Macroeconomic Impact on Business Operations

Trent Rhodes

Executive Summary

Employment, stability of prices, economic growth: these are the focuses of officials and legislators who take part in the decision-making processes to create policy. At every level of society, policy dictates the norms and goals to strive for. The ultimate aim of the citizen in one's country is to become as productive as possible for the pursuit of one's happiness. With the Employment Act of 1946, the Federal government is committed to "take action through monetary and fiscal policy in order to maintain economic stability" (McConnell-Brue, 2004, p.214). After World War II, this reorganization of the country opened a macroeconomic perspective not only to business and industry, but of the social realm. Each of these factors play a pivotal role and are unable to be examined under silos. The factors influencing monetary policy work in relationships that collectively influence the methodology of policy.

In order to understand how monetary policy affects factors including gross domestic product, inflation and the rate of unemployment, one must understand the creation of money and how the medium is used in transactions. Originally, goldsmiths served as the official "bankers" who held onto accumulated gold. According to McConnell and Brue, goldsmiths used "a 100 percent reserve system; they backed their circulating paper money receipts fully with the gold that they held 'in reserve' in their vaults" (McConnell-Brue, 2004, p.253). The trust level depositors had for goldsmiths prompted the lowered frequency of gold recalls. Depositors rarely withdrew their gold, and this activity allowed goldsmiths to hold larger amounts of gold in their vaults. Rather than withdraw excessively large amounts of gold, goldsmiths began issuing paper representatives. These papers represented the amount of gold a particular depositor held. The 100 percent reserve system ensured each paper representative was created for a specific amount of gold.

The creation of money began with the establishment of loans. Attached with interest rates, or the money paid to borrow money (McConnell-Brue, 2004, p.545), goldsmiths were able to lend unrealized reserves to borrowers with the expectation that the paper representatives would be repaid, with interest. The interest served as profit, allowing the bank to utilize more funds and expand its practices to lend further.

In order to spark chance and influence monetary policy, the Federal Reserve utilizes a series of tools to enforce control over monetary direction. Open-market operations, the activity of selling and buying bonds from the government, or the selling of government bonds to the public and commercial banks are transactions that influence monetary policy (McConnell-Brue, 2004, p. 270). Considered the most important means for monetary control, the Federal Government has the option to purchase forms of securities from the public and banks. Should a bank elect to sell its securities to the Federal Reserve, ownership of those securities are transferred to the Fed. The exchange benefits the bank, resulting in an increase of monetary reserves which can be used to expand business and deeper lending. In the assets equation, securities are considered the assets, as the commercial bank reserves balance the sheet being liabilities and net worth.

An additional benefit, McConnell and Brue express the advantages of selling securities to the public, “the purchases of securities from the public increases the lending ability of the commercial banking system” (McConnell-Brue, 2004, p. 271).

In cases where commercial banks become too prudent to lend, the Federal Reserve Bank can toggle the reserve ratio to influence activity. As McConnell and Brue state, “raising the reserve ratio forces banks to reduce the amount of checkable deposits they create through lending” (McConnell-Brue, 2004, p. 274). This ratio influences the amount of money a bank can hold deemed “reserve.” The excess funds, depending on the raising or lowering of the reserve ratio can be utilized for lending purposes of a single bank. By lowering the reserve ratio, the percentage of funds held by banks considered reserves also lowers, thus opening the additional money for lending.

The discount rate serves as another means of controlling monetary policy. Central banks in this position are considered to be a “lender of last resort” (McConnell-Brue, 2004, p.274). Because commercial banks at some point in time may require additional funds with expediency, they have the opportunity to borrow in the form of loans from the Federal Reserve Bank. These loans are deemed short-term, and the interest rate attached to these loans is called the discount rate. Results of this transaction include an increased accumulation of reserves for the commercial bank. Contrarily, if the Federal Reserve decides to apply a stoppage to the supply of money, there may be application of an increase in the discount rate. This method “discourages commercial banks from obtaining additional reserves through borrowing from the Federal Reserve Banks” (McConnell-Brue, 2004, p. 276.).

References

McConnell-Brue. (2004). *Macroeconomic Measurement and Basic Concepts*. Measuring Domestic Output and National Income. New York: The McGraw-Hill Companies.

McConnell-Brue. (2004). *Money, Banking, and Monetary Policy*. New Banks and Thrifts Create Money. New York: The McGraw-Hill Companies.

McConnell-Brue. (2004). *Money, Banking, and Monetary Policy*. Monetary Policy. New York: The McGraw-Hill Companies.

McConnell-Brue. (2004). *Microeconomics of Resource Markets*. Rent, Interest and Profit. New York: The McGraw-Hill Companies.