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MONETARY POLICY WITHIN THE FEDERAL RESERVE SYSTEM IN THE FUNCTION OF ECONOMIC POLICY OBJECTIVES

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Abstract: *The competences and responsibilities of the Federal Reserve System include the implementation of monetary policy, thus affecting the money and credit conditions in the economy, in order to achieve full employment and price stability. The objectives of monetary policy are defined in the Federal Reserve Act, which states that the Board of Governors and the Federal Commission for its open market operations should promote full employment, stable prices and moderate long-term interest rates. Stable prices are a prerequisite for long-term sustainable growth in output and employment, as well as moderate long-term interest rates. Stable prices of goods, services, materials and labor are in efficient allocation of resources and thereby contribute to increasing living standards, encourage saving and capital formation, because when the risk of decline in value of assets due to inflation is minimal, households are encouraged to save more, and entrepreneurs to invest more.*

Keywords: *Federal Reserve System, employment, stable prices, moderate long-term interest rates*

1. INTRODUCTION

Issuing bank directly regulates and directs monetary-credit courses in each country, which in market conditions is used to energize and stabilize economic activity in the country[1].

The organization of the central bank depends on the political and administrative organization of the country, as well as the development and the structure of economic and financial system of the country. The Federal Reserve System was established by the Law on the

1 Krstić B. (1966.) *Banking*, University of Niš, Economics Faculty, p. 46.

Federal Reserve in 1913, and has been implemented since1914. It is a complex system of the central bank, typical for federal and confederal state structure, which consists of a central Board of Governors in Washington and 12 district Federal Reserve Banks located in major cities throughout the United States.

This paper analyzes regulating and directing the monetary-credit flows within the Federal Reserve System - the FED, through the objectives and tasks of monetary policy, in order to attain goals and objectives of the overall economic and financial policy.

2. MONETARY POLICY INSTRUMENTS

The Federal Reserve System runs monetary policy using the following instruments of monetary policy - reserve requirements, open market operations and the discount rates.

2.1. Reserve requirements policy

The Federal Reserve System can change the amount of reserve requirement by changing the reserve requirement rates, by changing the amount to which the rate is applied, or both. Changes in reserve requirement can have profound effects on the money supply and the cost of bank credits, which is the reason why the reserve requirements don`t often change. However, reserve requirements play a useful role in the open market operations, helping to ensure an increase in the Federal Reserve and the control over state reserves.

In the 60s and 70s of the last century, the Federal Reserve System actively used the reserve requirement as a monetary policy means in order to influence the expansion of money and credit, as well as to influence the banks funding costs.

Since financial innovations bore new sources of bank funding, the Federal Reserve System has adjusted the reserve requirement to these new financial products.

During the 70s it was becoming more clear that the structure of the reserve requirement became obsolete. At that moment, only the banks that were members of the Federal Reserve System were subject to reserve requirement established by the Federal Reserve System. Competitive pressures during the periods of high interest rates thus put much more burden on the member banks. Considering this situation, monetary policy makers believe that reserve requirement should be applied to a wider group of institutions in order to obtain more efficient monetary control, that is, to strengthen the link between the amount of reserves and the total amount of money in the economy. The Monetary Control Act[2] of 1980 (MCA) solves the problem of monetary control through the reform of the reserve requirement, so to comply with this Act, all depository institutions are subject to reserve requirements, regardless of whether they are members of the Federal Reserve System[3].

According to the Monetary Control Act of 1980, reserve requirement rate may vary from 8-14% on transaction deposits and from 0-9% on term deposits. The Board of Governors can also determine the reserve requirements on net liabilities of depository institutions in the United States to its foreign affiliates or other foreign banks. In December 1990, the reserve requirement rate on term deposits decreased from 3% to 0% in April 1992 from 12% to 10% on transaction deposits. These actions suggest that some lenders adopted more cautious approach to lending, which increased costs and limited availability of credit to some borrowers. Reduction of the financing costs and changing the reserve requirements can

2 http://www.federalreserve.gov/paymentsystems/pfs_pricingpol.htm(20.10.2015.)
3 http://www.federalreserve.gov/pf/pf.htm (07.10.2015.)

result in the easier access to capital markets and better position depository institutions to extend credit. Although the reserve requirement rates have not been changed since the early 90s, the level of reserve requirements has declined significantly due to the widespread use of sweep program by depository institutions. Under that program, the depository institution moves funds from an account which is subject to the reserve requirement to one which is not, and therefore reduces their reserve requirements. Without changes in cash, depository institutions can reduce their reserve requirements, which do not earn interest, and invest the funds previously held at the Federal Reserve in the interest-bearing activity.

