Lecture 26

Tools of Monetary Policy
Tools of Monetary Policy

- Open market operations
  - Affect the quantity of reserves and the monetary base
- Changes in borrowed reserves
  - Affect the monetary base
- Changes in reserve requirements
  - Affect the money multiplier
- Federal funds rate—the interest rate on overnight loans of reserves from one bank to another
  - Primary indicator of the stance of monetary policy
Demand in the Market for Reserves

- What happens to the quantity of reserves demanded, holding everything else constant, as the federal funds rate changes?

- Two components: required reserves and excess reserves
  - Excess reserves are insurance against deposit outflows
  - The cost of holding these is the interest rate that could have been earned

- As the federal funds rate decreases, the opportunity cost of holding excess reserves falls and the quantity of reserves demanded rises

- Downward sloping demand curve
Supply in the Market for Reserves

- Two components: non-borrowed and borrowed reserves
- Cost of borrowing from the Fed is the discount rate
- Borrowing from the Fed is a substitute for borrowing from other banks
- If $i_{ff} < i_d$, then banks will not borrow from the Fed and borrowed reserves are zero
- The supply curve will be vertical
- As $i_{ff}$ rises above $i_d$, banks will borrow more and more at $i_d$, and re-lend at $i_{ff}$
- The supply curve is horizontal (perfectly elastic) at $i_d$
FIGURE 1 Equilibrium in the Market for Reserves
Affecting the Federal Funds Rate

- An open market purchase causes the federal funds rate to fall; an open market sale causes the federal funds rate to rise, shifting the supply curve.

- If the intersection of supply and demand occurs on the vertical section of the supply curve, a change in the discount rate will have no effect on the federal funds rate.
Affecting the Federal Funds Rate (cont’d)

- If the intersection of supply and demand occurs on the horizontal section of the supply curve, a change in the discount rate shifts that portion of the supply curve and the federal funds rate may either rise or fall depending on the change in the discount rate.

- When the Fed raises reserve requirement, the federal funds rate rises and when the Fed decreases reserve requirement, the federal funds rate falls, shifting the demand curve.
FIGURE 2  Response to an Open Market Operation
FIGURE 3  Response to a Change in the Discount Rate
FIGURE 4 Response to a Change in Required Reserves
Open Market Operations

- Dynamic open market operations
- Defensive open market operations
- Primary dealers
- TRAPS (Trading Room Automated Processing System)
- Repurchase agreements
- Matched sale-purchase agreements
Advantages of Open Market Operations

- The Fed has complete control over the volume
- Flexible and precise
- Easily reversed
- Quickly implemented
Discount Policy

- Discount window
- Primary credit—standing lending facility
- Secondary credit
- Seasonal credit
- Lender of last resort to prevent financial panics
  - Creates moral hazard problem
Figure 5: How the Primary Credit Facility Puts a Ceiling on the Federal Funds Rate
Advantages and Disadvantages of Discount Policy

- Used to perform role of lender of last resort
- Cannot be controlled by the Fed; the decision maker is the bank
- Discount facility is used as a backup facility to prevent the federal funds rate from rising too far above the target
Reserve Requirements

- Depository Institutions Deregulation and Monetary Control Act of 1980 sets the reserve requirement the same for all depository institutions.

- The Fed can vary the 10% requirement between 8% to 14%.
Disadvantages of Reserve Requirements

- No longer binding for most banks
- Can cause liquidity problems
- Increases uncertainty
- Recommendations to eliminate