

Money. It's the stuff that makes the world go round. We use it to get the things we need and the things we want. We sell stuff for it, work long hours for it, and even go on game shows for it. But what exactly is it?

We humans have used a lot of different things as money in the past, for a long time now we've been using small pieces of paper, handing them to each other directly or sending electronic messages with credit cards and account numbers saying, "I owe you this much of that paper and you owe me that much of this paper." So why do we work and trade and gamble for paper?

Well, our modern currencies—dollars, pounds, and yen—were once backed by gold, with each bill representing a certain amount of the valuable metal. With this system, a currency's value was tied to the supply of gold. Eventually, the world moved on to our modern system based on what's called fiat money. Instead of being backed by gold, governments simply declare that these pieces of paper are actually valuable. Their core value comes from government rules that make them legal tender. This means that any business within a country must accept that country's particular currency in exchange for goods and services, and taxes must be paid to the government in that currency. As long as people want to conduct business in a country, there will be a demand for the legal tender, and it will have some value.

But business doesn't stop at a country's borders. People and businesses buy things and make investments with people and businesses all over the world. In order to make this happen, they need a way to exchange their country's currency for one that is accepted in other countries. So if a British person wants to buy a kimono from Japan, they'll have to exchange their British pounds for Japanese yen, and then use the yen to purchase the kimono.

For most major currencies, their exchange rates with other currencies shift up and down depending on constantly changing economic factors. Some governments try to manipulate their currency's exchange rates. For example, a government might sell a lot of its money in currency markets so that it becomes cheaper relative to other currencies. This makes it easier for that country's companies to sell products abroad and harder for foreign-produced goods to be sold at home, boosting domestic industries and creating jobs.

But other countries often respond negatively to currency manipulation and use economic and financial tools to stop manipulators. So in general, economic factors ultimately determine how much of one currency can be

Transcript: An Overview of Monetary Policy

exchanged for another. One of those factors is the supply of money, and as it changes, it can have major effects on a country's economy. When the money supply increases, the cost of borrowing goes down. Businesses can get cheap loans and use that money on investments, creating jobs and economic growth.

However if the money supply increases too much, businesses will expand too fast. Their demand for new buildings or machines or workers will grow faster than they're being supplied. When too much money chases too few goods, their prices will increase, resulting in inflation. This isn't the only reason inflation occurs. For example, if people expect there to be inflation, they'll ask for higher wages, which forces businesses to charge more for their products, resulting in higher price levels and thus inflation.

But inflation isn't universally negative. It often creates winners and losers. For example, it can benefit people who owe others money. Typically, if you borrow \$100, you will continue to owe \$100, even if there is inflation and the actual value of a dollar has declined. So if people in debt are getting paid a higher wage because of inflation, it will require a smaller portion of their income to repay their debts.

While some inflation is a natural part of modern economies, too much inflation can cause an economic crisis. People can't afford basic necessities, and their savings become worthless. They don't know what the money in their pockets will be worth in a month's time. They can't plan for the future. Amid that uncertainty, investment falls, and economic growth suffers, and faith in government disappears.

In contrast, when the money supply decreases, inflation becomes less likely and it's possible that prices for goods and services might even decrease. This is called deflation. But then there is less money for businesses to hire people and with less people working, less money is available to spend, so the economy shrinks.

Many governments try to manage their economies and avoid severe inflation or deflation by changing their money supply through what's called monetary policy. They use expansionary monetary policies, which encourage banks to make loans cheaper and lend out more money, making it easier to borrow. This increases the money supply and expands the economy. Or governments use contractionary monetary policies, which encourage banks to make loans more expensive and lend out less money, making it more difficult to borrow. This decreases the money supply and contracts the economy.

Transcript: An Overview of Monetary Policy

Monetary policy is typically conducted through a central bank. The United States' central bank is the Federal Reserve, but you'll also hear it called the Fed. It operates independently from the rest of the U.S. government. That way, instead of making politically convenient decisions in the short term, it's able to focus on what's best for the economy in the long term. The Fed has two goals, known as its dual mandate: to maximize employment and to keep inflation rates low. Maximizing employment often requires increasing the money supply with expansionary policies, while keeping inflation rates low often requires slowing the growth of the money supply with contractionary policies. So the Fed is constantly performing a balancing act: making sure that inflation doesn't get too high by making sure that employment doesn't fall too low, essentially protecting the economy from running too hot or too cold.

The Fed also regulates large banks and important financial institutions in an attempt to limit the economic risk they pose to the country. Like most central banks, the Fed has a domestic mission and focuses on managing the United States' economy.

But the Fed is unique. Why? Because changes in the U.S. economy affect the global economy and because the U.S. dollar is the most widely used currency in the world. The majority of international business is conducted in U.S. dollars and many foreign central banks hold on to a lot of U.S. dollars as a reserve currency, ensuring they have enough dollars for their countries to buy things from abroad in good economic times and bad. So when the Fed adjusts its monetary policy, it has major effects throughout a world that trades and saves in U.S. dollars, changing the prices we pay, the amounts we earn, and the value of everything we've got.