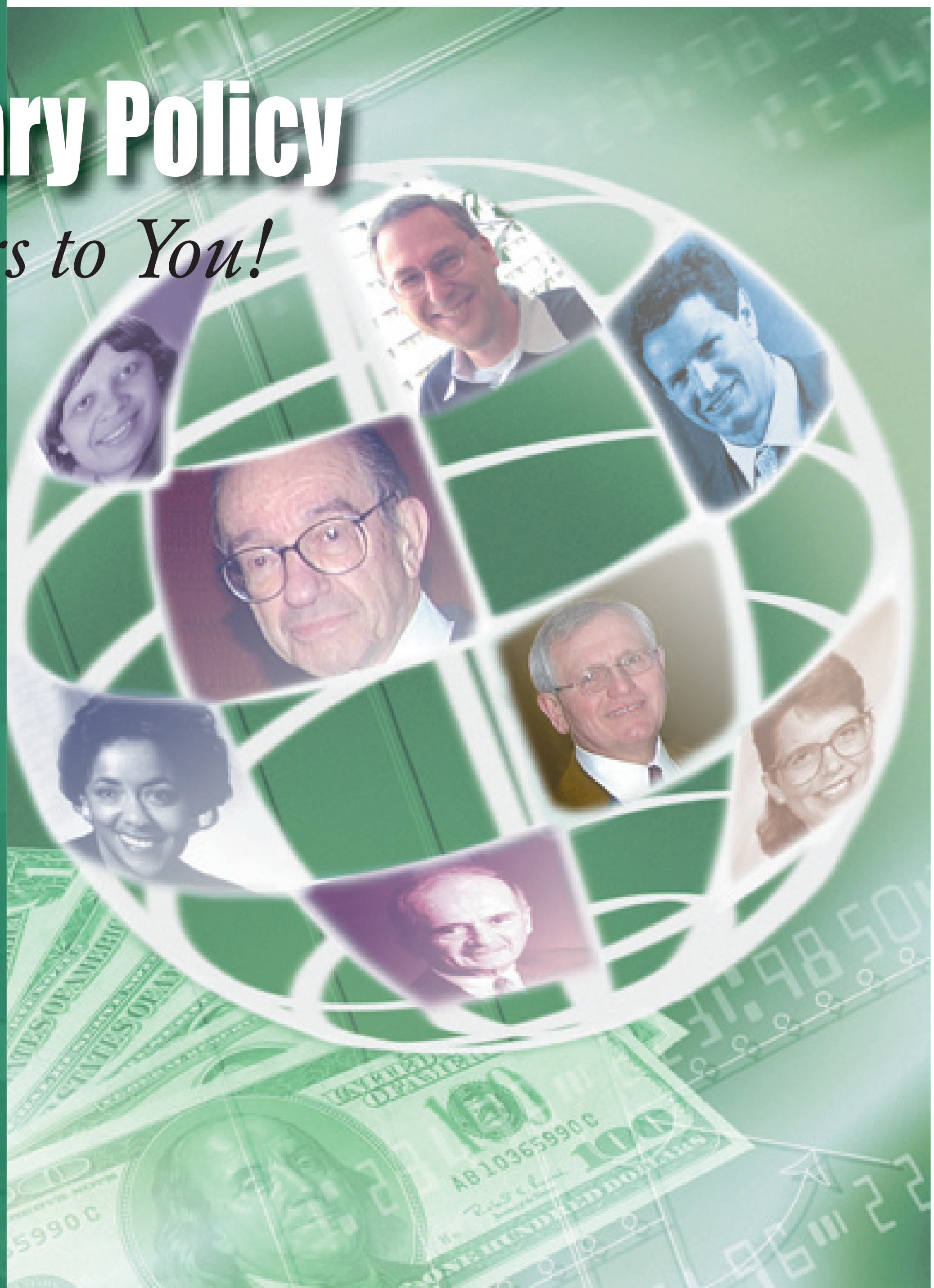
The Federal Reserve Bank of San Francisco

ECON ED & THE FED

Resources and Information for Educators • Spring 2004

Monetary Policy

It Matters to You!



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THE FEDERAL RESERVE BANK OF SAN FRANCISCO

ECON ED & THE FED

SPRING 2004

Econ Ed & the Fed is a semiannual publication of the Federal Reserve Bank of San Francisco. Reaching approximately 10,000 educators throughout the Western U.S., it's provided as part of the Fed's commitment to economic and financial education.

