

# Monetary Policy and the Fed

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Econ520

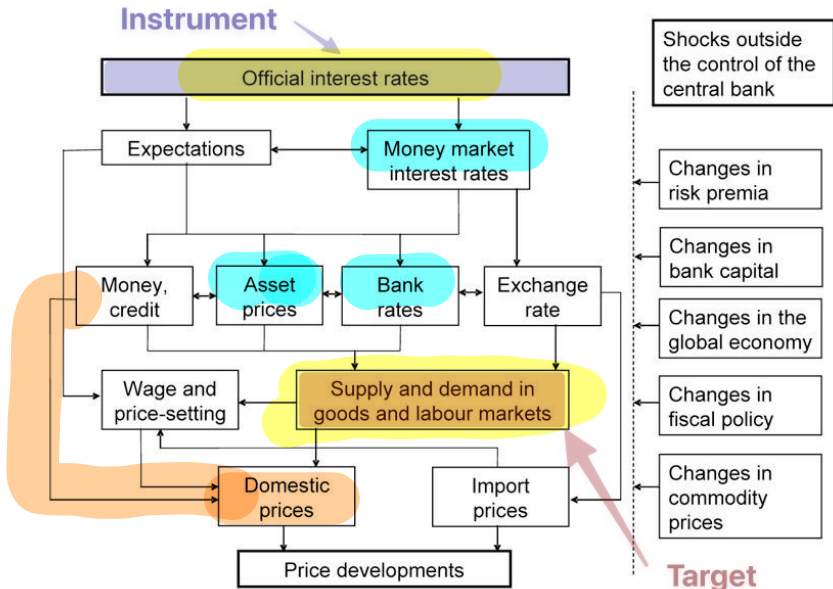
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# Topics

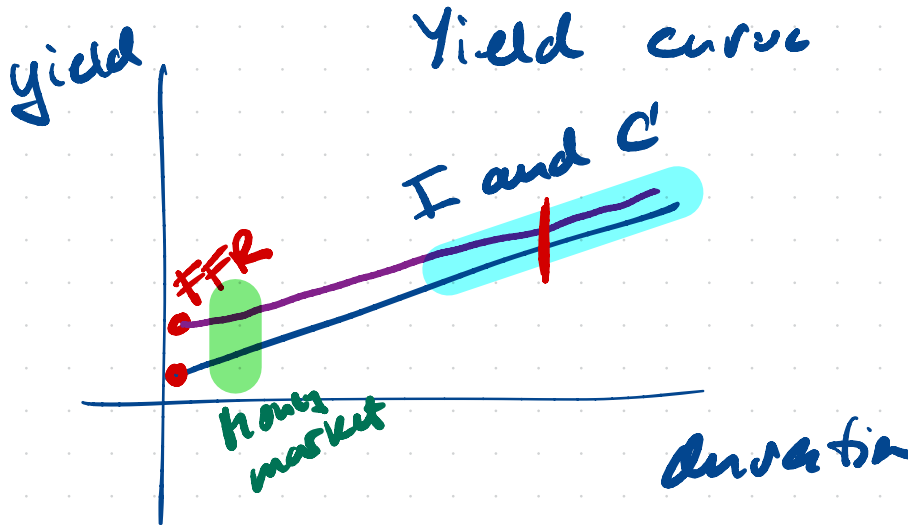
How does the Fed operate in reality?

It complicated...

# Traditional Monetary Policy



Source: ECB, Transmission mechanism of monetary policy



# The Fed Funds Rate

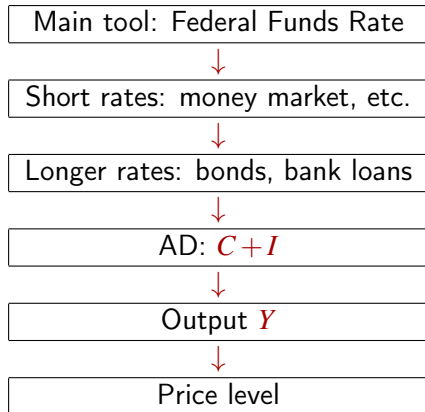
Traditionally, the Fed's main policy tool is the **Federal Funds Rate (FFR)**.

