Removing the "Punch Bowl": Inflation and the Federal Reserve's Use of Contractionary Monetary Policy

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Standards and Benchmarks (see page 15)

Lesson Description

Since its creation in 1913, the Federal Reserve has played a crucial role in influencing the American economy through its monetary policy decisions. This lesson focuses on contractionary monetary policy by analyzing a 1955 primary source document of a speech Federal Reserve Chair William McChesney Martin Jr. gave. In his speech, Martin made the famous analogy that in times of economic expansion the Fed should "remove the punch bowl" before the party gets out of hand. Students will develop critical thinking skills through this primary document analysis using the FRASER® historical economic information website, as well as develop data literacy skills using FRED® to determine the best monetary policy decisions given an economic situation.

Grade Level

10-12

Concepts

Consumer price index (CPI)

Contractionary monetary policy

Expansionary monetary policy

Federal funds rate

Federal Open Market Committee (FOMC)

Inflation

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Objectives

Students will be able to

- define contractionary monetary policy set by the Federal Reserve,
- provide examples of how monetary policy decisions have affected the economy,
- explain how Federal Reserve monetary policy has changed over time,
- analyze economic data to develop an economic argument, and
- analyze primary and secondary source material.

Compelling Question

How does the Federal Reserve manage inflation?

Time Required

One 50-minute class period (NOTE: If students require supplemental background knowledge for the activities mentioned in the procedure, add an additional class period or assign activities as homework prior to starting the lesson.)

Materials

- Online access: https://fred.stlouisfed.org/
- Handouts 1 and 2, one copy of each for each student, or one electronic copy of each for display
- Handout 3, one copy for each student
- Handout 3 Answer Key, one copy for the teacher

Procedure

1. If students are unfamiliar with the Federal Reserve's (the Fed's) role in setting monetary policy in the United States, you you may show students the following 13-minute video covering the same material: https://www.stlouisfed.org/education/in-plain-english-video.

2. Review the role the Fed plays in influencing the American economy. Distribute a physical copy of *Handout 1: Economic Terms* to each student or display an electronic copy for the class. Ask a volunteer to read aloud the definition of **contractionary monetary policy** from the handout.

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Discuss what this means. For classes that may not have as much prior knowledge of monetary policy, tell students that when the economy is in an expansionary phase, raising interest rates will make everything from student loans to credit cards more expensive, which will "cool off" the economy before **inflation** becomes unbearable. In fact, one of the Fed's jobs is to promote price stability, which means the Fed works to keep inflation low and stable. Follow up and again ask a student to read the definition of contractionary monetary policy. Discuss the following:

- What could the Fed do to inspire economic growth when the economy is in a contractionary phase, such as a recession? (*Answers will vary but may include variations of expansionary monetary policy, such as lowering interest rates.*)

3. Distribute a physical copy of *Handout 2: Excerpts from William McChesney Martin Jr.'s October 19, 1955, Speech* to each student or display an electronic copy for the class. Also distribute one copy of *Handout 3: The "Punch Bowl" Lesson—Student Answer Sheet* to each student. Explain that they will use Handout 3 to record their answers throughout the lesson.

4. Remind students that during the mid-1950s, the United States was in post-World War II economic expansion. The American economy had rarely been as strong as it was then due to its emergence from the war as a military and economic superpower and its tremendous domestic growth from the Baby Boom. During this time of economic affluence, the Federal Reserve Chair was William McChesney Martin Jr., a native Missourian whose father served as President of the Federal Reserve Bank of St. Louis and who previously served as the President of the New York Stock Exchange. On October 19, 1955, Martin Jr. gave a speech at the Waldorf Astoria Hotel in New York City to the Investment Bankers Association of America, outlining his thoughts about what role the Fed should play during a time of economic prosperity.

5. Instruct students to read Martin's remarks. You may assign either the excerpts on Handout 2 or the full speech text, available on FRASER® at https://fraser.stlouisfed.org/title/statements-speeches-william-mcchesney-martin-jr-448/address-new-york-group-investment-bankers-association-america-7800. Tell students they can refer to Handout 1 for a list of economic terms Martin uses in his speech. Instruct them to answer the questions on Handout 3 after they have finished reading.

