

Other Policy Instruments of the Federal Reserve System

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The Three Policy Instruments

- Open Market Operations
- Reserve Requirements
- Discount Window

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- **Open Market Operations**
 - Reserve Requirements
 - Discount Window
- We have seen how Open Market Operations work. The ability to print money is its most vital power.
 - The transactions are paper transactions, not freshly printed money.

The Three Policy Instruments

- Open Market Operations
 - **Reserve Requirements**
 - Discount Window
- Banks routinely get around reserve requirements. The Fed almost never changes reserve requirements.

The Three Policy Instruments

- Open Market Operations
 - Reserve Requirements
 - **Discount Window**
- The Fed is a lender of last resort. If a bank cannot borrow from anyone else, then it can go to the Fed.
 - For historical reasons, the rate at which banks borrow is the *discount rate*.

Practical Use of Discount Window

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 - As a general policy, the Fed will lend the money.
 - The CEO must report the borrowing to its board.
 - Repeated borrowing brings significant questions.

Practical Use of Discount Window

- A particular bank is in trouble. It goes to the Fed.
- There are national troubles. The Fed throws the discount window open.
 - October, 1987
 - September 11

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- Fear of people defaulting on brokerage debts.
 - I buy 10,000 shares at \$100, and have 5 days to pay up (now 3 days).
 - The stock drops to \$70, and I refuse to pay.
 - The brokerage firm is responsible for a \$300,000 loss

October, 1987

- DJIA went from 2,200 to 1,700 in one day.
- Fear of people defaulting on brokerage debts.
- Brokerage firms are highly levered.
 - Their bankruptcy can trigger bank bankruptcy.
 - So people begin to pull money out of banks before they go bankrupt.

October, 1987

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- Fear of people defaulting on brokerage debts.
- Brokerage firms are highly levered.
- Greenspan guaranteed liquidity.

Where does a good bank get money?

- Fred decides to close his account at Key Bank and take cash.
- Normally, no big deal. For every Fred withdrawing, there is usually an Alice depositing. Things average out.
- But suppose this day, all the depositors like Alice stay away and Key doesn't have enough cash.

Where does a good bank get money?

- Key can call up the Cleveland Fed and withdraw cash from its deposit at the Cleveland Fed.
- But suppose that those reserves are low and Key thinks it improvident to withdraw.
- Key Bank is a sound bank, it does not need a lender of last resort and it does not want to make the Fed too interested in its affairs.

The Federal Funds Market

- Banks can borrow and lend reserves, for as little as one day (overnight).
 - Sometimes referred to as overnight money market.
- The rate, the *federal funds rate*, is reported in *Wall Street Journal* and other financial publications.

Wire Transfers

- The exact means is a *wire transfer*.
- All Electronic Funds Transfers take place this way.

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Key then adds \$1,000 to my account.



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- Many banks had payments due, and were relying on payments from other banks, which could not be made.
- The Federal Reserve System provided enormous funds via the discount window to help banks out.

End

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