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IN FOCUS

Updated January 7, 2026

Introduction to U.S. Economy: Monetary Policy

The Federal Reserve (Fed), the nation's central bank, is responsible for monetary policy. This In Focus explains how monetary policy works. Typically, when the Fed wants to stimulate the economy, it reduces short-term interest rates to make policy more expansionary. When it wants to make policy more contractionary or tighter, it raises rates. For example, the Fed reduced interest rates in 2024 and 2025 to make policy less contractionary. For background on the Fed and its other responsibilities, see CRS In Focus IF10054, *Introduction to Financial Services: The Federal Reserve*.

Federal Open Market Committee

Monetary policy decisions are made by the Federal Open Market Committee (FOMC), whose voting members are the Fed's seven governors, the New York Federal Reserve Bank president, and four other reserve bank presidents, who vote on a rotating basis. The FOMC is chaired by the Fed chair. FOMC meetings are regularly scheduled every six weeks, but the chair sometimes calls unscheduled meetings. After these meetings, the FOMC statement is released, announcing any changes to monetary policy.

Statutory Goals

In 1977, the Fed was statutorily mandated to set monetary policy to promote the goals of "maximum employment, stable prices, and moderate long-term interest rates." The first two goals are referred to as the dual mandate. The dual mandate provides the Fed with discretion on how to interpret maximum employment and stable prices and how to set monetary policy to achieve those goals. There are no formal repercussions when goals are not met.

Since 2012, the FOMC has explained how it carries out its mandate in its *Statement on Longer-Run Goals*. It defines *stable prices* as 2% inflation using the annual percentage change in the personal consumption expenditures price index (i.e., the increase in prices paid by consumers). In the FOMC's view, maximum employment "is not directly measurable and changes over time owing largely to nonmonetary factors that affect the structure and dynamics of the labor market." The Statement is revised every five years, most recently in 2025.

Federal Funds Rate

In normal economic conditions, the Fed's primary instrument for setting monetary policy is the federal funds rate (FFR), the overnight interest rate in the federal funds market, a private market where banks lend to each other. The FOMC sets a target range for the FFR that is 0.25 percentage points wide and uses its policy tools (discussed below) to keep the actual FFR within that range. (The current FFR target can be found here.)

Monetary Policy and the Economy

Changes in the FFR target lead to changes in interest rates throughout the economy, although these changes are mostly less than one to one. Changes in interest rates affect overall economic activity by changing the demand for interest-sensitive spending (goods and services that are bought on credit). The main categories of interest-sensitive spending are business physical capital investment (e.g., plant and equipment), consumer durables (e.g., automobiles, appliances), and residential investment (new housing construction). All else equal, higher interest rates reduce—and lower rates increase—interest-sensitive spending.

Interest rates also influence the demand for exports and imports by affecting the value of the dollar. All else equal, higher interest rates increase net foreign capital inflows as U.S. assets become more attractive relative to foreign assets. To purchase U.S. assets, foreigners must first purchase U.S. dollars, pushing up the value of the dollar. When the value of the dollar rises, the price of foreign imports declines relative to U.S. import-competing goods, and U.S. exports become more expensive relative to foreign goods. As a result, net exports (exports less imports) decrease. When interest rates fall, all of these factors work in reverse and net exports increase, all else equal.

Business investment, consumer durables, residential investment, and net exports are all components of gross domestic product (GDP). Thus, if expansionary monetary policy causes interest-sensitive spending to rise, it increases GDP in the short run. This increases employment, as more workers are hired to meet increased demand for goods and services. An increase in spending also puts upward pressure on inflation, as greater demand can bid up prices. Contractionary monetary policy has the opposite effect on GDP, employment, and inflation. The Fed chooses whether to make monetary policy expansionary or contractionary based on how employment and inflation are performing compared to its statutory goals—expansionary policy can boost employment but risks spurring inflation, while contractionary policy can constrain inflation but risks decreasing employment.

Most economists believe that although monetary policy can permanently change the inflation rate, it cannot permanently change the level or growth rate of GDP, because long-run GDP is determined by the economy's productive capacity (e.g., the size of the labor force and capital stock). If monetary policy pushes demand above what the economy can produce, then inflation should eventually rise to restore equilibrium. The Fed can preemptively change interest rates to take into account the lags between a change in monetary policy and its effect on economic conditions. The Fed generally tries to avoid

policy surprises, and FOMC members regularly communicate their views on the future direction of monetary policy to the public. The Fed describes monetary policy as "data dependent," meaning plans would be altered if actual employment or inflation deviate from its forecast. Data are volatile, however, and truly data-dependent policymaking would lead to sudden shifts in policy. In practice, the Fed likes to avoid surprises if possible, so large-scale policy shifts are relatively infrequent.