6. Use the *Handout 3: The "Punch Bowl" Lesson—Teacher Answer Key* to discuss answers with students. Be sure to emphasize that the Fed's original intention was to make monetary policy decisions that, while not always politically popular, ensure the overall health and stability of the national economy by acting like a counterweight. Explain that in poor economic situations, the Fed will conduct **expansionary monetary policy**, which lowers interest rates, encouraging people to spend to improve economic conditions. If done correctly, expansionary monetary policy can lead to long, sustained periods of good conditions, but there is a catch—inflation. Like a fun party, nobody wants a good economic period to end, but, if left unchecked, expansion can lead to serious consequences such as uncontrollable inflation. Therefore, the Fed must take on the role of a chaperone and keep the economic party in check by raising interest rates: This may be unpopular—like taking away a party's punch bowl—but it can maintain the economy's stability by keeping inflation under control.

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This type of contractionary monetary policy, combined with good government fiscal policy, as Martin stated, can be extremely effective at keeping the overall economy balanced.

7. Refer students to Handout 1 and have them read aloud and discuss the remaining definitions. Check for understanding on these concepts. Highlight the term **federal funds rate**. Tell them that this is the Fed’s policy rate, which is the interest rate the Fed uses to set and communicate its monetary policy stance (or position). In short, the **Federal Open Market Committee (FOMC)** sets a target range for the federal funds rate to conduct monetary policy. And it uses its monetary policy tools to ensure the “effective” federal funds rate stays within the target range. Once that range is announced, the Fed implements that policy by using financial “tools” to actually steer the federal funds rate into the target range.
(NOTE: The effective federal funds rate is the rate used in the figures in this lesson. On any given day, there are many transactions that settle at slightly different federal funds rates. The effective federal funds rate is the volume-weighted median rate of these transactions.)

8. Tell students that they will use the federal funds rate in building a FRED® graph. Explain that the discount rate that Martin mentions in his speech is one of the Fed’s policy tools that it uses to steer the federal funds rate into that target range. Be sure that students also understand the concept of the **consumer price index (CPI)**—the most commonly used measurement for inflation—as they will be transforming that dataset in FRED®. More information on monetary policy tools the Fed uses currently to guide the federal funds rate into the target range is available on the Federal Reserve Bank of St. Louis’s YouTube channel: https://www.youtube.com/watch?v=vHurDbCAfkA. Discuss the following:
   - Do you agree that an independent Federal Reserve should be like a chaperone and raise interest rates (“remove the punch bowl”) before inflation becomes a serious problem? (*Answers will vary.*)

9. Instruct students to now use FRED® to look up and edit several datasets to test Martin’s notion that the Fed should “act like a chaperone and take away the punch bowl” by initializing contractionary monetary policy before inflation becomes too big of an economic problem. Tell students to follow the step-by-step instructions on Handout 3 and answer the questions as they go along. Refer to the Handout 3 Answer Key to help students if necessary. For reference, students should create a FRED® graph showing the inflation rate and the Fed’s effective federal funds rate. It should look like the graph below by the end of this part of the lesson. (NOTE: For students without computer access, teachers may pull up the graph using the source link to show students and discuss together.)

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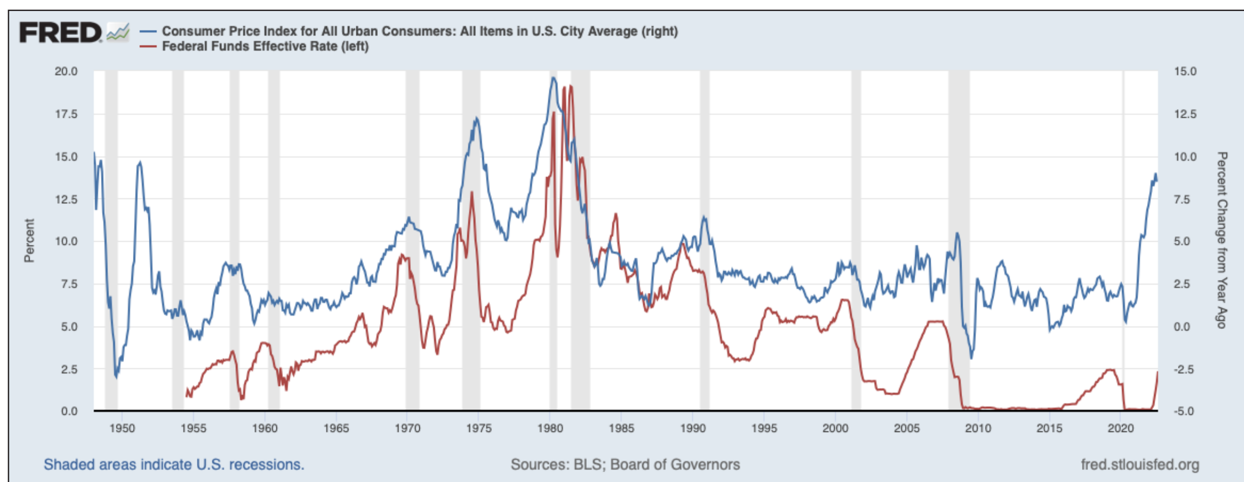

