Fed Chair Simulator

WITSOOTH · CLEVER TRUTH

AP MACROECONOMICS · UNIT 4

Name _____ Period _____

DRIVING QUESTION

You have four different levers that all claim to control the same interest rate. Why would you ever need to switch levers mid-crisis?

Gut instinct now. Answer it again at the end using the floor and corridor systems.

BEFORE THE GAME

> *"The Federal Reserve raised the federal funds rate by a quarter point today." One headline, but that's not one dial. The Fed has open market operations, reserve requirements, interest on reserves, and the discount rate, all aimed at that one number.*

Your gut answer — if the Fed has four tools aimed at the same target, why not just pick one and stick with it forever?

_____

_____

Quick prediction — does selling bonds (OMO) increase or decrease bank reserves?

☐ Increase ☐ Decrease

_____

DURING THE GAME — SET THE TOOLS

QTR	OBJECTIVE	OMO	RR%	IOR%	DISC. SPREAD	FED FUNDS RATE	MET?
1							☐ Y ☐ N
4							☐ Y ☐ N
8							☐ Y ☐ N
★ Crisis Qtr							☐ Y ☐ N
12							☐ Y ☐ N

Log quarters 1, 4, 8, 12 — plus whichever quarter the Banking Crisis event hits (★). That's the quarter where your usual tools stop working.

AFTER THE GAME

At the ★ crisis quarter — which tool (OMO or RR) stopped moving the funds rate, and which tool did you pivot to instead?

Now use the vocabulary: in a floor system, IOR sets a floor and the discount rate sets a ceiling — a "corridor." Why does OMO stop mattering once reserves are already abundant?

TRANSFER — SAME MECHANISM, REAL HISTORY

"After 2008, the Fed Stopped Using Reserve Requirements to Steer Rates"

Before 2008, the Fed nudged the funds rate mainly by buying and selling small amounts of bonds (OMO), making reserves scarce or plentiful. After the crisis, quantitative easing flooded the banking system — reserves became so abundant that tiny OMO trades couldn't move the rate at all. The Fed had to switch to setting interest on reserves (IOR) directly.

A. Why did OMO stop working once reserves became abundant? What's the difference between a scarce-reserves system and an ample-reserves system?

B. Why does setting IOR directly work even when reserves are abundant?

C. Connect it to the game — which quarter matched this real event?

RETURN TO THE DRIVING QUESTION

You have four different levers that all claim to control the same interest rate. Why would you ever need to switch levers mid-crisis?

Use the floor and corridor systems in your final answer.