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A Word from the Editor

Sharon Strahm

In this issue, we wanted to take a different approach and continue to make improvements that best respond to your needs. This edition focuses on practical information related to monetary policy because we've heard that high school students continue to have difficulty understanding key concepts even though monetary policy is part of the national voluntary economics standards. The articles and topics that follow all share a common goal: to illustrate why this topic relates to you–both as a teacher and as a consumer. In doing so, we hope that you are better able to relate monetary policy at the Fed to your students' lives.

Tom Waldman

We also want to welcome a new articles editor of this newsletter. Tom Waldman, who works in our Los Angeles office, is joining our educational team and brings his journalism background to help enhance this newsletter. We hope you enjoy this issue and will write to either of us if you have ideas for stories.

Best,

Sharon

Monetary Policy: It Matters to You!

By Shayna Olesiuk

Monetary policy…it's part of the national voluntary economics standards and is incorporated in several states' social studies standards…but we hear that high school students continue to have difficulty understanding key monetary policy concepts. To meet this need, we have summarized some of the ideas presented in the new San Francisco Fed lobby exhibit to offer suggestions on ways you can link monetary policy to teenagers' daily lives.

What's Worth Over $10 Trillion?

Can your students find something that's worth over $10 trillion? You can turn a question like this into the start of a lesson by sharing with students that over $10 trillion worth of goods and services are produced in the United States in every year. You can also let them know that we all participate in the economy by the purchases we make each day–a candy bar, a movie ticket, a new family car, or a house. It's the job of the Federal Reserve, through monetary policy, to stabilize the growth of the multi-trillion dollar economy. Fed economists monitor the health of the economy by tracking developments in financial markets and the banking industry and by observing trends in interest rates, wages, prices, jobs, and output.

Interest Rates…The Price of Money

Interest rates may not seem as complicated if students think of the interest rate as the price of borrowing money. Furthermore, the public's response to interest rates is similar to their response to other prices; when interest rates are low, people will be more willing to borrow and spend money, but when interest rates are high, people will be less willing to borrow and spend money.

The Fed targets a specific interest rate, called the fed funds rate, when it uses monetary policy to influence the health of the economy. The fed funds rate is the interest rate that banks charge each other for an overnight loan. Each business day, individual banks make billions of dollars of loans in the federal funds market to other banks that need to fund loans and meet their reserve requirement. Remember, the reserve requirement is the amount of vault cash and deposits with the Federal Reserve that a bank must set aside and not use to make additional loans.

How does the federal funds rate affect you? Well, changes in the interest rate on federal funds often influence the interest rates on longer term loans including auto loans and even home mortgage loans.

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A Day in the Life of Alan Greenspan

Did you know that The Fed Today ***lesson plans contain an FOMC simulation that you can do in a high school classroom? Students analyze an economic scenario and learn about monetary policy decisions. To access this simulation, see Lesson Four (Part 2) of*** The Fed Today ***which is available online at: www.phil.frb.org/education/ftlesson.html.***

If you want to extend this lesson beyond simulations and have your students analyze real-time economic data and determine monetary policy decisions based on current conditions in the national economy, you may want to try the lesson plan from the New York Fed that's available at: www.newyorkfed.org/education/fomcsim.html.

For further information on reserve requirements: www.frbsf.org/publications/federalreserve/monetary.

While none of us can see the future, the Fed tries to keep inflation low and stable so that prices tomorrow are similar to prices today.

What's a Paycheck Worth?

How many of your students have jobs? Have you ever asked students why they work? For students and adults alike, one of the most common answers to this question is that they work to get a paycheck. But we may take for granted that our salary buys about the same amount of goods and services from month to month. Ask your students if they expect their paycheck to buy a similar amount of goods and services each month. This is where the Fed's role in price stability comes into play. While none of us can see the future, the Fed tries to keep inflation low and stable so that prices tomorrow are similar to prices today. With inflation in check, it is easier and less risky for everyone to plan purchasing decisions. $

Take Some of the Mystery out of Monetary Policy

Are you looking for some solid, straightforward answers when your students ask you about the Federal Reserve and monetary policy? You've come to the right place–we have a great resource for you.

