“Hello, I’m Ben Bernanke. I’d Like to Buy Your Government Bond.”

Imagine a knock at a door in the middle of the afternoon. It must be someone selling something, probably vacuum cleaners or religion. A woman opens the door and sees a bald fifty-something man standing on the porch. He’s nice looking, in an academic sort of way, with a well-trimmed gray beard and friendly eyes. He looks good, with a very nice dark blue suit, a laundered white shirt with French cuffs, and a silk tie with a tasteful, conservative pattern. His black shoes shine like he just left the stand at the airport.

“Hello,” he says, “I’m Ben Bernanke. I’d like to buy one of your government bonds.”

“My what?” She says.

“One of your government bonds,” says Mr. Bernanke.

“Say, haven’t I seen you somewhere before? Yeah, on TV, or in the newspaper.”

“Perhaps you have,” he says, “I’m Chairman of the Board of Governors of the Federal Reserve System. Most people call us the Fed.”

“That’s it,” she says, “You’re the guys who change the interest rate.”

“That’s right,” says Mr. Bernanke.

“So, why aren’t you out changing interest rates?” the woman asks, “Instead of coming around here trying to buy, to buy…..”

“Government bonds.” He says.

“Yes, government bonds. Why are you buying government bonds?”

“Because that’s the way we change the interest rate,” Mr. Bernanke says. “When we buy government bonds, we write checks to people who sell them to us. These people deposit these checks in their banks. Because bank deposits are money, we now have more money in banks, and bankers are willing to lend this money at lower interest rates. It’s sort of supply and demand. The supply of money goes up in the banking system, so there’s a greater supply of loans by bankers who have the money. This lowers the price of a loan, which is the interest rate. Are you familiar with supply and demand analysis?”

“Oh yes. I was a finance major in college.”

“Good for you.” says Mr. Bernanke. “Well, what about it?”

“What about what?” she asks.

“Do you want to sell one of your government bonds?”

“I’m not sure. I don’t think so. My portfolio is pretty much balanced.” She says.

“What did you pay for your government bonds?” asks Mr. Bernanke.

“I can’t remember exactly, but it was near the initial time the bonds were issued. It was probably about their face value, $1,000.”

“I’ll give you $1,250.”

“No kidding?” she asks.

“No kidding.” he says.

“Make it $1,300 and you have a deal.” she says.

“Done.” says Mr. Bernanke.

As he wrote the check, Ben Bernanke new the money supply was increasing, and interest rates on bank loans would decline when this and many more checks he would write that day found their way into checking accounts. As an economist, he also knew that rates had already fallen. At the new higher price of $1,300, the yield on the bond had fallen, and a yield is an interest rate. The yield is calculated as the fixed amount of cash received per year from the bond, divided the price. As the price had gone up, the yield (interest rate) had gone down.

“By the way,” the woman says, “What do you do with those bonds, anyway?”

“Oh, I slip them in the bottom right drawer of my desk.” Mr. Bernanke says.

If you are the smart person I think you are, you most likely doubt whether Ben Bernanke, Chairman of the Fed, would go door to door conducting monetary policy. You’re right, he doesn’t. But Mr. Bernanke and his colleagues at the Fed direct the New York Federal Reserve Bank to go into the general market for existing government bonds. To increase the money supply and lower interest rates, they buy bonds. To decrease the money supply and increase interest rates, they sell bonds. It’s much easier than going door to door, but the effect is the same. Bond sellers get checks from the Fed, which they deposit, increasing the amount of money in the banking system. When the Fed sells bonds, bond buyers write checks to the Fed. Their bank account balances fall. With less money in their banks, bankers are stingier with loans, and interest rates rise.

“Being the Fed sounds like a pretty good business.” The woman says.

“We do earn quite a bit of interest on those bonds we own.” Says Mr. Bernanke. “But we have to give most of it back to the U.S. Treasury.”

“That doesn’t seem fair.” She says.

“Oh it’s not so bad. We pay our employees very well, and have the best cafeteria in Washington, and tennis courts right outside.”

“Oh.” She says.