LESSON 12: THE FEDERAL RESERVE

***Focus Question:* To what extent should businesses be concerned about actions taken by the Federal Reserve?**

Objectives

Students will be able to:

- Examine the goals of monetary policy.
- Analyze the role played by the Federal Reserve Bank in making and implementing monetary policy.
- Discuss how businesses are affected by Federal Reserve policy decisions.

Standards

NES: 10, 11, 12, 16, 17, 18, 19, 20
ELA: 1, 2, 3

Time Frame/Notes to Teacher

One day, double period

Materials

Textbook chapter on: The Federal Reserve

Teaching Strategies

I. All Eyes on the Fed

Distribute Worksheet 12A, "All Eyes on the Fed." Have students complete the exercise on the worksheet. Then have them explain their answers to the following:

— What do we learn about the Federal Reserve from the article?
— How do you explain the headline, "All Eyes on the Fed"?
— Should people in business be just as concerned as everyone else about what the Fed does or should they be more concerned?
— What questions for discussion does this article suggest?

II. The Fed's Goals

Distribute Worksheet 12B, "The Fed's Goals." Have students complete the exercise on the worksheet, then have them explain their answers to the following:

— In your own words, describe each of the Fed's goals.
— Why are these goals important to a healthy economy?
— In what ways are these goals important to people running businesses?
— Which goal is most important to people running businesses?

III. The Fed's Tools

Distribute Worksheet 12C, "The Fed's Tools." Have students complete the exercise on the worksheet. Then, as part of the whole-group discussion, ask students to explain their answers to the following:

— What do we learn from this chart about how Federal Reserve policies affect the economy?
— Why would the Fed most likely raise rates if it wanted to fight inflation?
— Why would the Fed most likely lower rates if it wanted to fight recession?
— To what extent do these charts support the idea that the Fed must be careful in not going too far in raising or lowering interest rates?

IV. Economic Indicators

Divide the group into three parts. Distribute Worksheet 12D. Assign each group one of the three indicators on the worksheet. Have them complete the exercise on the worksheet. As part of the whole-class discussion, have students explain their answers to the following:

— What does the indicator that you were assigned measure?
— To what extent do the recent measures of these indicators show us the economy is either healthy or in danger of inflation or recession?
— Why does the Fed look at this indicator in deciding what to do about interest rates?
— Based on these three indicators, if you were a Fed decision maker, would you vote to raise interest rates, lower interest rates, or keep them the same?

Summary/Assessment

The amount of money that individuals and business firms can spend depends in part on how much they can borrow. How does availability of credit affect business activity? When would the economy as a whole benefit from an increase in the supply of money and credit? When would the increase damage the economy?

Homework

- Read materials in preparation for Lesson 13.
- Assign questions for homework.

Worksheet 12A

"All Eyes on the Fed"

Exercise. *Underline three sentences that help explain why all eyes are on the Fed.*

All Eyes on the Fed

Economists predict change in risk assessment

By Rachel Koning, CBS.MarketWatch.com
Last Update: 9:32 AM ET Aug. 13, 2002

WASHINGTON (CBS.MW) – Will they or won't they? While few Federal Reserve watchers expected the central bank to trim interest rates on Tuesday, a move to loosen monetary policy wouldn't be a huge surprise either. Tuesday's meeting got underway as planned, a Fed spokeswoman confirmed. An announcement is expected around 2:15 p.m. Eastern.

Some economists are even challenging the rate-setting Federal Open Market Committee to make the move now rather than later. Corporate-governance scandals, these economists say, have taken such a toll on the stock market that they have tainted the broader economy now as well. And consumers are keeping their wallets sealed tight, while capital spending remains tenuous.

The Fed has left interest rates alone since late last year and has, so far, maintained its view that the risks to the economy are evenly split between weak growth and inflation.

Worksheet 12B

The Fed's Goals

Prior to the creation of the Federal Reserve in 1913, there were many weaknesses in the banking system. People who deposited their savings in banks sometimes lost it—as banks were not well supervised. Secondly, businesses and consumers often had difficulty getting credit when they needed it most. Finally, the money supply couldn't expand to meet the customers' needs or shrink when money was not needed—this led to prolonged periods of inflation on the one hand and economic downturns on the other.

As a result of the above, Congress created the Federal Reserve Board in 1913. The goals of the Fed are listed below. In the space under each goal, describe what the goal means to you. Place an asterisk (*) next to the goal that you think is most important.