SOURCE: FRED®, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/graph/fredgraph.png?g=FHLH.

Closure

10. Discuss student responses about the FRED® graph they created—especially question #17 at the end of the FRED® graph analysis. Emphasize that the Fed has traditionally raised the federal funds rate (i.e., "removed the punch bowl") to bring inflation into check. With the COVID-19 recession of 2020, the Fed took the unprecedented expansionary monetary policy step of reducing the lower end of the target range for the federal funds rate to 0% to deal with the economic crisis brought on by the pandemic. Once the nation emerged from the lockdown, demand for goods and services—along with all the fiscal stimulus Congress provided in forms of direct payments, unemployment benefits, and child tax credits—increased into 2021, sending inflation to rates unseen since the early 1990s. Close the lesson by discussing the following:
    - Do you believe raising interest rates will help curb inflation? If so, how quickly or how often should the Fed conduct this contractionary monetary policy? (*Answers will vary.*)

11. Optional: A good lesson extension or homework assignment would be to have students read the *Page One Economics*® 2021 article "Inflation Expectations, the Phillips Curve, and the Fed's Dual Mandate," available at https://www.stlouisfed.org/education/page-one-economics-classroom-edition/inflation-expectations-phillips-curve-feds-dual-mandate or through www.econlowdown.org.

Assessment

12. Use student responses to the questions from the lesson and Handout 3, along with their graph creation, as an assessment of their learning.

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Handout 1: Economic Terms

Consumer price index (CPI): A measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Contractionary monetary policy: Actions taken by the Federal Reserve to increase interest rates and thereby discourage spending by consumers and businesses.

Discount rate: The interest rate charged by the Federal Reserve to banks for loans obtained through the Fed's discount window.

Expansionary monetary policy: Actions taken by the Federal Reserve to lower interest rates and thereby encourage spending by consumers and businesses.

Federal funds rate: The interest rate depository institutions charge each other to borrow or lend reserves in the federal funds market; these funds are immediately available.

Inflation rate: The percentage increase in the average price level of goods and services over a period of time.

Purchasing power: The amount of goods and services that a unit of currency can buy.

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Handout 2: Excerpts from William McChesney Martin Jr.'s October 19, 1955, Speech (page 1 of 2)

Full speech available from FRASER® at https://fraser.stlouisfed.org/title/statements-speeches-william-mcchesney-martin-jr-448/address-new-york-group-investment-bankers-association-america-7800.[1]

…In our economic affairs, the major questions confronting us are in large measure hardy perennials: How do we attain and retain prosperity? How do we achieve normal healthy growth? How do we preserve the purchasing power of our money? The answers to these interrelated questions in the 1950's thus far differ in important respects from those of earlier decades.

My purpose tonight is to explore with you some of the main currents and undercurrents of thought which have colored and shaped these differing answers….

…The Federal Reserve System, which I have the honor to represent, was our earliest institutional response to such a demand. It emerged out of the urgent need to prevent recurrences of such disasters as the money panic of 1907, and out of the thought that the Government had a definite responsibility to prevent financial crises and should utilize all its powers to do so.

Accordingly, 42 years ago Congress entrusted to the Federal Reserve System responsibility for managing the money supply. This was an historic and revolutionary step. In framing the Federal Reserve Act great care was taken to safeguard this money management from improper interference by either private or political interests….