Table 1. Structure and rates of required reserves

Structure of required reserves	Rate	Effective Date
	Transaction deposits	
0-14,5 million $	0%	22.01.2015.
14,5-103,6 million $	3%	22.01.2015.
103,6 million $ over	10%	22.01.2015.
Time deposits	0 %	27.12.1990.
Euro currency obligations	0%	27.12.1990.

Source: http://www.federalreserve.gov/monetarypolicy/reservereq.htm (20.10.2015.)

2.2. OPEN MARKET OPERATIONS POLICY

Federal Commission on Open Market Operations (FOMC) is responsible for the implementation of the policy of open market operations, which is the main instrument of national monetary policy. These operations affect the amount of Federal Reserve available to depository institutions, thereby affecting the overall monetary and credit conditions. FOMC also directs operations of the Federal Reserve in foreign exchange markets. In theory, the Federal Reserve may conduct open market operations by purchasing or selling any property. In practice, however, most of the assets can not be easily adjusted to its open market operations. In order to make open market operations more efficient, the Federal Reserve System has to be able to buy and sell quickly, at any time. These conditions require that the purchase or sale of instruments are traded on a wide and very active market, and the market of securities within the US Treasury satisfies these conditions. Market Securities US Treasury has the widest and most active of the US financial markets. The transactions are conducted over counters, rather than via organized exchange. Although most trading takes place in New York, over the phone and computer, dealers, brokers and customers get in touch with each other - regardless of their location - so as to form a global market.

Federal Reserve System has a program of lending marketable securities, which is designed to provide secondary and temporary source of securities in the market, in order to promote smooth sales of Government securities. This program includes the securities in the portfolio that are offered to dealers for loans through the process an auction, every day at noon, and there are restrictions on the amount of securities that can be borrowed to a dealer. As collateral, the dealer gives the Federal Reserve other securities rather than cash.

In the period from 2006 to 2015. year, securities trading reached its peak in June 2011, as shown in the previous chart.

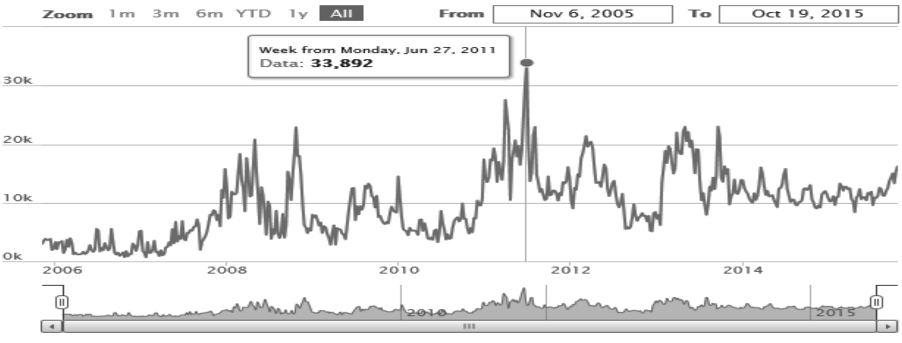

Figure 1. Trading in securities in the period of 2006-2015., in USD million (11)

2.3. DISCOUNT RATE

The Federal Reserve System allows depository institutions the discount loans in the form of primary, secondary and seasonal credit programs. The rates for each of the three credit programs are the same in all Federal Reserve banks, except occasionally for a short time, after the actions of the Board when the change of course is requested.

The primary loan is approved depository institutions in a very short period of time, usually "overnight". To assess whether the depository institutions are in good financial state, the Federal Reserve Bank regularly reviews business within the institutions, using supervisory powers. Depository institutions are not obliged to ask for alternative sources of funds before requesting occasional primary loans, but it is expected that the primary loan is used occasionally, and not as a regular source of financing. The interest rate of the primary loan is usually set 1% above the FOMC target of the federal rate, but the spread may vary depending on the circumstances.