U.S. Monetary Policy: An Introduction presents a series of questions and answers about the goals, tools, and impact of monetary policy. Here are some highlights:

- What are the goals of U.S. monetary policy?
- Why don't the goals include helping a region of the country that's in recession?
- What about preventing stock market "bubbles"?
- What are open market operations?
- What are real interest rates and why do they matter?
- How does monetary policy affect the economy and inflation?
- How does the Fed decide where to set the federal funds rate?

You can access the updated and revised
U.S. Monetary Policy: An Introduction
online at:
www.frbsf.org/publications/federalreserve/monetary.

A View from Inside the FOMC:

Q&A with President Robert Parry

Robert Parry

We recently talked with Robert T. Parry, who retires June 1 after 18 years of distinguished public service as President and CEO of the Federal Reserve Bank of San Francisco. These have been pivotal years for the Fed and its monetary policymaking body, the Federal Open Market Committee–or FOMC. It has dealt with recessions, booms, bubbles, stock market crashes, currency crises, and the Russian debt default, just to name a few dramatic events. And arguably its most notable achievement is successfully bringing inflation within range of its announced goal of price stability. Come meet one of the architects of this success and learn what happens when monetary policymakers deliberate about how to set short-term interest rates to help the economy function at its optimum.

Q. ***What is it like to represent the nine states in the 12th District at FOMC meetings?***

A. The 12th District is very large. I like to say we're 20 percent of about everything, including population and economic significance. The category where it's much larger is geography. I see it as my responsibility to communicate to my colleagues what's happening in our District.

That's extremely difficult because it's so diverse. For example, not every part of the District is dependent on the same types of industries. Not every part of the District performs at the same level, so at times you can't really generalize about the District. Right now, it's even difficult to characterize California, because of the difference of the performance between Northern California and Southern California. Southern California is doing quite well, and Northern California and the Central Valley are doing less well. That dichotomy isn't new; in 1990-91, Southern California was getting hit quite hard, and we up here were doing pretty well.

In addition to providing my colleagues a picture of this very important District, I try to put it into a national context. At times that might not be the same as what's happening with the economy of this District, although, given the size, there's probably a closer correlation between our District and the national economy than is the case with most other Districts.

"In addition to providing my colleagues a picture of this very important District, I try to put it into a national context."

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Q&A with President Robert Parry (continued)

Q. ***What are FOMC meetings like under Chairman Alan Greenspan?***

A. We (the members of the FOMC) go into the meetings with the benefit of a lot of briefings from our Research staffs. We all feel we're pretty well up-to-date in terms of what we think is going to happen with the economy. And I think we all have a view as to what the appropriate policy should be.

The FOMC deliberates around the famous table at the Board Room in Washington, D.C.

The first part of the meeting consists of a briefing on the financial markets by the executive vice president of the New York Fed, who is in charge of the Open Market Desk in New York. Then we get a briefing from staff economists at the Board of Governors on the domestic and international outlooks. Following each of these presentations, we have an opportunity to ask questions. After that, we do what's called the "go-around." The 12 Reserve Bank presidents each talk about developments in their Districts and give their views on what they believe the likely course of the economy will be; the Governors also each speak about national economic issues and their outlooks.

We then take a coffee break, and when we come back, Board staff gives us a presentation on potential options for monetary policy. Again, we have an opportunity to comment and ask questions.

Up to this point, the Chairman usually doesn't speak–other than having asked questions or made comments. This is when he'll talk about economic issues and financial issues as he sees them, and he'll conclude his remarks with a view–often fairly specific–about what he thinks is the appropriate policy.

Next, there will be a discussion; sometimes people will disagree with the recommendation. As a matter of fact, at the June meeting last year, I expressed the view that we should reduce rates more than the group concluded was appropriate. There was an 11-1 vote. I felt we should reduce the federal funds rate by ½ percent, and the other 11 members thought we should reduce it ¼ percent.

Q. ***How is consensus achieved?***

A. Consensus is a combination of all the members doing their homework, all the members expressing their views and having others hear their views, and then obviously hearing the Chairman express his views. We each have one vote, but it's obvious the Chairman's views are listened to very closely.

The fact that there is strong consensus is useful. It gives an indication that these participants see the situation in pretty much the same way. Still, I think a dissent at times also is useful.

"The fact that there is strong consensus is useful. It gives an indication that these participants see the situation in pretty much the same way. Still, I think a dissent at times also is useful."

