

# Lecture 16: Monetary Policy

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Prof. Robert Shiller, Yale University

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# Bank of England 1694

- Granted monopoly on joint stock banking by Parliament in return for war loans.
- Not an invention of economists, started off as a powerful bank that was able to demand that other banks held deposits in it.
- Did not have government monopoly on note issue, but achieved it through its monopoly power.
- Independence not until 1997

# Gold Standard

- England 1717
- US 1900
- England abandoned 1931
- US abandoned 1933
- No country remains
- Leads to redefinition of central banks

# Federal Reserve System - 1913

- Created flexible money supply, responding to business situation
- Fed was lender of last resort
- 12 Regional banks, each presides over a district.
- Two in Missouri
- Board of Governors in Washington DC

# Banking Panic of 1933

- Despite Fed's lending, a banking panic forced Roosevelt to declare a banking holiday
- Led to establishment of Federal Deposit Insurance Company (FDIC) opened doors in 1934, funded by premia paid by banks
- No U. S. panics since

# European Central Bank

- Founded 1998
- Eurozone members and non Eurozone members
- Had to construct Eurozone data for first time
- President Jean-Claude Trichet since 2003
- Otmar Issing

# Bank of Japan

- Toshihiko Fukui, Governor since 2003
- Interest rates have been brought down virtually to zero
- Purchase of government bonds to try to stimulate economy
- Proposals to buy foreign bonds, dollars
- Japanese banks sitting on unlent funds
- Independence 1997

# Monetary Problem in Japan

- Inflation often negative
- Gensaki rate zero
- Real rate often substantial, Bank of Japan can do nothing
- Svensson proposal to peg yen at, say, 160 to dollar, unheeded by conservative B of J



# Reserve Requirements 2008

- Reserve requirements are progressive, larger for larger size
- Largest size requirements:
- Net transaction accounts (over \$43.9 million) 10% (since 12/20/2007)
- Nonpersonal time deposits 0% since 12/27/90
- Eurocurrency accounts 0% since 12/27/90

# Term Auction Facility

- Created December 12, 2007
- Created in collaboration with Banks of Canada, England and ECB and Swiss National Bank
- Auction determines interest rate determined on loan, quantity fixed and preannounced
- Fed takes collateral
- \$80 billion already loaned, promise to increase that to \$100 billion (hasn't happened yet)

# Term Securities Loan Facility Announced March 11, 2008

- Said it will lend up to \$200 billion U.S. Treasury Securities in Exchange for Collateral to primary dealers
- 28-day term
- Auctions will be held, first auction is March 27, 2008 (tomorrow)
- There is a lending rate on the Treasury Securities, determined by the auction.

# Primary Dealers Credit Facility

- Announced March 16, 2008, opened for business March 17 (Monday)
- Loans to Prime Dealers (not just banks) with collateral including subprime loans
- They can borrow at the discount rate, same as depository institutions, now 2.5%
- An emergency measure, the Facility created only for six months

# List of the 20 Primary Dealers 2007

- BNP Paribas Securities Corp.
- Banc of America Securities LLC
- Barclays Capital Inc.
- Bear, Stearns & Co., Inc.
- Cantor Fitzgerald & Co.
- Citigroup Global Markets Inc.
- Countrywide Securities Corporation[6]
- Credit Suisse Securities (USA) LLC
- Daiwa Securities America Inc.
- Deutsche Bank Securities Inc.
- Dresdner Kleinwort Wasserstein Securities LLC.
- Goldman, Sachs & Co.
- Greenwich Capital Markets, Inc.
- HSBC Securities (USA) Inc.
- J. P. Morgan Securities Inc.
- Lehman Brothers Inc.
- Merrill Lynch Government Securities Inc.
- Mizuho Securities USA Inc.
- Morgan Stanley & Co. Incorporated
- UBS Securities LLC

# FOMC

- Federal Reserve Board, President of New York Fed, and four other reserve bank presidents.
- Meets roughly once a month
- Since 1994, has made immediate announcements of policy decision
- Since 1997 has made immediate announcements of federal funds rate target

# Changed Definition of Discount Rate

- Prior to 2003, discount rate was usually 50 basis points lower than the funds rate
- Then, borrowing at discount window carried stigma
- On Jan 9, 2003, Fed raised discount rate above funds rate, eliminating stigma
- Primary discount rate (sound banks) about 100 basis points above funds rate
- Secondary discount rate (banks that do not qualify) 50 points above primary discount rate

# Stabilization and 1980 and 1981-2 Recessions

- New Fed Chairman Paul Volcker thought inflation had gotten out of hand.
- Created “the great recession” that stopped inflation
- Many foreign countries similar experience



# Stabilization and 1990-1991 recession

- Fed was misled by inaccurate GDP numbers, didn't see recession coming.
- First started cutting interest rates Dec. 1990, after recession had been on for six months

# The 2001 Recession

- Not brought on by rising interest rates to curb inflationary pressure
- A post-stock-market bubble recession
- Dramatic cuts in rates starting early 2001
- Recession short lived (March-November)
- Housing boom started by rate cuts

# 2008 Recession?

- Consumer confidence already below bottom of 2001 recession
- Near bottom of 1990-91 recession
- Financial crisis is worse than in either of those recessions