

# The Tools of Monetary Policy

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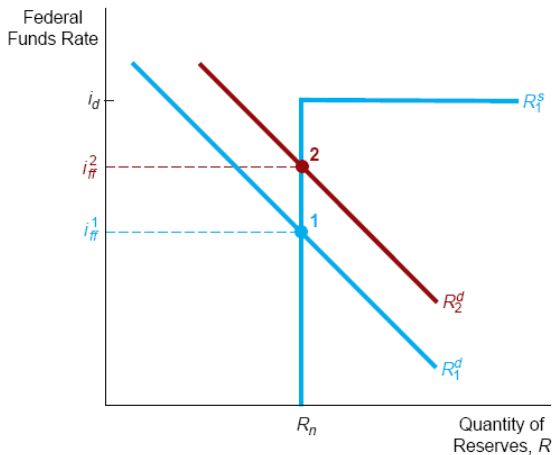
What is the impact of each of these tools on bank reserves? Why do we care about bank reserves? Money supply.

# How Does Reserve Requirement Instrument Work?

Suppose the Central bank increases RRR?

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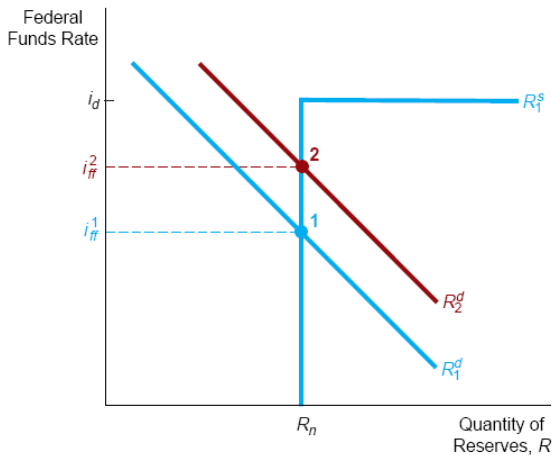
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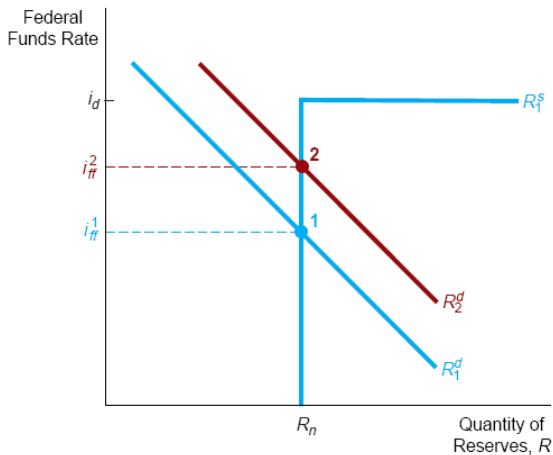
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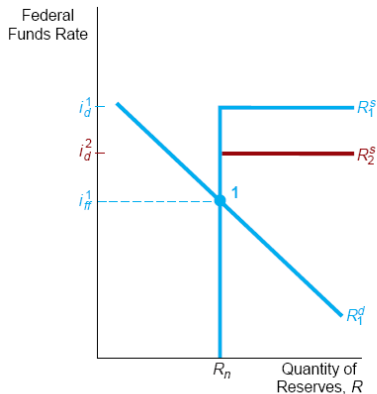
Interbank interest rate (FED Funds Rate)  $\uparrow$ ,  $M_s \downarrow$

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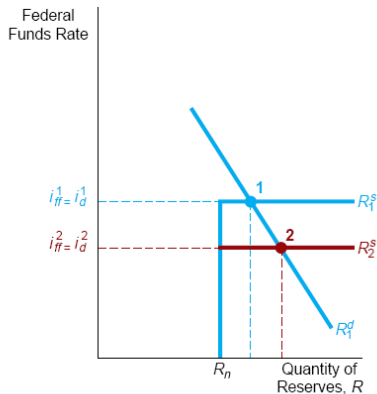
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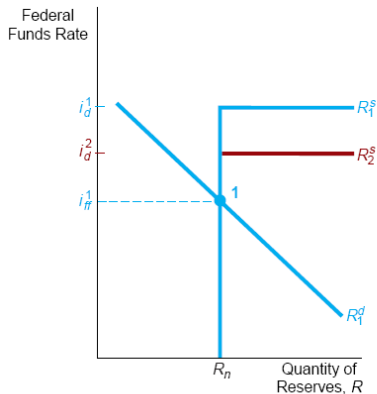
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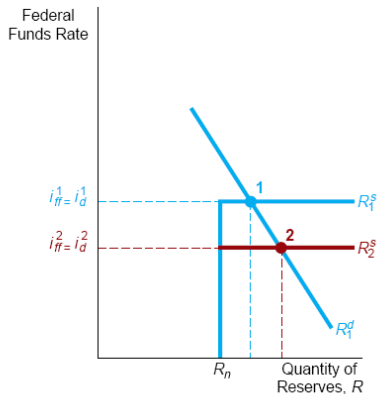
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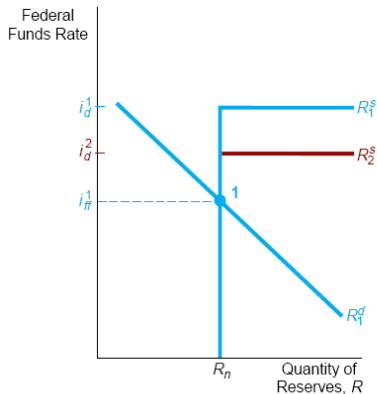


