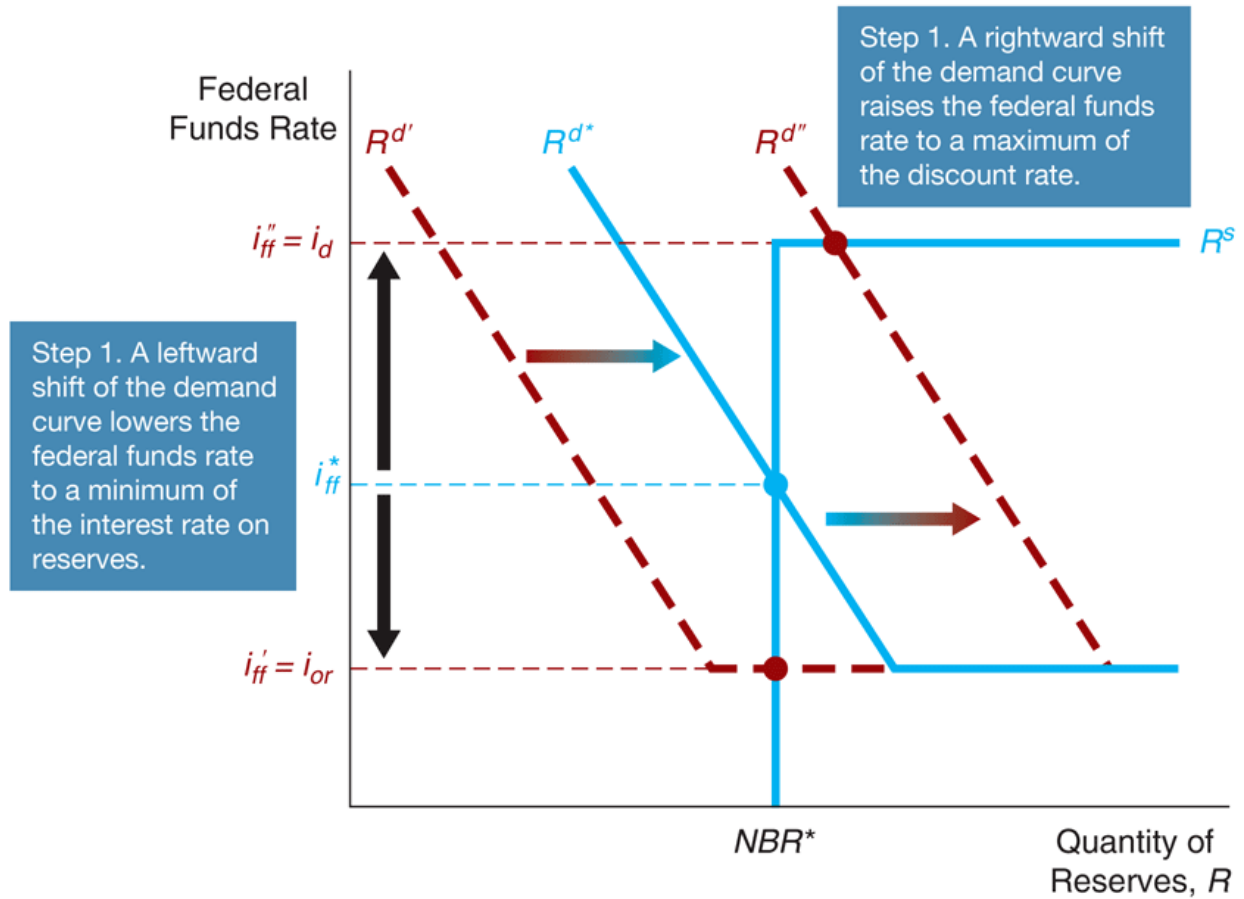


Chapter 16 (cont)

Questions for discussion:

1. During Christmastime, when the public's holdings of currency increase, what defensive open market operations typically occur?
2. Using the supply and demand analysis of the market for reserves, show what happens to the federal funds rate, holding everything else constant, if the economy is surprisingly strong, leading to an increase in checkable deposits.
3. "The only way the Fed can affect the level of borrowed reserves is by adjusting the discount rate." Is this statement true, false, or uncertain? Explain your answer.