Q. ***How did the Fed contribute to the economic boom of the 1990s?***

A. I never claim to be impartial in my assessment, but I do think the Fed played an important role. There were other factors, of course; toward the end of the decade the economy moved toward budget surpluses, which was helpful. I want to give credit to others as well.

But there is an aspect of it that is Fed-related. One of the things we saw in the second half of the decade was that the economy seemed to be experiencing a pickup in the growth rate of productivity.

The fact that the Fed–and I give primary credit to the Chairman on this–was able to recognize that was extremely important to how the Fed acted in the last half of that decade.

Sharon Strahm interviews Bob Parry.

When I studied economics in graduate school, people generally agreed that the U.S. economy could grow at about 2-2 ½ percent on a sustainable basis–that is, without generating inflationary pressures. If it grew year after year at a rate faster than that, you *would* see inflationary pressures.

In the 1970s and 1980s, if the economy started to grow too fast relative to that standard, the Fed would put on the brakes. However, in the 1990s, we didn't do that, and we took a little bit of a gamble. We gradually reached the conclusion that productivity was rising so rapidly that the potential growth rate of the economy had accelerated. That meant you could allow the economy to grow faster without risking the buildup of inflationary pressures.

I think that's very significant. What it means to me is that if we had not been correctly observant, we would have run the risk of really aborting that expansion.

There are some people who'll give you a different view of that period. They'll say the Fed let things get out of hand, that there was a bubble in the stock market. Perhaps there was–I'm not going to disagree with that. But when you look at the economy in general–the growth of incomes, the growth of living standards–I think we made the right decision. It enabled the economy to grow at a really historically high rate through most of the 1990s, particularly the second half.

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Q&A with President Robert Parry (continued)

> *"It seems to me that even in our society today there isn't a great understanding of either the Federal Reserve or the FOMC."*

Q. *Is there anything else you'd like to point out to teachers or students about the FOMC?*

A. The Federal Reserve–and let me stress the FOMC's role, in particular–is an institution that has a profound impact on almost everyone's life, and certainly on their economic lives. It seems to me that even in our society today there isn't a great understanding of either the Federal Reserve or the FOMC. I'm not 100 percent sure it's necessary for people to understand much about the technical parts of what the FOMC does. But at times I'm surprised by the fact that even people in the financial services industry are not really all that knowledgeable about the Federal Reserve and the Federal Open Market Committee.

Members of the FOMC at the Federal Reserve building in Washington, D.C. Federal Reserve Vice Chairman Roger Ferguson is pictured to the left of Chairman Greenspan. Bob Parry is behind Ferguson.

Q. *How do you think history will view the Greenspan era?*

A. The final chapter hasn't been written yet, because I assume Chairman Greenspan will be around for a few more years. But based upon what I know now, and what I think is likely to occur, I think he'll go down as the most effective Chairman in the history of the Federal Reserve. I know that's saying a great deal, because you have others such as Paul Volcker, William McChesney Martin, and Marriner Eccles who occupy major chapters in our financial history. $

Stability in Uncertain Times:

A New Video and Lesson Plan from the Fed

In times of financial uncertainty, what role do you think the Federal Reserve would play?

A new 15-minute video *Stability in Uncertain Times: The Federal Reserve Responds* explains how the Fed stepped in to help stabilize our country's economy after September 11, 2001. It explores what the Fed did to ensure that cash was available to consumers who wanted it and checks were processed even though no planes were allowed to fly. It also looks at how the Fed worked with commercial banks that wanted to borrow from the Fed's discount window and explains the monetary policy decisions that were made in order to meet financial institutions' needs for liquidity.

When it's available, you can visit www. frbsf.org/education to order the video and download the lesson plan.

Students can watch this video about what happened "behind the scenes" and why. Then you can use the lesson plan to lead them through an interactive game of "Fed Squares," a tic-tac-toe-style game that reviews key points from the video. The video and lesson plan meet the voluntary national content standards in economics, and they are scheduled to be released in the summer. $

Announcements

Lorraine Thayer, FRB Portland, at an econ ed event.

Calendar Listing of Events Goes Online

To save space and make it easier for you to locate relevant information, we've moved our listing of educational materials, workshops, and conferences to our website at: www.frbsf.org/education/workshops.