Secondary credit is available to depository institutions that do not qualify for primary credit. This loan is also obtained in a very short period of time. Referring to the less significant financial condition of the secondary loan borrower rate of the secondary loan is usually 50 basis points above the primary loan rate, although it may vary. Secondary credit is available to the depository institution for the purposes of the liquidity reserve and return to the market sources of funding or to solve problems. Secondary credit can not be used to finance the expansion of the debtor's assets. Loans of the secondary credit programs include a higher level of control and supervision of loans than those within the primary credit program.

Seasonal credit program is designed to help small depository institutions to overcome seasonal fluctuations in their loans and deposits. Seasonal credit is available to depository institutions that can demonstrate a clear pattern of repeating fluctuations in funding requirements, usually institutions in agriculture or tourist areas. Borrowing from these loans, depository institutions are enabled to make available more resources for local lending. The interest rate for seasonal loans is based on market interest rates.

All these credit programs have to be insured by marketable securities and the value of the assets is the maximum of the loan amount that can be obtained. The loan is determined by the market value of the property, but depends on how accurately the assets can be valued and how its value tends to vary over time.

Table 2. Interest rates on the primary, secondary and seasonal loans in the period 2005-2015.

	2005.	2006.	2007.	2008.	2009.	2010.	2011.	2012.	2013.	2014.	2015.
Primary credit	5,25	6,00	4,75	1,25	1,25	1,25	1,25	1,25	1,25	1,25	1,25
Secondary credit	5,75	6,50	5,25	1,75	1,75	1,75	1,75	1,75	1,75	1,75	1,75
Seasonal credit	3,10	4,70	5,30	2,70	0,25	0,15	0,15	0,20	0,15	0,15	0,20

Source: https://www.frbdiscountwindow.org/Pages/Discount-Rates/Historical-Discount-Rates.aspx (21.10.2015.)

3. MONETARY POLICY IN THE FUNCTION OF ECONOMIC POLICY

In its functioning, the Federal Reserve System performs in order to achieve the overall objectives of economic and financial policy in the USA. The competences and responsibilities of the Federal Reserve System can be classified into four general areas[4]:

- The implementation of monetary policy, which influences the money and credit conditions in the economy, in order to achieve full employment and price stability,
- Monitoring and the regulation of banks and other financial institutions in order to ensure the safety and stability of the banking and financial system of the country and protect the rights of consumers of banking and financial services,
- Maintaining the stability of the financial system and minimizing the risks that may occur in financial markets,
- Providing financial services to the USA Government and USA financial institutions and foreign official institutions, which plays a major role in the management and supervision of the payment system of the country.

The objectives of the monetary policy are defined in the Federal Reserve Act, which states that the Board of Governors and the Federal Commission for its open market operations should promote full employment, stable prices and moderate long-term interest rates. Stable prices are a prerequisite for long-term sustainable growth in output and employment, as well as moderate long-term interest rates. Although price stability can help to achieve maximum sustainable growth in output and employment in the long term period, in the short term period there may be a contradiction between the goals. Often, the deceleration of employment is in order to reduce pressure on prices. Attempts to restrain inflationary pressures would increase weaknesses in the economy, and attempts to increase employment would increase inflation. In such circumstances, those responsible for monetary policy face a dilemma and have to decide whether to focus on alleviating price pressures or to mitigate the fall in employment. Therefore, the increase in inflation can be incorporated into decisions on prices and wages.

Federal Reserves affect the overall financial conditions by adjusting the speed of establishing the federal funds, that is. over the rate that banks charge for short-term loans. Movement of these rates is transmitted to other interest rates that affect the costs of borrow-

4 http://www.federalreserve.gov/faqs/about_12594.htm (06.10.2015.)

ing loans among companies and households. Furthermore, changes in long-term interest rates affect other asset prices, mostly equity prices and foreign exchange value of the dollar. These changes affect economic activity. For example, when short-term and long-term interest rates are falling, borrowing becomes cheaper, so that households are willing to purchase goods and services, and companies are in a better position to expand their business activites by increasing their assets and equipment. This results in an increase of the total number of employees and increase in production, and in household wealth rising, which furthermore encourages consumption. Monetary policy has an important impact on inflation. When the rate of federal funds is reduced, the demand for goods and services increases, which raises wages, which leads to greater demand for workers and the resources required for production. In addition, political actions can influence the expectations of how the economy would prosper in the future, including the expectations relating to prices and wages, and those expectations may themselves directly influence the current inflation.

