Money, interest, and monetary policy

Rush

February 2015

Objectives

- Students describe how changes in the money supply can affect the average level of prices.
- Students explain how the Fed uses the major tools of monetary policy to regulate the economy’s money supply.
- Students explain the chain of events that occur in the economy when the Fed engages in a specific monetary policy.

Question for you

- Show of hands: How many of you would be better off with more money?
- This may be true for EACH of you, but it may not be true for EVERYONE. We are going to conduct a simulation to determine if everyone is better off if everyone receives more money. I will hold three auctions for three identical bags of snacks.

Free money for you

- Each student will get five popcorn puffs.
- Each popcorn puff is worth 10 cents.
- What is our classroom money supply? (Write it on the board.)
- Auction No. 1 ... (Write price paid on the board.)

More money for you!

- Five more popcorn puffs for each student.
- What is our classroom money supply?
  (Write it
  on the board.)
- Auction No. 2 ...
  (Write price paid
  on the board.)

And yet more money for you!

- Each student will get five beans.
- Each bean is worth $1.
- What is our classroom money supply? (Write it on the board.)
- Auction No. 3 ... (Write price paid on the board.)

What's going on?

- The classroom money supply increased while the amount of goods available to be consumed in each period remained constant, driving up the price of candy.
- Was everyone better off with more money?
- What term describes this situation?

Inflation

- Inflation is an increase in the average price of goods and services in the economy.
- During the second and third auctions, you witnessed the fundamental long-run source of inflation in an economy – the supply of money growing faster than the supply of goods and services available for purchase. Or, too much money chasing too few goods.

Discuss with neighbor

- What happened to the price of the item between the first and third auctions?
- What happened to the amount of “money” in classroom between first and third auctions?
- What gave the popcorn and beans value?
- When students had more money to spend, what happened in the successive auctions?

Discuss with neighbor

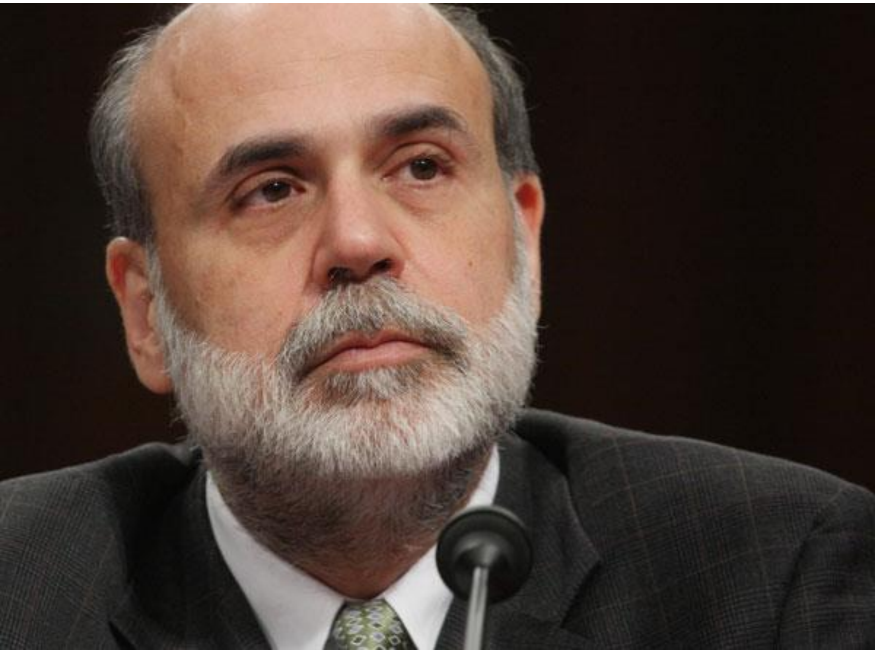
- What do you think would happen in the third auction if you knew 100 more items would be sold in subsequent auctions?
- Under what conditions is increasing the supply of money inflationary?
- Under what conditions is increasing the supply of money not inflationary?

The money supply in summary

- When the money supply increases, it is important that it grow at an appropriate rate – not too fast, not too slow.
- Next we will have an activity to show how the Federal Reserve System (the Fed) can determine, at least to a large extent, how fast or how slowly the U.S. money supply grows.

The Fed

- The Fed is responsible for regulating the U.S. money supply. It influences interest rates, which are the price of loanable funds.



Three groups of students

- Group 1 each gets $10,000 Treasury bonds (meaning you have lent $10,000 to the U.S. Treasury, and the government will repay you, with interest, at a certain time).
- Group 2 each gets $10,000 in currency.
- Group 3 each gets $10,000 in checking.
- Question: Who can buy something at a store?

Money supply?

- All students with money – meaning cash or checks – raise your hands.
  (Write the money supply on the board.)

Change in money supply?

- Four students with bonds, assume you want to buy something, so you must get money by selling your bonds.
- Four students with money (cash or checks), assume you now want to buy bonds in order to earn interest.
- Exchange the bonds and money.
- Has the money supply changed?

Change in money supply?

- Four more students with bonds, assume you want to get money by selling your bonds.
- I am going to act as the Fed for the rest of the activity, and I have decided to buy these four bonds.
- The Fed buys bonds when it engages in EXPANSIONARY monetary policy.

Change in money supply?

- What has happened now to the amount of money in the classroom?
- Where did the money come from?
- Where did the Federal Reserve get the money?
- When the Fed buys bonds, it engages in expansionary monetary policy. Why is it called expansionary?

Now let’s reverse it

- The Fed will sell bonds to four students in exchange for money (cash or checks).
- When the Fed sells bonds, what happens to the money supply?

Open market operations

- When the Fed buys or sells government bonds, this is called open-market operations.
- This is the most important tool used by the Fed to regulate the money supply. Open-market operations are used on a week-to-week basis to make both large and small adjustments to the nation's money supply.

Closure

- If the money supply is growing faster than the production of goods and services in our economy, what will be the result?
- What is inflation?
- What is the primary role of the Fed?
- What are open market operations of the Fed?

Closure

- If the Fed sells government bonds, what type of monetary policy is it pursuing?
- If the Fed buys government bonds, what type of monetary policy is it pursuing?

Closure

- Describe the chain of events in the economy when the Fed engages in an expansionary monetary policy using open-market operations.
- The Fed purchases government bonds, the money supply increases, interest rates fall, people and businesses borrow and spend more money, the production of goods and services (real GDP) increases.

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We the Economy!

- That Film About Money
- https://www.youtube.com/watch?v=pfXlA_zTfxY&list=PLHJwMKzESQAJkbqYBEJGl8nsKGRqbtsHQ
- The Second Part of That Film About Money
- https://www.youtube.com/watch?v=cGJTE4V6e_k
- Fed Head
- https://www.youtube.com/watch?v=BwZzZdaKMDQ