

The Tools of Monetary Policy

ECO 420 Lecture 10.1.

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1 How Do the Tools of Monetary Policy Work?

What Does a Central Bank Do?

The main goals of the central bank are:

- use monetary policy tools to prevent crises
 - 1 set reserve requirements
 - 2 determine discount rate
 - 3 make open market operations
- intervene when crises occur

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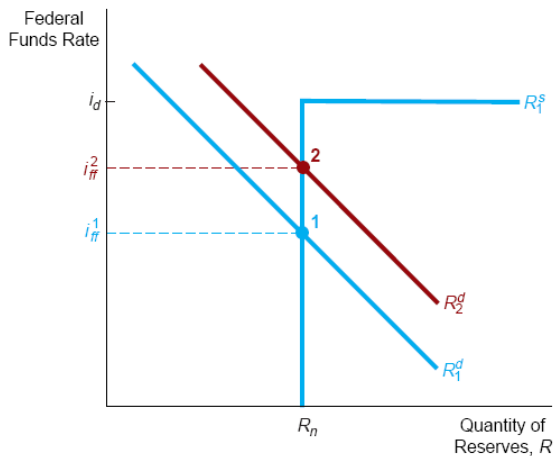
What is the impact of each of these tools on bank reserves? Why do we care about bank reserves? Money supply.

How Does Reserve Requirement Instrument Work?

Suppose the Central bank increases RRR?

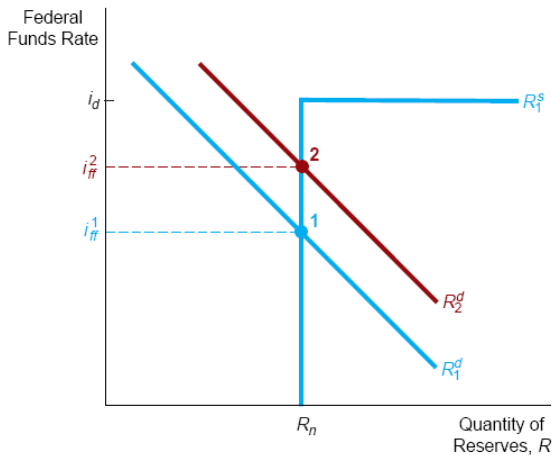
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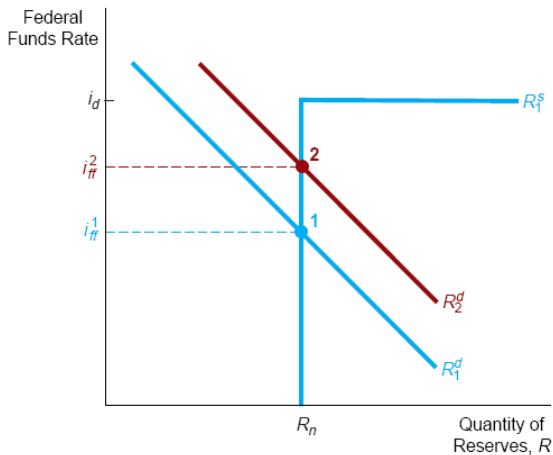
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Interbank interest rate (FED Funds Rate) \uparrow ,

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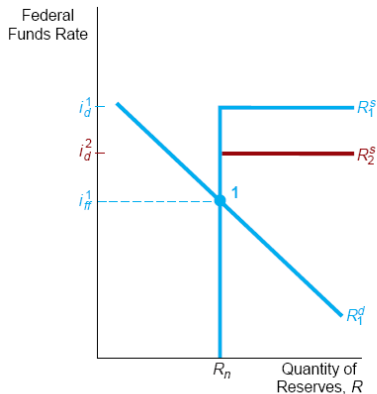
Interbank interest rate (FED Funds Rate) \uparrow , $M_s \downarrow$

How Does the Discount Rate Instrument Work?

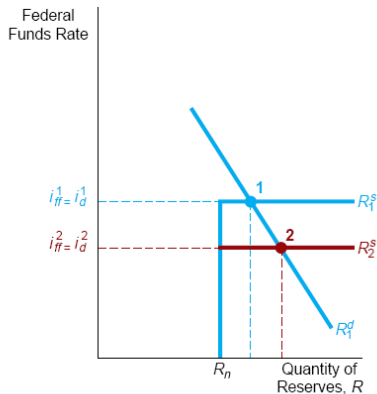
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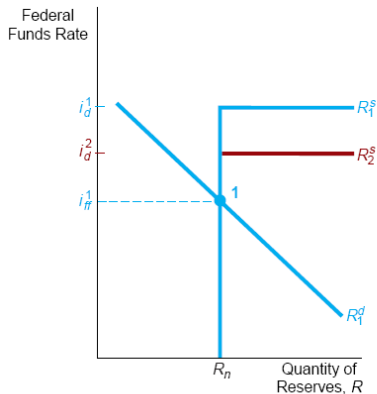
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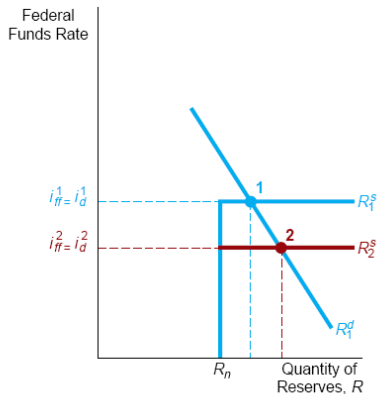
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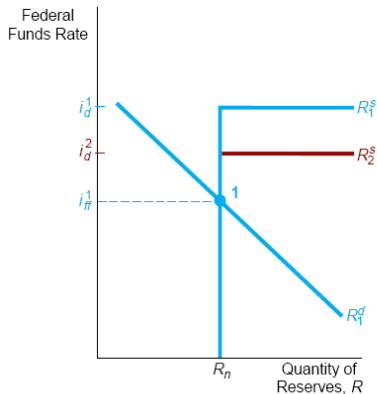