In 2008, short-term interest rates were approximately zero and could not have fallen much, so that the Federal Reserve took monetary policy measures so as to provide additional support to the economy. Since the end of the 2008. till October 2014., the FED bought long-term mortgage-backed securities and bills issued by individual companies, as well as long-term government bonds and bills. The main purpose of these purchases is to help to reduce the level of long term interest rates, thereby improving financial conditions[5].

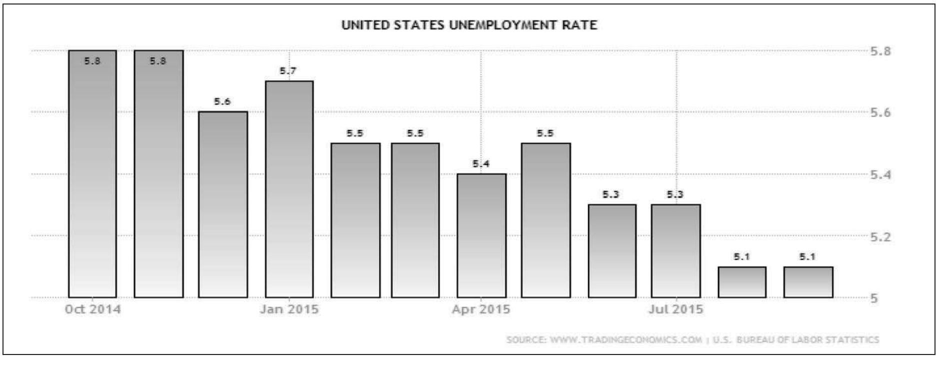

Figure 2. The unemployment rate in the US (9)

The unemployment rate has been decreasing in the past few years , but it`s still high. It decreased to 7.0% in the fourth quarter of 2013. and 6.7% in December, after reaching its peak at almost 10% in the fourth quarter of 2009. To a large extent, the slow recovery of the labor market reflects slow growth in demand for goods and services, and hence GNP. It is estimated that GNP was 7.5% lower than the potential (maximum sustainable) GNP at the end of the recession, and by the end of 2013, less than half of this gap is closed. To a less extent, slow labor market recovery is the result of structural factors arising from the recession and the slow recovery of production. It is projected that the unemployment rate will fall to 5.8% by the end of 2017 and to 5.5% by 2024 (compared to 4.8% at end-2007) and that the employment rate will rise to 60, 8% in 2024 (compared to 66.0% at the end of 2007). In August 2015, prices in the USA increased by 0.2% compared to the same period in the previous year, the same pace as in July, in line with market expectations. On a monthly basis, prices show first

5 http://www.federalreserve.gov/faqs/money_12856.(10.10.2015.)

decline in seven months, down 0.1% due to lower prices of gasoline and fuel. Annual core inflation remained unchanged at 1.8%.

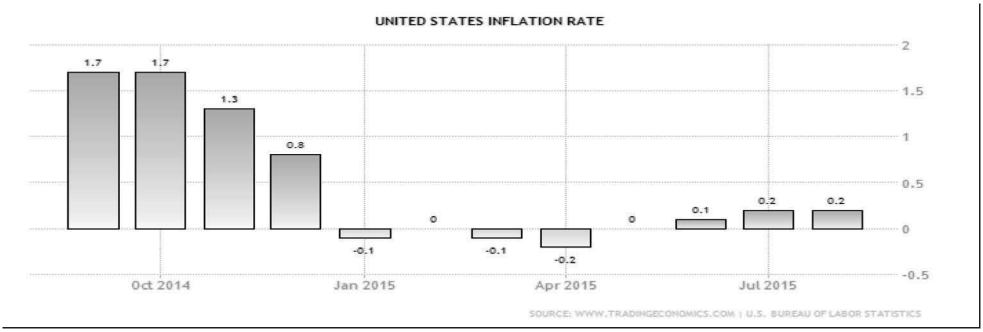

Figure 3. Inflation rate in the US (9)

It is expected that the price index will increase by less than 2.0% annually over the next few years. With such low inflation and considerable surplus labor in the labor market, it is anticipated that the Federal Reserve will keep short-term interest rates (such as those at 3 months with T-bills) at their current low levels until mid-2015, but that the long-term interest rates (such as those on 10-year T-bills) will gradually increase as the economy strengthens.