…But a note should be made here that, while money policy can do a great deal, it is by no means all powerful. In other words, we should not place too heavy a burden on monetary policy. It must be accompanied by appropriate fiscal and budgetary measures if we are to achieve our aim of stable progress. If we ask too much of monetary policy, we will not only fail but we will also discredit this useful, and indeed indispensable, tool for shaping our economic development….

…Free markets, like free economies, have a way of going down as well as up, and thus reminding us that our system is one of profit and loss, entailing penalties as well as rewards. During the last four and a half years the Federal Reserve has pursued a monetary policy characterized by flexibility, or prompt adaptation to the sharply changing needs of a dynamic economy. It has been necessary in this period to combat both the forces of inflation and of deflation.

There are some who contend that a little inflation—a creeping inflation—is necessary and desirable in promoting our goal of maximum employment….

…If inflation would in fact make jobs, no reasonable man would be against it. But as I have frequently emphasized, inflation seems to be putting money into our pockets when in fact it is robbing the saver, the pensioner, the retired workman, the aged—those least able to defend themselves…. That doesn't mean jobs. It means just the opposite….

[1] Address of William McChesney Martin Jr., Chairman, Board of Governors of the Federal Reserve System, before the New York Group of the Investment Bankers Association of America, October 19, 1955; https://fraser.stlouisfed.org/title/statements-speeches-william-mcchesney-martin-jr-448/address-new-york-group-investment-bankers-association-america-7800.

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Handout 2: Excerpts from William McChesney Martin Jr.'s October 19, 1955, Speech (page 2 of 2)

…If we fail to apply the brakes sufficiently and in time, of course, we shall go over the cliff. If businessmen, bankers, your contemporaries in the business and financial world, stay on the sidelines, concerned only with making profits, letting the Government bear all of the responsibility and the burden of guidance of the economy, we shall surely fail…. But the fact is that the Government isn't something apart and remote from you. It is you—all of us….

In the field of monetary and credit policy, precautionary action to prevent inflationary excesses is bound to have some onerous effects—if it did not it would be ineffective and futile. Those who have the task of making such policy don't expect you to applaud. The Federal Reserve, as one writer put it, after the recent increase in the discount rate, is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up.

But unless the business community, leaders in all walks, exhibit moderation, prudence, and understanding, then we will fail and deserve to fail. I cannot believe we will be so blind. I have a deep and abiding faith in that undefinable yet meaningful phrase we frequently use—"the American Way of Life."

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Handout 3: The "Punch Bowl" Lesson—Student Answer Sheet (page 1 of 3)

NAME: ____ HOUR: ______

Part 1

Read Handout 2 and answer the following questions:

1. Toward the beginning of his speech, what does Martin say are questions the Federal Reserve tries to answer?

2. When the Fed was created, officials hoped that monetary policy would not be interfered with by which groups? Why is this so important?

3. What else does Martin say needs to happen to keep the economy stable?

4. According to Martin, what is the problem with inflation?

5. In his analogy of the punch bowl, Martin listed which specific action the Fed can take to prevent excess inflationary pressures?

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Handout 3: The “Punch Bowl” Lesson—Student Answer Sheet (page 2 of 3)

Part 2

Now you will look up and create some economic graphs to see if the Fed has followed Martin’s idea of instituting contractionary monetary policy to stop inflation pressures in the U.S. economy, and if those policy actions had any positive or negative effects on overall economic conditions.

Go to https://fred.stlouisfed.org/ and type “consumer price index” in the main search bar. Select the dataset “Consumer Price Index for All Urban Consumers: All Items in U.S. City Average.”

