Monetary policy 101

Juan F. Imbet

Banking and Financial Intermediation

Introduction

- Monetary policy is one of the two principal means (the other being fiscal policy) by which government authorities in a market economy regularly influence overall economic activity.
- Governments carry out monetary policy, typically via specialized agencies called central banks, by exploiting their control over the supply of certain kinds of claims against the central bank.
- In most financial systems, banks in particular are legally required to hold claims against the central bank in order to create deposits and make loans, and so the central bank's control over the supply of claims against itself also gives it a form of control over the economy's money and credit.

How Monetary Policy Arises

- Providing money for use in everyday transactions has been a commonplace function of governments for well over two thousand years.
- In the US the constitution explicitly reserves to Congress the power to ”coin money and regulate the value thereof...”
- Over time, most governments have created specialized central banks to which they delegate this function.
- The Swedish Riksbank was established in 1668, the Bank of England in 1964, the Banque de France in 1800, and the US central bank, the Federal Reserve System in 1914.

How Monetary Policy Arises

- In early days money provided by governments took the form of coins, and therefore required a supply of gold, silver or other valued metal.
- In the mid eighteen century some governments also began to issue paper currency. These paper claims gave the bearer the right to demand payment in coin, with the only exception under unusual circumstances like wars.
- The perceived need for such banking disappeared, so that today almost all paper currency is "fiat money". It has value only because the government mandates that within the country's borders.

How Monetary Policy Arises

- In principle, the existence of fiat currency alone would be sufficient to enable a government to carry out a primitive form of monetary policy.
- Central banks conduct monetary policy differently, by exchanging claims against themselves for other claims against the government. Typically interest-bearing bills, notes and bonds. (The government borrows from the central bank).
- Central banks nowadays have other mandates that differ from simple financing the government.

How Monetary Policy Works

- The chief objectives of monetary policy in modern times have typically been to maintain stability of a country's general price level, and to promote levels of output and employment.
- Other often accepted goals include maintaining balance in a country's international trade, preserving stability in its financial markets, and fostering increased capital investment.
- Central banks' monetary policy operations take place exclusively in the financial markets.
- Monetary policy requires a "transmission mechanism".

Demand for central bank liabilities

- Individuals in a country own a claim on a country's central bank. (Currency)
- Individuals and companies hold and exchange central bank liabilities.
- In the past, sudden large increases in the demand for currency when not met by an increase in currency supplied by the central bank, often triggered financial crises and consequent economic downturns.
- After WWII, most central banks have passively supplied whatever changing volume of currency the public seeks. As a result, demand for currency typically plays no significant role in the monetary role process.
- What matters are the claims that the country's private sector banks hold in the form of deposits (reserves) at the central bank. For several reasons, the banks' need for these reserves expands or contracts roughly in pace with the overall level of activity taking place in the nonfinancial economy.
- Reserves are proportional to the volume of deposits, and since the volume of loans is proportional to the amount of deposits available to invest, reserve requirements affect the creation of loans.

Demand for central bank liabilities

- Even if a country requires no reserve requirements, their banks hold balances at the central bank to use for settling the claims among themselves that arise whenever an account holder at one bank deposits a check drawn from another bank.
- These situations can easily be settled by shifting reserves on the books of the central bank.
- Risk free banks are ideal in providing interbank settlement services.

The central bank as monopolist

- The central bank's power to conduct monetary policy stems from its role as the sole source of reserves.
- **Open market operations**: Buying or selling securities (normally debt obligations of the CB country's) in the market. When a central bank buys securities, it makes payment by increasing the reserve account of the seller's bank.
- Although private-sector banks regularly trade existing reserves, no bank can change the total volume of reserves in the economy.
- An expansionary open market operation (in which the central bank expands the supply of reserves) creates downward pressure on short-term interest rates.
- A contractionary open market operation puts upward pressure on short-term interest rates.

Reserve Requirements

- In a banking system that imposes RR an alternative way for the central bank to achieve the same objective is to adjust the required percentage of deposits required to be held in the central bank.
- Lowering the reserve requirement (reducing the demand for reserves) has roughly the same expansionary effect as an open market operation.
- Raising reserve requirements is a contractionary policy.

Central Bank Lending

- Another way in which central banks can change the supply of reserves is by lending reserves directly to some bank.
- In countries that have reserve requirements this direct lending is normally small in scale.
- In countries without reserve requirements, lending directly to banks is an important part of how the central bank supplies reserves, and it provides an alternative mechanism for controlling interest rates.

Effects on the nonfinancial economy

- To have a real economy impact, short term interest rates should affect real output and employment.
- Long term interest rates move in the same direction as short term interbank rates (cost of capital).
- Banks ability on create credit depends directly on having reserves.

The Design of Monetary Policy

- Tradeoff between boosting output and controlling inflation.
- Reserve Requirements
- Supply of Money (Friedman's view $\neq$ Neo-Keynesian view)
- Change amount of reserves by changing the supply
- Set exchange rate (less common)

Central bank independence

- The performance of central banks that are more independent from the government tends to be better.
- Independence limits the impact of coinage.
- More independent central banks deliver lower inflation.
- Central Banks' objective nowadays is mostly inflation based. Having clear defined inflation targets makes the CB's job more transparent.
- Maintaining low inflation and full output and employment is not realistic.