Fed Workshops Go on the Road in 2004

A team of Fed education specialists will travel to several cities in the Western states to facilitate economic education workshops in 2004. These events will be conducted in collaboration with school districts, state councils on economic education, and universities.

Topics focus on detecting counterfeit currency, an in-depth review of the Fed's history and structure, and creative ideas for teaching monetary policy. For information, contact Lupe Jaramillo at: lupe.jaramillo@sf.frb.org. Or visit our website at: www.frbsf.org/education/workshops.

Gear up for the 2004 Economics Challenge

Teams of high school students from the West will compete in Scottsdale on April 26 for the title of "Western Regional Champions" as part of the NCEE/Goldman Sachs Foundation National Economics Challenge. The Challenge is a college-bowl competition that tests students' knowledge of complex economic concepts. Winners of the Regional Finals earn U.S. Savings Bonds, medals, and a trip to New York to compete in the National Championship Round on May 22-24.

Check out www.ncee.net or contact your state Council on Economics. $

Making Sense of the FOMC

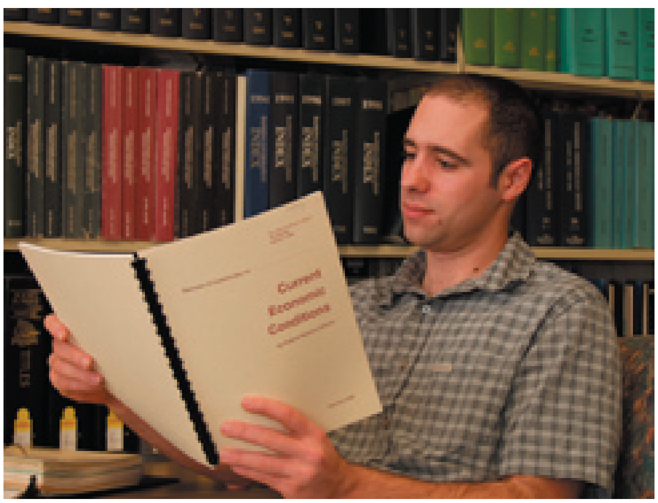
By Shayna Olesiuk

January 30, 2004

Have you ever wondered what really goes on during a Federal Open Market Committee (FOMC) meeting? What information and data leads to the FOMC's decision to change the federal funds target rate or hold it steady? Many students and educators believe that the FOMC has some sort of crystal ball that simply takes in all available economic data at the time of the meeting and then gives Fed policymakers the appropriate level of interest rates. But, the process is actually much more involved, and *much more interesting!*

Q. *How is economic data used to determine a target for interest rates?*

A. It's true that Fed economists use lots of economic data; however, even the most up-to-date economic data on variables such as employment, growth, and productivity, reflect information about past conditions. At best, these data reflect conditions from a few weeks in the past, although the lag could be as much as six months to one year. Plus, information is revised and refined as more detail is available. In other words, using strictly economic data to make monetary policy decisions is like driving down the road but only looking in the rearview mirror. Even though history can be a very good predictor of events, FOMC members also consider other forward-looking information in their decision-making process.



One way to project future economic conditions is with economic models and Fed economists have developed several. Economic data are plugged into these models; then, the results are analyzed and used to make monetary policy decisions at FOMC meetings. Such models also help economists evaluate projections of future economic activity and evaluate alternative scenarios. However, data and economic models are only part of the story; the Beige Book also provides key information.

Q. *How does the Beige Book fit into the FOMC process?*

A. The Beige Book is a report that's quite important to the FOMC decision-making process, and yes, the cover of the paper version is indeed beige. It's published eight times per year and contains anecdotal information about the state of the economy in each of the 12 Federal Reserve Districts. The Beige Book also contains an assessment of national economic conditions and a summary of conditions by sector.

Economic Research Departments across the Federal Reserve System gather input from hundreds of people in their respective regions. The process begins several weeks before every scheduled FOMC meeting. Each Federal Reserve Bank surveys business contacts, economists, and market experts and asks questions about economic conditions in particular geographic areas and industry sectors. Survey responses are then combined into a report that serves as an up-to-date supplement to historical economic data and projections from economic models.

The Beige Book is a report that's quite important to the FOMC decision-making process, and yes, the cover of the paper version is indeed beige.