Click the red “Edit Graph” button near the top right of your screen. Change the Units in the dropdown menu from “Index 1982-1984=100” to “Percent Change from Year Ago.” Recall that the consumer price index (CPI) is a sample of many goods and services purchased by people in the United States and that by changing the units we can see the rate of inflation in the United States over time. Close the edit box window. Answer the following questions:

6. When was inflation the highest and what was the inflation rate?

7. When was inflation the lowest and what was the inflation rate? (NOTE: Negative inflation is known as deflation.)

8. What is the inflation rate now?

You will now add a different dataset to this graph. Click the red “Edit Graph” button again. Select the “Add Line” tab. Type “effective federal funds rate” and select “Federal Funds Effective Rate: Monthly, Percent, Not Seasonally Adjusted: FEDFUNDS.” Click “Add data series.” Change the Units for Line 2 to “Percent.” Select the “Format” tab. Shift Line 1’s Y-Axis position from the left to the right. Recall that setting the target range for the federal funds rate is an important step the Fed takes as it conducts monetary policy. Generally speaking, the higher the federal funds rate is, the higher interest rates are for individuals and businesses when they apply for loans and bank accounts. Answer the following questions:

9. When was the effective federal funds rate the highest and what was the rate?

10. When was the effective federal funds rate the lowest and what was the rate?

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Handout 3: The "Punch Bowl" Lesson—Student Answer Sheet (page 3 of 3)

11. What is the effective federal funds rate now?

12. Is there a relationship or any patterns between the two datasets from 1955 forward?

Adjust the timeline to show the past 10 years by clicking on the "10Y" above the FRED® graph.

13. For November 2015 to July 2019, what type of monetary policy did the Fed conduct?

14. What type of impact did this Fed action have on inflation?

15. What would have caused both the effective federal funds rate and CPI to dramatically decrease in early 2020?

16. What might have caused the CPI to dramatically increase starting in early 2021?

17. Given a dramatic increase in the CPI, what might the Fed do to curb inflation? Would contractionary or expansionary monetary policy be better to deal with this situation? Be sure to support your answer with relevant facts.

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Handout 3: The "Punch Bowl" Lesson—Teacher Answer Key (page 1 of 3)

Part 1

Read Handout 2 and answer the following questions:

1. Toward the beginning of his speech, what does Martin say are questions the Federal Reserve tries to answer?

   How do we achieve a prosperous economy with healthy growth? How do we maintain purchasing power?

2. When the Fed was created, officials hoped that monetary policy would not be interfered with by which groups? Why is this so important?

   The Fed was created to be independent from political or private sector interference. Answers will vary but may include that independence allows the Fed to make tough monetary policy decisions that, while benefiting the economy as a whole, may not be politically easy or financially prudent in the short term. While unpopular, contractionary monetary policy—taking away a punch bowl—keeps an economy stable in the long run.

3. What else does Martin say needs to happen to keep the economy stable?

   Monetary policy must be accompanied by appropriate fiscal and budgetary measures.

4. According to Martin, what is the problem with inflation?

   Inflation appears to be more money in people's pockets, but it hurts savers (because of fewer opportunities to save with higher interest rates), hurts pensions and retirees (because of reduced purchasing power), and does not create jobs. (NOTE: Students may need more detailed information about purchasing power. Refer them to the definition on Handout 1 and remind them that while more money circulating in the economy at first appears to be positive, it takes more money to purchase the same amount of goods and services.)

5. In his analogy of the punch bowl, Martin listed which specific action the Fed can take to prevent excess inflationary pressures?

   Martin said that increasing the discount rate will curb inflation—even though it appears to most that good economic times are still coming in the short term.

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Handout 3: The "Punch Bowl" Lesson—Teacher Answer Key (page 2 of 3)

Part 2

Now you will look up and create some economic graphs to see if the Fed has followed Martin's idea of instituting contractionary monetary policy to stop inflation pressures in the U.S. economy, and if those policy actions had any positive or negative effects on overall economic conditions.

Go to https://fred.stlouisfed.org/ and type "consumer price index" in the main search bar. Select the dataset "Consumer Price Index for All Urban Consumers: All Items in U.S. City Average."

Click the red "Edit Graph" button near the top right of your screen. Change the Units in the dropdown menu from "Index 1982-1984=100" to "Percent Change from Year Ago." Recall that the consumer price index (CPI) is a sample of many goods and services purchased by people in the United States and that by changing the units we can see the rate of inflation in the United States over time. Close the edit box window. Answer the following questions:

6. When was inflation the highest and what was the inflation rate?

   March 1980; 14.59%

7. When was inflation the lowest and what was the inflation rate? (NOTE: Negative inflation is known as deflation.)

   August 1949; –2.98%.

8. What is the inflation rate now?

   Answers will vary based on most recent data.