The goals of the Federal Reserve are to promote:

- Sustainable Economic Growth

- Full Employment

- Stable Prices

Worksheet 12C

The Fed's Tools

To reach its goals, the Fed takes actions to either raise or lower a key short-term interest rate, called the Fed Funds Rate. The Fed Funds rate is the interest rate that banks charge each other for short-term (mostly overnight) loans. Most banks use the Fed Funds Rate as the basis for determining the interest rate they charge their customers. Therefore, it is likely that when the Fed raises the Fed Funds Rate, consumers and businesses that borrow from banks will pay more in interest than before. Likewise, when the Fed lowers the Fed Funds Rate, those who borrow from Banks will pay less in interest than before.

Exercise*. Try to determine the effects on the economy of the Fed raising rates, as in Example 1 and lowering rates, as in Example 2. In each of the boxes in Examples 1 and 2, circle a) or b) indicating which you think would be the more likely effect of the Fed's action.*

Example 1.

Fed's Action

Fed raises rates.	⇒	a) more b) fewer loans are made	⇒	Consumers and businesses spend c) more d) less	⇒	Business Revenues c) go up d) go down	⇒	Prices a) rise b) fall	⇒	a) more b) fewer workers employed

Example 2.

Fed's Action

Fed lowers rates.	⇒	Consumers and businesses spend a) more b) less	⇒	Business revenues a) go up b) go down	⇒	a) more b) fewer loans are made	⇒	a) more b) fewer workers employed	⇒	Prices go: a) up b) down

Worksheet 12D

Your Decision

Exercise. *In a previous lesson you learned about economic indicators. The Fed studies thousands of these to help them decide what they should do about interest rates. Three of the most important indicators appear below.*

- Read 1, 2, or 3 below, as assigned.
- Access the web pages indicated to determine the current status of the indicator you have been assigned.
- Be prepared to answer the following question as part of the whole-class discussion: "Does the most recent measure of your indicator tell us that the economy is healthy or threatened by recession or inflation?" Explain.

1) REAL GROSS DOMESTIC PRODUCT (GDP)

Definition: The total value of goods and services produced within the borders of the United States, regardless of who owns the assets or the nationality of the labor used in producing that output. [In contrast, Gross National Product (GNP) measures the output of the citizens of the U.S. and the income from assets owned by U.S. entities, regardless of where located.] The growth of output is measured in real terms, meaning increases in output due to inflation have been removed.

Source: U.S. Department of Commerce; Bureau of Economic Analysis

Frequency: Quarterly

Availability: Data are typically released during the final week of the month. The first or advance estimate is released during the final week of the month immediately following the end of a calendar quarter.

Reason: The Federal Reserve's primary goal is sustained growth of the economy with full employment and stable prices. Real GDP is the most comprehensive measure of the performance of the U.S. economy. By monitoring trends in the overall growth rate as well as the unemployment rate and the rate of inflation, policy makers are able to assess whether the current stance of monetary policy is consistent with that primary goal.

Web site: www.newyorkfed.org/rmaghome/dirchrts/pi_9.pdf

2) CONSUMER PRICE INDEX (CPI)

Definition: An index designed to measure the change in price of a fixed-market basket of goods and services. The market basket of goods and services is representative of the purchases of a typical urban consumer. The index is intended to measure pure price change only; attempts are made to remove changes in price resulting from changes in quality.

Source: U.S. Department of Labor; Bureau of Labor Statistics

Frequency: Monthly

Availability: Generally available the second week of the month immediately following the month for which data is being released; always released after the Producer Price Index.

Reason: The rate of change of the CPI is one of the key measures of inflation for the U.S. economy. Acceleration or deceleration of inflation may signal that a change in monetary policy may be appropriate.

Web site: www.newyorkfed.org/rmaghome/dirchrts/pi_7.pdf

(continued)

Worksheet 12D, continued

3) NONFARM PAYROLL EMPLOYMENT

Definition: An estimate of the number of payroll jobs at all nonfarm business establishments and government agencies. Information is also provided on the average number of hours worked per week and average hourly and weekly earnings.

Source: U.S. Department of Labor; Bureau of Labor Statistics

Frequency: Monthly

Availability: Usually the first Friday of the month for the immediately preceding month; occasionally released on the second Friday.

Reason: Growth of employment and hours worked provide important information about the current and likely future pace of overall economic growth. Trends in average hourly earnings provide information about supply and demand conditions in labor markets, which may provide signals about the overall level of resource utilization in the economy.

View chart: http://www.newyorkfed.org/rmaghome/dirchrts/pi_8.pdf