- ▶ Banks borrow from each other over night
  - ▶ moving excess liquidity around
  - ▶ the FFR is the interest rate charged for this borrowing
- ▶ The Fed controls the FFR by adjusting the liquidity available to banks
  - ▶ e.g., by buying and selling bonds in exchange for reserves held with the Fed

## Key point

The Fed directly only controls a very short term (overnight) interest rate.

# Monetary Transmission Simplified



# Monetary Transmission

Aggregate demand depends on **long-term** interest rates

- ▶ mortgages and consumer loans
- ▶ bank loans to firms

The Fed has **no direct control** over these rates.

Monetary transmission means:

- ▶ How do Fed actions (e.g., changes in the FFR) translate into changes in aggregate demand?
- ▶ There are several channels.

# Monetary Transmission: Channels

Higher FFR works through these channels:

## 1. Interest rates

investors hold more short term reserves  $\implies$  sell long-term bonds  $\implies$  **bond interest rates** rise

## 2. Asset prices

lower stock prices  $\implies$  **wealth effects** reduce consumption  
higher return on competing assets  
higher cost of capital  $\implies$  lower **investment**

## 3. Credit supply

higher cost of funds for banks  $\implies$  less credit creation

## 4. Inflation expectations

lower expected inflation  $\implies$  higher real interest rates



# Problems

Transmission is quite indirect

- ▶ The Fed directly controls only the FFR
- ▶ Aggregate demand depends on longer interest rates
- ▶ Long rates may not move as expected

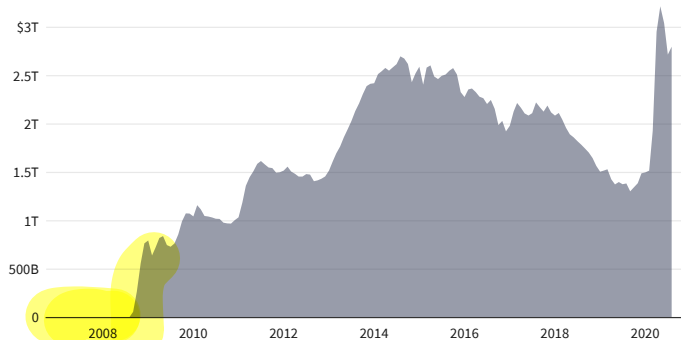
This is the key difficulty of monetary policy:

- ▶ long and variable lags
- ▶ it typically takes about **a year** for the real effects of a monetary stimulus to take full effect

## Example: The Great Financial Crisis

- ▶ Banks soaked up all of the liquidity generated by the Fed as excess reserves
- ▶ Essentially no credit creation

### Excess Reserves of Depository Institutions: 2007—Present



Source: [St. Louis Fed](#)

## Digression: How do Banks Work?

The main function of commercial banks:

- ▶ take in deposits
- ▶ give out loans (to finance investment and consumption)

Profit: the spread between loan rates and deposit rates.

Fed reserves:

- ▶ banks must hold a certain fraction of their deposits in low interest Fed accounts  
(reserve requirement - abolished in 2020)
- ▶ when banks fear uncertainty, they hold **excess reserves** instead of giving out loans

Excess reserves indicate that banks do not lend as much.

# Unconventional Monetary Policy

# Conventional Monetary Policy

What we described so far is “conventional” monetary policy.

- ▶ what the Fed has been doing for decades

Recently, conventional monetary policy has stopped working.

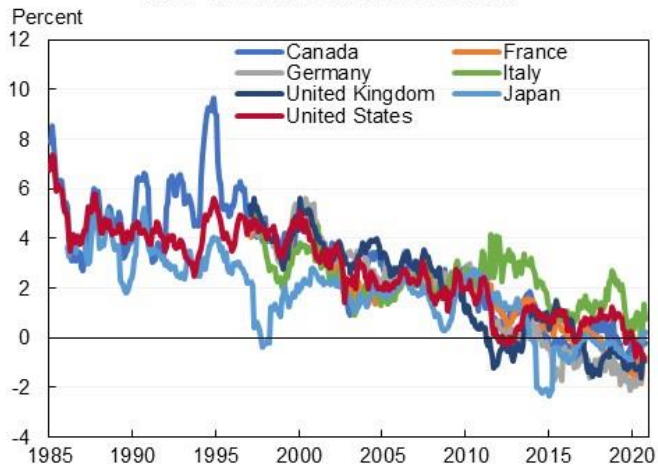
- ▶ even zero interest rates are no longer low enough