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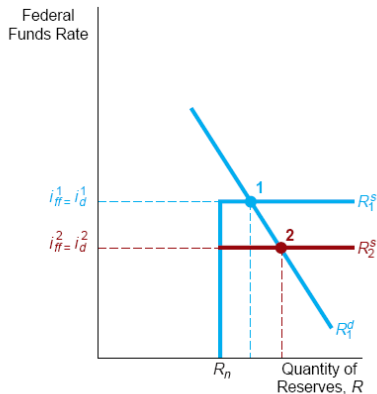
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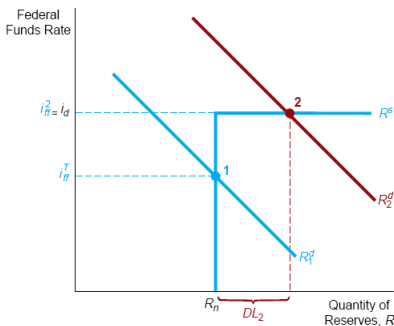


(b) Some discount lending

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

# Why Does the Central Bank Need This Instrument?

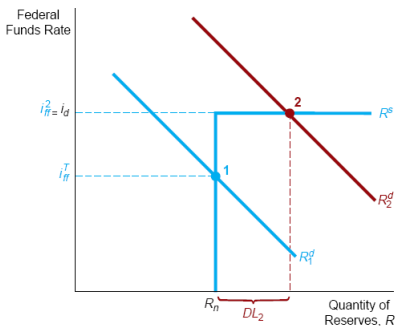
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- 2 A roof for the targeted interbank interest rate



- 3 A lender of last resort: prevent crises.

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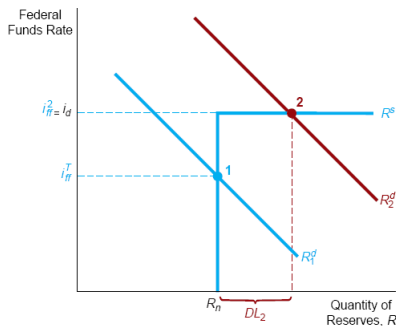


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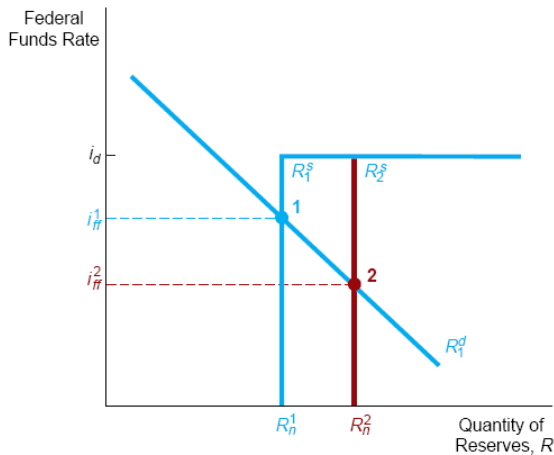
- 3 A lender of last resort: prevent crises. Disadvantages? Moral hazard.

# How Do the Open Market Operations Work?

Suppose the Central bank buys some G bonds?

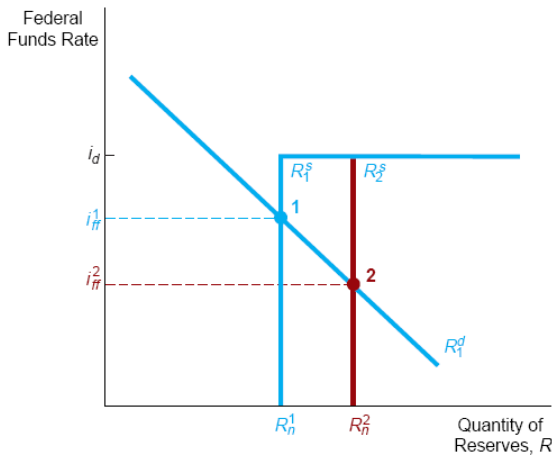
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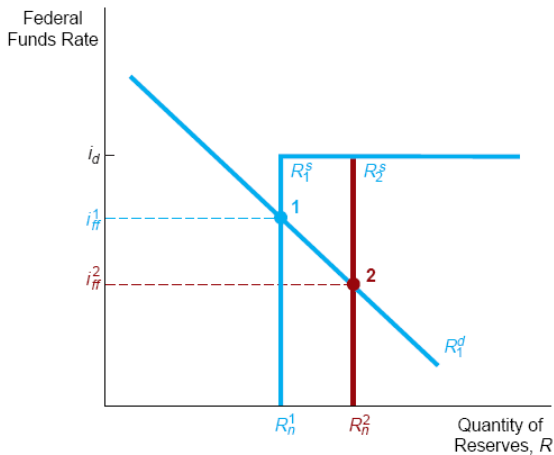
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- 2 Easy to reverse in case of overshooting
- 3 Quick: a matter of day in US (a week in Europe)