

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.
- III. Types of interest rates and the multiplier
 - a. The Fed operates by altering the interest rate through the money supply. But there are multiple interest rates: rates banks borrow from

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.

the Fed, rates banks borrow from each other, rates banks grant savers, rates bank charge lenders, and so on.

- b. The *federal funds rate*—the interest rate which banks lend from one another on overnight loans of reserves—is the key interest rate for monetary policy. It's the interest rate which seeps into all sectors of economy and thus directly relates to economic growth.
 - i. It's called the federal funds rate because it involves loans banks make to each other so they can meet the federally mandated reserve requirement.
 - ii. Think of the Fed trying to influence the market for wood products. The best way to do this would not be focusing on the prices of wooden chairs, sawhorses, and toys for that would only capture one aspect of the market. Instead, they would be best to focus on a price that affects each firm in the market they are trying to understand: the price of wood.
 - iii. Similarly, focusing on just a handful of interest rates of a handful of banks wouldn't do much. But focusing on the price they all share—the price they charge each other—allows influence of the whole industry.
- c. In addition to the federal funds rate, we should be made aware of the *discount rate*—the rate at which banks borrow from the Federal Reserve. Banks use this option when they have unexpected and immediate needs for funds.
- d. The monetary multiplier
 - i. The fiscal multiplier exists because the spending of one person becomes the income of another person.
 - ii. When banks lend money, something similar happens. Some (not all due to required reserves) of the money you save in Bank A goes to someone else as a loan. They put that loan in Bank B to use while they spend it.
 - iii. Bank B uses a portion of this money to lend out to someone else who puts it in Bank C, and so on and so on.
 - iv. Like the fiscal multiplier, the *monetary multiplier* describes the how much the money supply expands with each dollar increase in reserves. It equals $1 / \text{reserve requirement}$.
 - v. If the reserve requirement is 10% (0.10) and there's an increase of \$2,000 in reserves, the money supply increases by \$20,000.