanation of interest on excess reserves from Atlanta Fed vice president and senior economist Paula Tkac.

1. What is the federal funds rate?
   *The federal funds rate is the interest rate financial institutions charge each other for overnight loans they make from their balances held at the Federal Reserve banks.*

2. How does the Fed target the federal funds rate?
   *Although the monetary policymaking body of the Federal Reserve, the Federal Open Market Committee, cannot directly change the federal funds rate, it can use monetary policy to influence this interest rate. If monetary policy is successful in achieving its target for the federal funds rate, the change will ripple through the financial system and influence interest rates on other types of loans in the economy.*

3. How do changes in interest rates affect people's behavior in the economy?
   *When interest rates rise, people borrow less because loans are more expensive. This reduction in borrowing tends to put the brakes on increases in the price level. When interest rates fall, borrowing is more attractive because the cost of loans has fallen. This tends to stimulate the economy by increasing the amount of spending on goods and services.*

4. Identify and describe the Federal Open Market Committee's (FOMC) main tool of monetary policy since the 2008 financial crisis.
   *The main tool of monetary policy today is changes to the interest rate paid on reserves banks and other financial institutions keep in accounts with the Federal Reserve.*

5. What is opportunity cost, and how does it play a role in today's monetary policy?
   *Opportunity cost is the value of the next best alternative one does not choose when making a decision. Banks have a choice about the excess reserves they hold. They can park their excess reserves at the Federal Reserve and earn a risk-free rate of return OR they can lend excess reserves overnight at an interest rate higher than the interest rate paid on reserves. As that rate increases, banks will be less likely to lend excess reserves in the federal funds market because they would need to charge a higher rate than the rate they are earning on their reserves at the Fed and the federal funds rate is generally set below or equal to this rate.*

6. Before the 2008 financial crisis, the FOMC's primary monetary policy tool was open market operations. What is open market operations, and why has its importance as a monetary policy tool diminished since the financial crisis?

*Open market operations is the buying and selling of government securities. The open market trading desk at the Federal Reserve Bank of New York would buy securities to increase or decrease the level of reserves held by banks and, in turn, increase or decrease the supply of money in the economy. Prior to the financial crisis, excess reserves in the banking system were low. Small changes in the supply of reserves could change the federal funds rate. The change in open markets operations' effectiveness came with the FOMC's use of quantitative easing from 2008 to 2014. Under this approach, the FOMC made large-scale asset purchases from a variety of U.S. government or government-backed agencies. The institutions selling the assets channeled some of the proceeds of these sales into reserves. As the supply of excess reserves became increasingly large, the open market operations tool was no longer able to move the federal funds rate.*