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LECTURE 34: MONETARY POLICY I

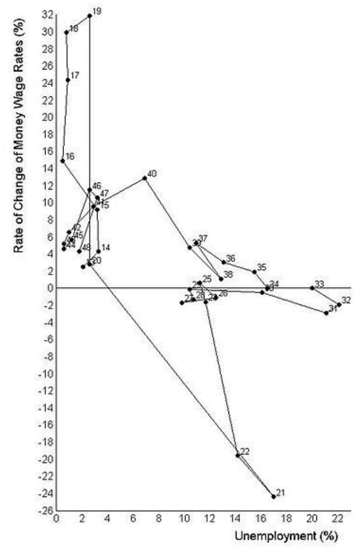
I. What is a central bank?
   a. A state-backed bank responsible for implementing monetary policy. (Engaging in actions that alter the interest rate, exchange rate, how private banks are run, etc.)
   b. "Bank" in this case is a little deceiving; a central bank isn't trying to make loans or earn a profit. It is more of an authority than a bank. But the terminology "central bank" is the norm so we will use it here.
   c. Because most countries use a fiat currency, the bank must print new money—the government's the only one that can supply it.

II. The Federal Reserve System (the "Fed")
   a. This is a network of the U.S.'s central bank, managed by the Board of Governors.
      i. There are twelve Federal Reserve Banks in the U.S. spread throughout the country. Each Bank is in charge of a District.[1]
      ii. The Board makes policy decisions which determine the monetary control of the United States. When the government increases the money supply, the Board made the decision.
      iii. Each board member is elected to a fourteen-year term. This lengthy term to help insulate the Board from political pressures.
      iv. The chair of the Board of Governors is currently Janet Yellen.[2]
   b. The Fed has a dual mandate: keep prices stable and keep unemployment low.
      i. Keeping prices stable typically means fighting inflation. The Fed is concerned about deflation as well, but historically the major concern in inflation.
      ii. Over the years, the Fed has adopted a second mandate: low unemployment. Money is incredibly powerful in how it affects the performance of the economy, and, by extension, the level of employment.

[1] The banks are in Boston (1); New York (2); Philadelphia (3); Cleveland (4); Richmond (5); Atlanta (6); Chicago (7); St. Louis (8); Minneapolis (9); Dallas (10); Kansas City (11); and San Francisco (12).
[2] As of April 2014; before Janet Yellen was Ben Bernanke; before Ben Bernanke was Alan Greenspan.

iii. The problem is in the short-run, there is a trade-off between inflation and unemployment. High inflation means low unemployment and vice-versa. We call this the Phillips Curve, after the economist who first articulated this historic relationship, William Phillips.

iv. This graph, from Phillips (1958), illustrates the relationship between inflation and unemployment from 1913 to 1948 in the United Kingdom.



III. Lender of last resort

a. In order to assuage the possibility of a systematic bank failure, the Fed is sometimes employed as a "lender of last resort."

b. When a bank is in danger of failing or is in desperate need of assistance, the Fed acts as a safety net and lends the needed amount to help keep it afloat.

c. While this adds a great deal to stability and cultivates public confidence in the US banking system, it also creates a moral hazard problem.

i. Suppose you go to a business conference in Las Vegas and your company agrees to reimburse you for any money you lose while gambling. Even if you're hesitant about gambling, this safety net against losses completely changes the calculation. The smart thing to do is to gamble. A lot.

ii. This is the problem with the Fed's role as a safety net for banks. Knowing the Fed will save them if they really screw up, banks have an incentive to take risks they wouldn't otherwise take.

iii. For example, in the wake of the subprime mortgage crisis the U.S. government bailed out several "too-big-to-fail" banks that faced a crippling number of defaults.