Rates in Motion

How Federal Reserve tools can affect borrowing

GE.7.2 "Define and explain monetary policy and its tools."

NAME _____ DATE _____

1 READ AND MARK

Read it twice

YOUR JOB Underline the definition of monetary policy and circle three Federal Reserve tools. Write a matching number beside each tool and one effect it can have on interest rates.

A Bus Company's Borrowing Decision

1. Imagine a bus company deciding whether to borrow money for new buses. Its loan rate can change when the Federal Reserve, the United States' central bank, adjusts monetary policy. Monetary policy means actions by the central bank that influence interest rates and the supply of money and credit to support a stable economy. Congress has given the Fed goals of maximum employment and stable prices. When inflation stays high, the Fed may aim for higher interest rates to slow spending and borrowing. When the economy weakens, it may aim for lower rates to encourage them. Neither result happens instantly.

2. One tool is open market operations, buying or selling U.S. Treasury securities in financial markets. A Fed purchase pays sellers and adds reserves to the banking system; a sale removes reserves. With fewer reserves, short-term rates tend to rise. These transactions help keep the federal funds rate, a short-term rate banks charge one another for overnight loans, within the Fed's target range. Another tool is the interest rate the Fed pays banks on reserve balances held at the Fed. Raising that rate makes banks less willing to lend reserves at lower rates, helping push short-term rates up. Lowering it can help push rates down.

3. The discount rate is the rate the Fed charges eligible banks that borrow directly from it. Changing this rate affects the cost of that backup source of funds, though banks usually borrow there less often than they trade in other markets. Together, these tools influence market interest rates, but they do not set the bus company's loan rate directly. A higher loan rate may lead it to delay buying buses, reducing demand for vehicles and workers. Lower rates may encourage investment instead. Lending decisions, expectations, and delays mean monetary policy cannot guarantee a particular inflation or employment result.

2 ANSWER WITH EVIDENCE

Use the passage

1. Define monetary policy and explain why the Fed might aim for higher interest rates when inflation stays high.

2. Explain how a Fed sale of Treasury securities can affect bank reserves and short-term interest rates.

3. How can raising the interest rate paid on reserve balances affect short-term interest rates?

4. What does the discount rate apply to, and why does it not directly set the bus company's loan rate?

3 YOUR TURN

Your own words

Suppose factory layoffs are rising while inflation is low. In four to five sentences, propose how the Fed could use one tool from the passage, explain a possible chain of effects on interest rates, borrowing, and employment, and identify one reason the result is uncertain.

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PART 1 · READ AND MARK

Underline the definition of monetary policy and circle three Federal Reserve tools. Write a matching number beside each tool and one effect it can have on interest rates. Accept any marking that follows this job and points at the right text.

PART 2 · ANSWERS

#	QUESTION	ANSWER
1	Define monetary policy and explain why the Fed might aim for higher interest rates when inflation stays high.	**Monetary policy is central bank action that influences interest rates and the supply of money and credit to support a stable economy. The Fed may aim for higher rates to slow borrowing and spending when inflation stays high.**
2	Explain how a Fed sale of Treasury securities can affect bank reserves and short-term interest rates.	**A sale removes reserves from the banking system. With fewer reserves, short-term interest rates tend to rise.**
3	How can raising the interest rate paid on reserve balances affect short-term interest rates?	**Banks become less willing to lend reserves at lower rates, which helps push short-term rates up.**
4	What does the discount rate apply to, and why does it not directly set the bus company's loan rate?	**It is the rate the Fed charges eligible banks that borrow directly from it. Fed tools influence market rates but do not directly set the rate a company pays its lender.**

PART 3 · YOUR TURN (SAMPLE ANSWER)

The Fed could lower the interest rate it pays banks on reserve balances. That change could help push short-term interest rates down and make borrowing less costly. Factories might then borrow to buy equipment and hire workers, easing the layoffs. The result is uncertain because lenders might still decide not to make those loans.

Accept other accurately explained tools and plausible chains of effects. Responses should distinguish the Fed's influence on market rates from direct control over a business loan rate.