# The Fed's Choices

Trace how monetary policy can affect spending, prices, and jobs.

**E.C.10.5** "Analyze how the Federal Reserve uses monetary policy tools (e.g., changes in the discount rate, reserve requirements, money supply) to influence economic conditions."

NAME _____ DATE _____

## 1 READ AND MARK

Read it twice

**YOUR JOB** Underline each Fed policy action and circle the economic condition it addresses. In one chain, write 1, 2, and 3 beside the action, its immediate effect on banks, and a possible effect on the wider economy.

### When the Economy Shifts

1. At a neighborhood appliance store, customers complain that many prices keep climbing, not just the price of one toaster. The Federal Reserve, or Fed, aims for stable prices and maximum employment, so it watches broad inflation and job conditions. To slow persistent inflation, it can raise the discount rate, the interest rate it charges eligible banks for short-term loans through its discount window. Borrowing from the Fed then becomes more expensive for those banks. If this change contributes to higher borrowing costs for households and businesses, spending may cool and price increases may slow. Slower spending can also mean fewer new jobs.

2. Suppose businesses begin cutting shifts and households postpone purchases. The Fed could lower the discount rate, making its loans to eligible banks cheaper and helping banks manage short-term funding needs. Easier funding may support credit, business investment, and hiring, though banks are not required to lend more. Another tool is the reserve requirement, the minimum share of certain deposits that banks must hold as reserves. The Fed set reserve requirement ratios to zero in 2020 and has not used changes in them as its routine steering tool. If it raised a requirement, banks might have less room to expand lending, which could restrain spending.

3. The Fed can also influence money and reserve balances by buying or selling government securities. When it buys securities, it pays by adding reserves to the banking system; greater reserves can help ease financial conditions and support lending and spending. When it sells securities, reserves leave the banking system, which can help tighten financial conditions and reduce spending pressure. Neither move guarantees a particular number of loans: banks consider borrowers' ability to repay and the interest rates they face. The Fed weighs these effects against both goals, since restraining inflation too sharply can weaken employment, while stimulating spending too much can worsen inflation.

## 2 ANSWER WITH EVIDENCE

Use the passage

1. If broad inflation stays high, how could raising the discount rate help slow price increases? Include one possible cost of this choice.

2. If the Fed raised reserve requirements from their current level, what might happen to lending and spending? Why is this not a routine policy change?

3. During a slowdown, how could buying government securities affect banks and then the wider economy?

4. How could selling government securities help when inflation is high, and what risk would the Fed need to weigh?

## 3 YOUR TURN

Your own words

A storm briefly raises food prices, but layoffs are spreading across many industries. Choose whether the Fed should ease, tighten, or hold policy, name one tool it could use, and explain the likely path from that tool to spending and one risk.

ANSWER KEY

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## PART 1 · READ AND MARK

Underline each Fed policy action and circle the economic condition it addresses. In one chain, write 1, 2, and 3 beside the action, its immediate effect on banks, and a possible effect on the wider economy. Accept any marking that follows this job and points at the right text.

## PART 2 · ANSWERS

| # | QUESTION | ANSWER |
|---|---|---|
| 1 | If broad inflation stays high, how could raising the discount rate help slow price increases? Include one possible cost of this choice. | **Fed loans become more expensive for eligible banks. If borrowing costs for households and businesses rise, spending may cool and price increases may slow, but job growth may weaken.** |
| 2 | If the Fed raised reserve requirements from their current level, what might happen to lending and spending? Why is this not a routine policy change? | **Banks might have less room to expand lending, restraining spending. Reserve requirement ratios have been zero since 2020, and the Fed does not routinely change them to steer the economy.** |
| 3 | During a slowdown, how could buying government securities affect banks and then the wider economy? | **Buying securities adds reserves to the banking system. This can ease financial conditions and support lending and spending, though more loans are not guaranteed.** |
| 4 | How could selling government securities help when inflation is high, and what risk would the Fed need to weigh? | **Selling securities removes reserves and can tighten financial conditions, reducing spending pressure. If spending slows too sharply, employment could weaken.** |

## PART 3 · YOUR TURN (SAMPLE ANSWER)

I would ease policy because widespread layoffs suggest weak demand, while a storm-related food price spike may be temporary. The Fed could buy government securities, adding reserves to the banking system. Easier financial conditions could support lending and spending, which may help employers keep workers. If demand rises too much, however, broader inflation could accelerate.

Accept different policy choices in Part 3 if the tool, causal chain, and risk fit the student's reasoning. Students should distinguish a brief food price spike from persistent broad inflation.