Lecture 16: Monetary Policy

Economics 252, Spring 2008
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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 depositary 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