How the U.S. government moves the economy

Steven Podnos *10:10 a.m. EST December 28, 2015*

It is impossible to pick up a newspaper or listen to the news without hearing about the Federal Reserve. There is indeed an intense focus on what the Fed will do to interest rates. Maybe you wonder what they are talking about here?

The Federal Reserve is a quasi-governmental group of banks that to a great degree control short term interest rates. By various methods, it can increase the supply of funds to our large banks. If the Fed wants to stimulate the economy, it floods the banks with money at a very low interest rate (exactly what it has been doing for the last six years). The purpose of this “monetary” policy is to make funds available cheaply for individuals and businesses. The intent is to have the “users” of the cheap money stimulate the economy by buying things. With more demand for things, there are higher prices and more jobs.

Conversely, a “tight” monetary policy would have the Fed pull cash from the banks, making it more expensive to borrow. Short term interest rates would rise at the same time.

Traditionally, the Federal Reserve monetary policy does not directly influence long term interest rates. A tight monetary policy (high short term rates and a decreased supply of short term loans) tends to cool the economy and decrease long term rates eventually, but the effect is indirect. However following the great recession of 2008, the Fed directly entered the long term markets also with “quantitative easing”, in which it purchased long term bonds, pushing up their prices and thereby lowering long term interest rates. Although the US central bank has stopped this now, both the European and Japanese central banks continue to manipulate both their short term and long term interest rates (downwards).

The other way that the government can influence the economy is through “fiscal policy”. Fiscal policy is the combination of how taxes and government spending (and borrowing) influences the markets and interest rates. Imagine if taxes dropped suddenly by 80%! We’d all have a lot more money to spend and would probably start doing so. Demand for products and services would go up, and prices would follow. If the economy began to overheat (inflation and/or interest rates that began to stifle borrowing), taxes could be raised to cool it off. Alternatively, the Fed could come in with its monetary policy and raise short term rates. The Government can also use fiscal policy by spending. Remember the trillion dollar “stimulus” of 2009? It was an attempt by the government to use predominantly borrowed money to stimulate the economy out of the recession.

Although there is a great deal of argument about how effective both fiscal and monetary policies are (especially when they are not coordinated), you can now understand at least what the government is trying to do.

Steven Podnos MD CFP is a fee-only planner in Brevard County. He can be reached at wealthcarellc.com or Steven@wealthcarellc.com.

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