Table 3. Economic projections for 2015 in the US

Real GDP growth	2,0%
Inflation rate	0,6%
Unemployment rate	5,2%
Interest rate (3-month Treasury bills)	0,1%

Source: www.cbo.gov/topics/economy/outlook-budget-and-economy(05.10.2015.)

Long-term interest rates are currently at a level of 2.17%, and the following chart shows trends in the last five years.

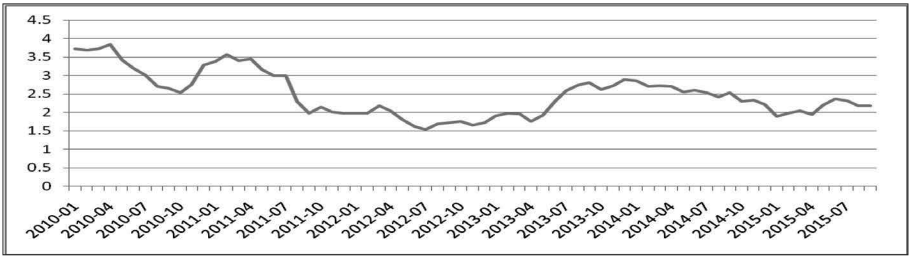

Figure 4. Long-term interest rates in the period 2010-2015. (11)

4.CONCLUSION

Data for 2015 show that the value of the USA economy is 17.419 billion USA dollars, which is 53.040 dollars per capita. The annual rate of GNP growth is 2%, inflation is 0.6% and the unemployment rate is 5.2%. Projections suggest that the United States will conclude 2015. with a budget deficit of 2.7% of GNP and public debt at 73% of GNP.

The Federal Reserve System, which is considered to be one of the most important financial institutions in the world, runs monetary policy via open market operations, the discount rates and reserve requirements. The discount rates and the reserve requirement rates are the responsibility of the Board of Governors of the Federal Reserve, and the Federal Commission on Open Market Operations is responsible for implementing the policy of open market operations.

The competences and responsibilities of the Federal Reserve System include the implementation of monetary policy, thus affecting the money and credit conditions in the economy, in order to achieve full employment and price stability; supervision and regulation of banks and other financial institutions, to ensure the security and stability of the banking and financial system of the country and protect the rights of consumers of banking and financial services; maintaining the stability of the financial system and minimizing the risk that may occur in financial markets, as well as providing financial services to the USA Government, USA financial institutions and foreign official institutions, which means that it plays a major role in the management and supervision of the payment system of the country. The objectives of monetary policy are defined in the Federal Reserve Act, which states that the Board of Governors and the Federal Commission for its open market operations should promote full employment, stable prices and moderate long-term interest rates. Stable prices are a prerequisite for long-term sustainable growth in output and employment, and moderate long-term interest rates. When prices are stable, and it is believed that it will remain so, prices of goods, services, materials and labor are used in efficient allocation of resources and thereby contribute to increasing the living standards. At the same time, stable prices encourage saving and capital formation, because when the risk of decline in value of assets due to inflation is minimal, households are encouraged to save more, and entrepreneurs to invest more.

In the short term, monetary policy affects inflation and demand for goods and services through the impact on the financial conditions in which people live and work. Federal Reserves affect the overall financial conditions over the interest rates on short-term loans. Movement of these rates is transmitted to other interest rates which affects the costs of loans borrowed by companies and households. Changes in short-term interest rates affect the long-term interest rates. Changes in long-term interest rates affect the cost of capital and economic activity. When short-term and long-term interest rates are falling, borrowing becomes cheaper, resulting in increased production and employment, and encouraging consumption.

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