Discount Rate

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover the discount rate, which is one of the tools the Fed uses to manage our nation's money supply.

Our discussion breaks down as follows:

1. FOMC
2. Fractional Reserve System
3. Reserve Requirement
4. Discount Rate
5. Expansionary vs. Contractionary Money Policy

1. FOMC

The FOMC is our Federal Open Market Committee. It is the part of the Fed that meets eight times a year to manage our nation's money supply.

They have various tools to control our money supply:

- The reserve requirement (amount of money banks must keep on hand)
- Open market operations (buying and selling of U.S. treasuries)
- Fed funds market
- Discount rate

Today's tutorial will focus on the discount rate.

2. Fractional Reserve System

We know that the U.S. has a fractional reserve system, because of how banks make money. If banks simply stored money, they would not profit at all.

When we deposit money into a checking account in a bank, we are entitled to demand that money at any time. We can write a check on it or swipe our debit card on it. For this reason, checking accounts are sometimes called demand deposits.

However, banks make money by lending out at least a portion of customer deposits and charging interest on these loans. This fractional reserve system allows for the creation of money in our economy, and it works well most the time.

However, if banks lend out too much money or if many people show up demanding the cash in their accounts, then the bank cannot meet these demands.

This used to happen a lot before the Fed was created, and banks would fail or go bankrupt, which was not good for our overall economy.

When people heard of banks failing or going bankrupt, bank runs and panics were common--a panic situation occurring when a lot of people would run to the banks and demand their money en masse. This happened anytime people lost their confidence that banks would have enough money to meet their demands.

Because this became such a major problem, the Fed now regulates how much of these reserves the banks must hold in their vaults or at the regional Fed bank.

3. Reserve Requirement

The Fed regulates bank reserves by setting a reserve requirement, usually expressed as a percentage (e.g., 10%).

If a bank cannot meet their reserve requirement for the day for some reason, that bank is not permitted to close until it has been met.

Therefore, sometimes they find themselves in a situation where they need to borrow money overnight. They have two options:

1. Borrow from another (Fed member) bank
2. Borrow from the Fed (usually a last resort)

In the first option, banks borrow from another Fed member bank that has excess reserves, paying the fed funds rate. In this tutorial, however, we will discuss the second option, which is when banks actually borrow money from the Fed itself.

4. Discount Rate

Now, when banks borrow money from the Fed itself, they pay the **discount rate**, also known as the **window rate**. This is the rate that the Fed charges member banks for short-term loans to meet temporary liquidity needs.

So the idea here is that the greater the supply of funds that banks can loan out, the greater the ability to increase our money supply.

If banks can loan out money, that gets money circulating in the economy and into the hands of consumers. Consumers can then go out and buy things and take out loans to build a house, buy a car, etc. This is how our money supply can increase.

Now, if the Fed wants to increase the amount of loanable funds and the money supply, to pick the economy up and get it moving, they can lower this discount rate.

If, instead, they want to decrease or contract the money supply and encourage money to stay in the banks, they can raise the discount rate.

TERM TO KNOW

Discount (Window) Rate
The rate the Fed charges member banks for short-term loans to meet temporary liquidity needs

5. Expansionary vs. Contractionary Money Policy

The idea with expansionary or easy money policy is that lowering the discount rate means that banks can borrow from the Fed at lower rates.

In turn, this makes it easier for them to loan us money. If banks are getting money at lower rates, then that will end up lowering the rates that we pay--and if we get lower rates, then we are encouraged to take out more loans.

When it is easier for us to get loans, this has an expansionary effect on the economy.

On the other hand, if the Fed wanted to tighten things up, tight money policy serves to contract the money supply and to encourage money to stay in the banking system versus out in people's hands in circulation.

Therefore, raising the discount rate means that banks have to pay higher rates to borrow from the Fed.

If banks are paying higher rates, this, in turn, makes it more difficult for them to loan us money.

When it is harder or more expensive for us to get loans, this has a contractionary effect on the economy. As rates go up, we do not want to take money out of the banks as much, because for one, our money is earning more interest in the banks, and two, we do not want to pay higher rates to take out loans to buy a home or car.

BIG IDEA

To expand the economy, the Fed can lower the discount rate, which is expansionary policy. To contract the economy, the Fed can raise this discount rate, which is known as a contractionary policy.

SUMMARY

In today's lesson, we reviewed the role of the Federal Open Market Committee, or **FOMC**, which is the organization in our country who manages and makes decisions about the supply of money. We also reviewed how banks make money by lending out a portion of customer deposits and charging interest, known as a **fractional reserve system**.

We learned about how the Fed has several tools that they can use to manage our nation's money supply, and that the **discount rate** is one of these tools. It involves the rate that banks pay to borrow from the Fed, as a last resort to meet their **reserve requirement** overnight or short-term. To expand the economy, the Fed can lower this discount rate, known as **expansionary money policy**, and to contract the economy, the Fed can raise this discount rate, which is **contractionary money policy**.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

Discount (Window) Rate
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