Since the Great Financial Crisis of 2009, the Fed has used “unconventional” tools

- ▶ which are, by now, pretty conventional

# Falling Interest Rates

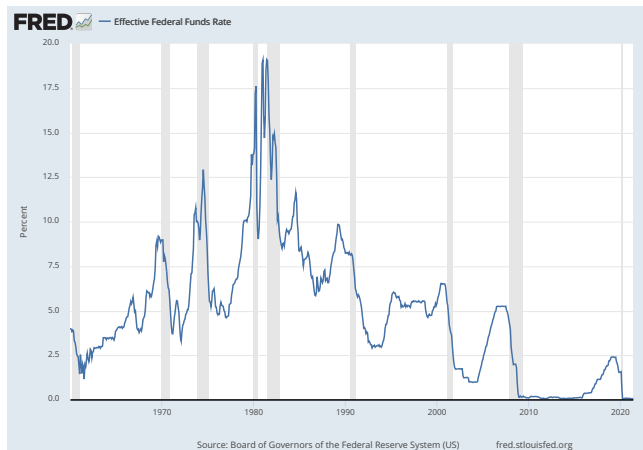
**Figure 1**  
**Real Ten-Year Benchmark Rate**



Source: Furman and Summers (2020)

Real interest rates have been falling (not clear why).

# The Zero-Lower Bound



The FFR has trended down.

In recessions, it hits the zero lower bound – now what?

# Quantitative Easing

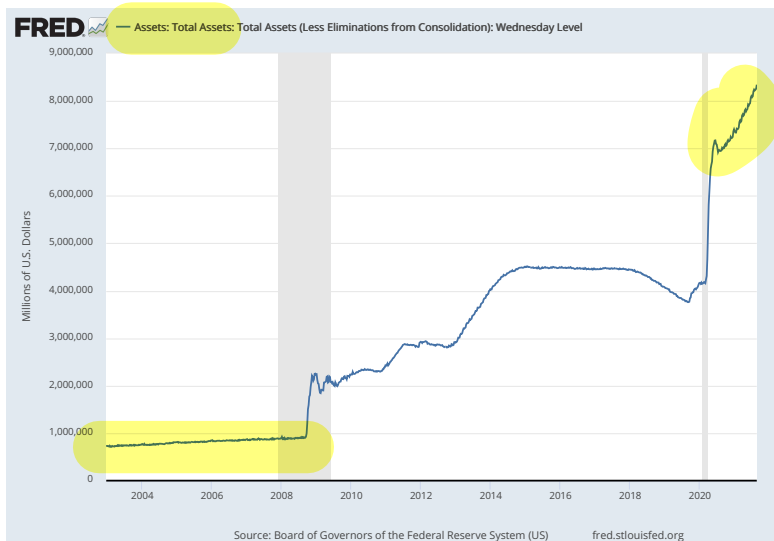
The Fed directly changes long-term interest rate by buying **long-term bonds**.

How does it work?

1. Liquidity (similar to traditional monetary policy)
2. Inflation expectations  $\implies$  lower real interest rates
3. Policy signaling: the Fed is serious about keeping inflation ~~low~~ *high* for a while



# QE: How Big is it?



## QE Risks

1. Inflation may rise (lots of liquidity in the system)  
This is happening right now (perhaps for different reasons)
2. At some point, the Fed has to unwind its asset positions.  
This causes demand contraction.
3. Distributional effects; see NY Times Opinion, July 12, 2021

## Reading

- ▶ Investopedia article on the Federal Reserve.
- ▶ ECB article on the “Transmission Mechanism of Monetary Policy”
- ▶ Johnson, Manuel (2002). “Federal Reserve System.” The Library of Economics and Liberty: a very brief overview of how the Fed operates.
- ▶ Monetary Policy Basics: a brief summary of fed operations.
- ▶ Labonte and Makinen (2017): A more detailed description (including unconventional monetary policy).

## References

- Furman, J. and L. H. Summers (2020): “A Reconsideration of Fiscal Policy in the Era of Low Interest Rates,” .
- Labonte, M. and G. E. Makinen (2017): “Monetary policy and the Federal Reserve: current policy and conditions,” Congressional Research Service, Library of Congress.