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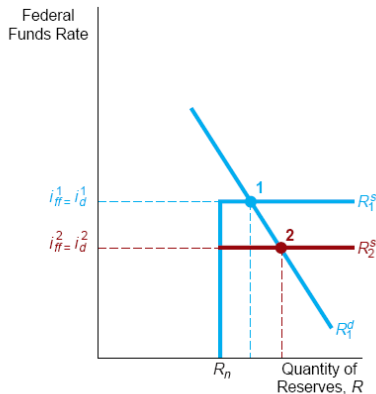
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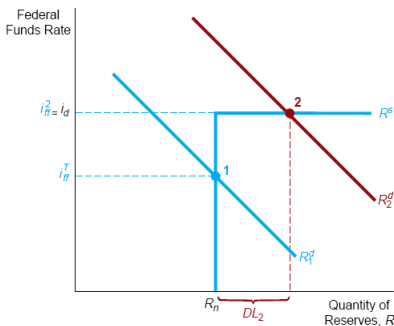


(b) Some discount lending

Interbank interest rate (FED Funds Rate) \downarrow , $M_s \uparrow$.

Why Does the Central Bank Need This Instrument?

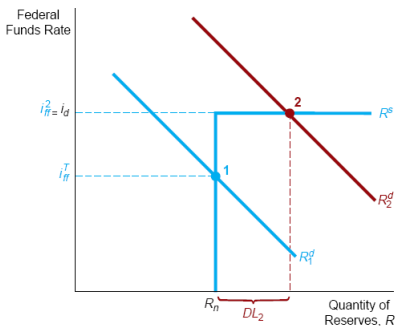
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- 2 A roof for the targeted interbank interest rate



- 3 A lender of last resort: prevent crises.

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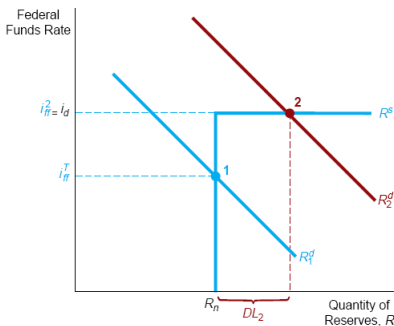
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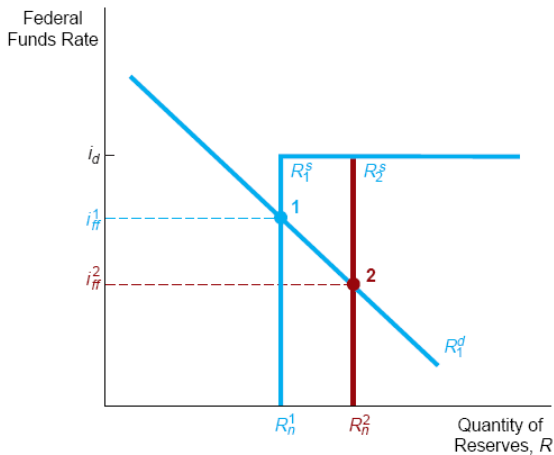
- 3 A lender of last resort: prevent crises. Disadvantages? Moral hazard.

How Do the Open Market Operations Work?

Suppose the Central bank buys some G bonds?

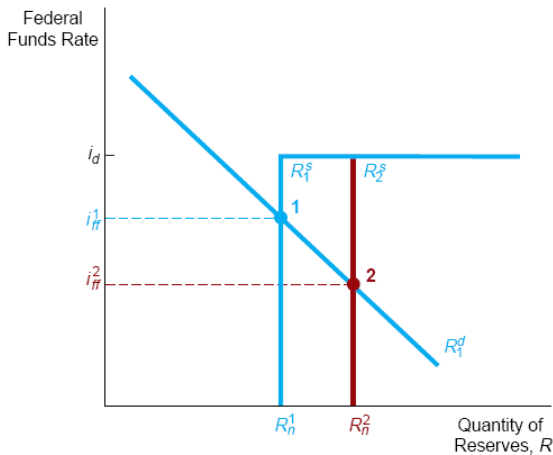
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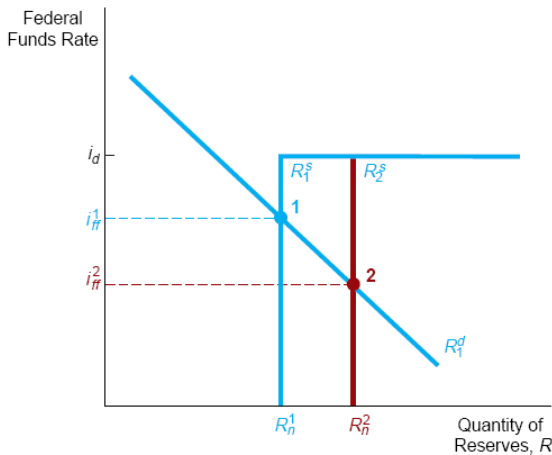
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- 3 Quick: a matter of day in US (a week in Europe)