The Fed's Balance Sheet

Like a company, the Fed holds assets on its balance sheet that are equally matched by the sum of its liabilities and capital. The Fed's assets are primarily Treasury securities, mortgage-backed securities, loans it has made, repurchase agreements (repos), and other assets acquired from emergency programs. Its liabilities are primarily currency, reverse repos, bank reserves held at the Fed, and Treasury deposits at the Fed. When the Fed purchases assets or makes loans, its balance sheet gets larger, which is matched by growth in reverse repos and bank reserves. Capital comes from stock issued to private banks that are "member banks" and the funds in its surplus account. As discussed in the next section, the Fed's balance sheet grew significantly from 2008 to 2014 and from 2020 to 2022 in response to the financial crisis and the pandemic, respectively. From June 2022 to December 2025, the balance sheet was gradually shrinking. Since then, the Fed has been allowing the balance sheet to gradually expand. For more information, see CRS In Focus IF12147, *The Federal Reserve's Balance Sheet*.

Unconventional Tools at the Zero Lower Bound

Twice in its history—during the 2007-2009 financial crisis and the COVID-19 pandemic—the Fed lowered the FFR target range to 0%-0.25% (called the zero lower bound) in response to unusually serious economic disruptions. Because the zero lower bound prevented the Fed from providing as much conventional stimulus as desired to mitigate these crises, it turned to unconventional monetary policy tools in an effort to reduce longer-term interest rates. Under *quantitative easing* (QE), it purchased trillions of dollars of Treasury securities and mortgage-backed securities, expanding its balance sheet, in an effort to directly lower their yield. Under *forward guidance*, it pledged to keep the FFR low for an extended period of time with the hope that reducing investor expectations of future short-term rates will reduce long-term rates today. It also used large-scale repos, equivalent to short-term loans, to directly pump more liquidity into the financial system.

In addition, the Fed has responded to these crises by using its lender-of-last-resort powers to establish temporary emergency facilities to stabilize the financial system.

The Post-Crisis Policy Framework

After the 2007-2009 financial crisis, the Fed changed how it conducted monetary policy. The Fed now maintains the FFR target primarily by setting the interest rate it pays banks on reserves held at the Fed (IOR) and by using a standing (i.e., on-demand) overnight reverse repo facility to drain liquidity from the financial system and standing repo lending operations to add liquidity to the system. Unlike the FFR, the Fed sets the IOR and the rates on its repo operations directly. The IOR and repo rates anchor the FFR because all three are relatively substitutable short-term funding sources. Currently, the top of the target range is set equal to the rate for borrowing from the Fed through the discount window and its standing repos, and the bottom of the range is set equal to the rate for lending to the Fed through the reverse repo facility.

Before the crisis, monetary policy was conducted differently. The Fed did not have authority to pay interest on bank reserves until 2008, so it could not target the FFR by setting the IOR. Instead, the New York Fed directly intervened in the federal funds market through open market operations that added or removed reserves from the federal funds market. Open market operations could be conducted by buying or selling Treasury securities but were typically conducted through repos. (As noted above, the Fed still purchases Treasury securities and uses repos, but it no longer does so to target the FFR. Whereas previously the Fed would offer the amount of repos needed to meet its FFR target, now market participants choose the amount.)

Before the crisis, the Fed could target the FFR through direct intervention in the federal funds market because reserves were scarce—banks held only enough reserves to slightly exceed the reserve requirements set by the Fed. Now, banks hold trillions of dollars of reserves despite the fact that the Fed eliminated reserve requirements in 2020. The overall level of reserves is the result of Fed actions—primarily QE—that have increased the Fed's balance sheet and are not a choice by banks.

After the Fed ended QE in 2014, it decided to maintain ample reserves instead of fully shrinking its balance sheet and returning to its pre-crisis monetary framework. With reserves so abundant, adding or removing reserves could not raise the FFR above zero in the absence of IOR and its repo operations.

The Money Supply and Inflation

Historically, money supply growth has been a predictor of the inflation rate. The logic behind this relationship is that inflation is caused by "too much money chasing too few goods." The money supply grew at historically high levels during the pandemic but shrank more recently. The money supply grew relatively rapidly during QE partly because of rapid growth in the monetary base, which consists of bank reserves and currency and is controlled by the Fed. Besides the pandemic, money supply growth and inflation have not moved together closely in recent decades. Although faster money supply growth would typically cause inflation to rise, all else equal, IOR gives the Fed a means to "tie up" bank reserves so that they do not potentially cause inflation.

Congress and Monetary Policy

Congress has delegated responsibility for monetary policy to the Fed but retains oversight responsibilities. For example, statute requires the Fed to semiannually produce a written report and testify on monetary policy to the House Financial Services Committee and the Senate Banking, Housing, and Urban Affairs Committee.

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