How the Fed’s operating procedures limit fluctuations in the federal funds rate



Conventional Monetary Policy tools

1) OMO

- The Fed buys and sells U.S. Gov’t securities in the secondary market in order to adjust the supply of reserves in the banking system.
- The Federal Reserve's most flexible means of carrying out monetary policy.
- The Fed does not participate directly in the Federal Funds market.
- The Fed participates indirectly through open market operations. The Fed adjust the level of reserves in the banking system to target the FF rate, influence short-term interest rates and reach monetary policy goals.

Advantages of OMO

- Implemented quickly
- Fed has complete control
- Flexible and precise
- Easily reversed

2) Discount lending

Discount window -

Types of Loans –

Primary Credit (sound credit)

- Short-term, typically overnight, borrowed from the primary credit facility or standing lending facility
- Historically 100 basis points above target Fed Funds Rate. Currently 50 bp

Secondary Credit

- For banks that do not qualify for primary credit
- Historically 150 basis points above target Fed Funds Rate.

Seasonal Credit

- Small banks with seasonal patterns of deposits and need cyclical farm loans

Lender of Last Resort

- Such lending is the Fed's primary tool for ensuring short-term financial stability, for eliminating bank panics, and preventing the sudden collapse of institutions that are experiencing financial difficulties.

Advantages and Disadvantages of Discount Policy

- Used to perform role of lender of last resort
 - Important during the subprime financial crisis of 2007-2008.
- 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
- Lender of last resort to prevent financial panics
 - Creates moral hazard problem

3) Reserve Requirements

- Depository Institutions Deregulation and Monetary Control Act of 1980 (MCA) subjected all banks to the same reserve requirements as member banks
- To reduce burden on small banks, first few million \$ in DD are exempt, then 3% up to about \$71 mil., then 10%

Advantages

- Powerful effect

Disadvantages

- Small changes have very large effect on M^s
- Raising causes liquidity problems for banks
- Frequent changes cause uncertainty for banks

4) Interest on Reserves

- Helps set a floor on the federal funds rate

Additional Reading: Section on nonconventional monetary policy

Operational Policy at the European Central Bank

- Main Refinancing Rate: Set via weekly auction of 2-week repurchase agreements. Inject and withdraw reserves in the banking system. Comparable to the Fed's target FFR.
- Marginal Lending Facility
 - 100 basis points above target refinancing rate
 - Deposit Rate: Banks earn interest on excess reserves.
- Reserve Requirements
 - 2% applied to checking accounts
- Overnight Cash rate (Market FFR)

Chapter 17 – Conduct of Monetary Policy Strategy and Tactics

- Price stability (low stable inflation)
 - Nominal Anchor – A nominal variable that policy makers use to achieve price stability such as the money supply or the inflation rate. The idea is to “anchor” inflationary expectations
 - Low Unemployment (high stable growth)
- Should the central bank have policy discretion regarding goals or be tied to a rule?
- The time inconsistency problem of discretionary policy
 - Definition: A scenario in which policymakers have an incentive to renege on a previously announced policy once others have acted on that announcement
 - Destroys policymakers’ credibility, thereby reducing effectiveness of their policies
- Example: To reduce expected inflation, the central bank announces it will tighten monetary policy and increase interest rates ... but faced with high unemployment, the central bank may be tempted to cut interest rates.
- To encourage investment, the government announces that it will not tax income from capital. ...but after factories have been built, the government is tempted to renege on its promise to raise more tax revenue from them.
- In general, rational agents understand the incentive for the policymaker to renege, and this expectation affects their behavior.
- The solution is to take away the policymaker's discretion with a credible commitment to a fixed policy rule.