Chapter 17
TOOLS OF MONETARY POLICY

The Market for Reserves and the Fed Funds Rate

Demand Curve for Reserves
1. \( R = RR + ER \)
2. \( i \downarrow \), opportunity cost of \( ER \downarrow \), \( ER \uparrow \)
3. Demand curve slopes down

Supply Curve for Reserves
1. \( i \uparrow \), discount loans \( \uparrow \), quantity of Reserves supplied \( \uparrow \)
2. Supply curve slopes up

Market Equilibrium
\( R^d = R^s \) at \( i_{ff} \)

Supply and Demand for Reserves

Response to Open Market Purchase or Lowering of Discount Rate

Open Market Purchase
Reserves \( \uparrow \), \( R^e \) to right, \( i \downarrow \) from \( i_{ff} \) to \( i_{ff}' \)

Discount Rate \( \downarrow \)
Discount Borrowing \( \uparrow \), Reserves \( \uparrow \), \( R^e \) to right, \( i \downarrow \) from \( i_{ff} \) to \( i_{ff}' \)
Response to Open Market Purchase or Lowering of Discount Rate

Response to Rise in Reserve Requirements

Rise in Required Reserve Ratio

$RR \uparrow$, $R^d$ to right, $i \uparrow$ from $i^1_{ff}$ to $i^2_{ff}$
Open Market Operations

2 Types
1. Dynamic:
   Meant to change MB
2. Defensive:
   Meant to offset other factors affecting MB, typically uses repos

Advantages of Open Market Operations
1. Fed has complete control
2. Flexible and precise
3. Easily reversed
4. Implemented quickly

Discount Loans

3 Types
1. Adjustment Credit
2. Seasonal Credit
3. Extended Credit

Lender of Last Resort Function
1. To prevent banking panics
   *FDIC fund not big enough*
   *Examples:* Continental Illinois and Franklin National
2. To prevent nonbank financial panics
   *Examples:* 1987 stock market crash

Announcement Effect
1. Problem: False signals

Discount Policy

Advantages
1. Lender of Last Resort Role

Disadvantages
1. Confusion interpreting discount rate changes
2. Fluctuations in discount loans cause unintended fluctuations in money supply
3. Not fully controlled by Fed

Proposed Reforms
1. Abolish discounting (Milton Friedman)
   A. Eliminates fluctuations in $M^s$
   B. However, lose lender of last resort role
2. Tie discount rate to market rate
   A. $i - i_d = \text{constant}$, so less fluctuations of $DL$ and $M^s$
   B. Easier administration
   C. No false announcement signals

Reserve Requirements

Advantages
1. Powerful effect

Disadvantages
1. Small changes have very large effect on $M^s$
2. Raising causes liquidity problems for banks
3. Frequent changes cause uncertainty for banks
4. Tax on banks

Proposed Reforms
1. Abolish reserve requirements
2. 100% reserve requirements (Milton Friedman)