Q. *How do the boards of directors contribute to monetary policy decisions?*

A. In addition to publicly available economic data and information from the Beige Book surveys, the Fed gathers important independent input from its members of the various Districts' Boards of Directors. In the 12th District, Boards of Directors at the San Francisco head office and at the Los Angeles, Salt Lake City, Portland, and Seattle Branches provide insights into consumer and business outlooks and anticipate changing trends in the economy. Branch Boards meet monthly for meetings at which directors offer commentary about developments in key industries and geographies and comment on whether current monetary policy is appropriate.

"There's a lot of reading and listening involved," said Mary Pugh, a member of the Board of Directors from the Seattle Branch. "Historically, if someone told me that a particular business was closing down I might reply, 'That's too bad.' Now, I ask why it's closing, who's impacted, and is this an industry trend. As a director, you become more of an investigative recipient and follow up on information."

The Fed's Board of Directors offer independent commentary about developments in key industries and geographic areas.

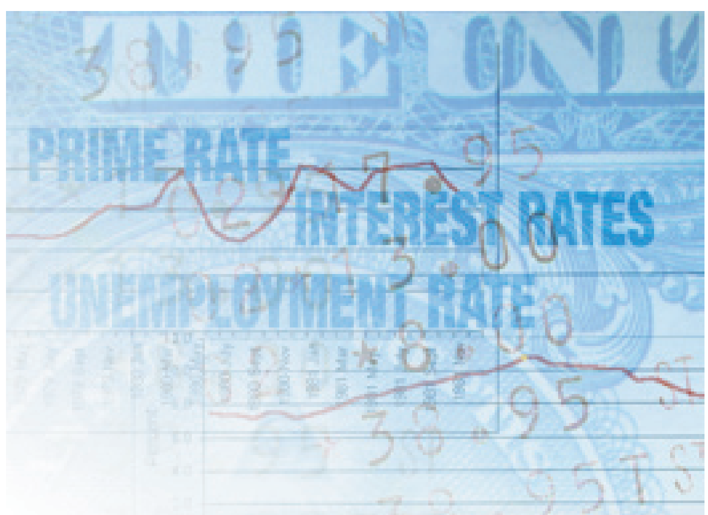
"As a director you become more of an investigative recipient and follow up on information."

Mary Pugh
Member,
Seattle Branch
Board of Directors

Q. *What is the role of Advisory Councils in the monetary policy process?*

A. Each Reserve Bank also has advisory councils, whose members are typically drawn from banking, business, and agricultural sectors of the economy. Before FOMC meetings, members of these councils typically meet with their District's Bank president to discuss important information about local businesses and the economy. These meetings provide Reserve Banks with additional detailed grassroots information that further refines the collective understanding of the District- and national-level economic conditions that influence business, agriculture, and banks. In turn, knowledge about these sectors contributes to monetary policy decisions.

Q. *So, with so much local and regional input to monetary policy, is there a movement toward having monetary policy stimulate specific geographic areas of the country?*



A. No. While there's significant regional input and information that flows to Reserve Bank Presidents during the monetary policy process, monetary policy decisions are made at a national level. There are two main reasons for this. First, monetary policy decisions are implemented through open market operations and the credit markets which are national in scope. The Fed simply can't direct open market operations to affect only a portion of the country. Second, if the Fed did attempt to stimulate certain states or regions that encountered hard economic times, it could be in a position to do this much of the time which might result in over-stimulation for the nation as a whole and perhaps even inflation. The fact that monetary policy is implemented nationally, however, doesn't discount the need for up-to-date comprehensive information provided by the Beige Book, boards of directors, and advisory councils. $

FED CENTER

Grand Opening of the San Francisco Fed Lobby

Would you like your students to…

- ✔ Learn about the Federal Reserve System?
- ✔ Understand how the Fed influences and participates in our nation's financial system?
- ✔ Discover how the Fed's actions affect their financial lives?

Then visit the Federal Reserve Bank of San Francisco's new lobby exhibit:

Fed Center: Exploring Our Nation's Central Bank. Students will tour a historic currency collection and learn about the major areas of responsibility of the Fed. This includes an understanding of the Fed's role in financial services, banking supervision, crisis management, and more.

The **Fed Center** offers 90-minute tours Monday through Thursday at 9:30 a.m. and 1:30 p.m.
Tours are available to anyone of high school age or older.
Tour groups include a minimum of 10 and a maximum of 30 guests.

For more information, call 415-974-3252, or visit **www.frbsf.org** and click on **tours.**

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