You will now add a different dataset to this graph. Click the red "Edit Graph" button again. Select the "Add Line" tab. Type "effective federal funds rate" and select "Federal Funds Effective Rate: Monthly, Percent, Not Seasonally Adjusted: FEDFUNDS." Click "Add data series." Change the Units for Line 2 to "Percent." Select the "Format" tab. Shift Line 1's Y-Axis position from the left to the right. Recall that setting the target range for the federal funds rate is an important step the Fed takes as it conducts monetary policy. Generally speaking, the higher the federal funds rate is, the higher interest rates are for individuals and businesses when they apply for loans and bank accounts. Answer the following questions:

9. When was the effective federal funds rate the highest and what was the rate?

   June 1981; 19.10%

10. When was the effective federal funds rate the lowest and what was the rate?

    April 2020; 0.05%

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Handout 3: The "Punch Bowl" Lesson—Student Answer Sheet (page 3 of 3)

11. What is the effective federal funds rate now?

    Answers will vary based on most recent data.

12. Is there a relationship or any patterns between the two datasets from 1955 forward?

    Answers will vary, but most students should describe that when the federal funds rate increases, inflation generally decreases.

Adjust the timeline to show the past 10 years by clicking on the "10Y" above the FRED® graph.

13. For November 2015 to July 2019, what type of monetary policy did the Fed conduct?

    Students will respond that either the effective federal funds rate steadily increased, or the Fed was conducting contractionary monetary policy.

14. What type of impact did this Fed action have on inflation?

    Answer will vary slightly, but most students will respond that inflation was held in check or remained stable.

15. What would have caused both the effective federal funds rate and CPI to dramatically decrease in early 2020?

    Answers should discuss the impact of the COVID-19 pandemic and economic shutdowns.

16. What might have caused the CPI to dramatically increase starting in early 2021?

    Answers will vary, but most students should mention the reopening of the American economy after public health lockdowns ended. Some might include the large expansionary fiscal policies enacted by Congress or supply-chain problems.

17. Given a dramatic increase in the CPI, what might the Fed do to curb inflation? Would contractionary or expansionary monetary policy be better to deal with this situation? Be sure to support your answer with relevant facts.

    Because this is an opinion question, answers will vary but may include contractionary monetary policy, raising the target range for the federal funds rate, or doing nothing as inflation might be transitory.

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Standards and Benchmarks

AP Macroeconomics Curriculum Alignment

AP Economic Skills

- Interpretation 2A: Using economic concepts, principles, or models, explain how a specific economic outcome occurs or what action should be taken in order to achieve and specific economic outcome.
- Manipulation 3C: Determine the effect(s) of a change in an economic situation using quantitative data or calculations
- Graphing & Visuals 4B: Demonstrate your understanding of a specific economic situation on an accurately labeled graph or visual

Unit Alignment

- Topic 4.6 Monetary Policy Learning Objective 1D: Explain the short-term effects of a monetary policy action

AP Government & Politics Curriculum Alignment

Disciplinary Practices

- Concept Application 1E: Explain how political principles, institutions, processes, policies, and behaviors apply to different scenarios in context.
- Data Analysis 3D: Explain what the data implies or illustrates about political principles, institutions, processes, policies, and behaviors.
- Source Analysis 4C: Explain how the implications of the author's argument or perspective may affect political principles, policies, and behaviors

Unit Alignment

- 4.9 Ideology & Economic Policy: PMI-4.D.1: Ideological differences on marketplace regulation are based on different theoretical support, including supply side positions on monetary and fiscal policies promoted by the president, Congress, and the Federal Reserve.

AP US History Curriculum Alignment

Historical Thinking Skills

- Sourcing & Situation 2C: Explain the significance of a source's point of view, purpose, historical situation and/or audience, including how these might limit the use(s) of a source.
- Making Connections 5A: Identify patterns among or connections between historical developments and processes
- Argumentation 6C: Use historical reasoning to explain relationships among pieces of historical evidence.

Unit Alignment

- Topic 8.4: Economy After 1945 Learning Objective D: Explain the causes of economic growth in the years after World War II
- Topic 9.4: A Changing Economy Learning Objective D: Explain the causes and effects of economic and technological change over time.

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