The Three Policy Instruments

- 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.

Banks routinely get around reserve requirements. The Fed almost never changes reserve requirements.

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.

A particular bank is in trouble. It goes to the Fed.
Practical Use of Discount Window
• A particular bank is in trouble. It goes to the Fed.
  – As a general policy, the Fed will lend the money.
  – The CEO must report the borrowing to its board.
  – Repeated borrowing brings significant questions.

Other Policy Instruments of the Federal Reserve System

October, 1987
• DJIA went from 2,200 to 1,700 in one day.
  • Fear of people defaulting on brokerage debts.

Practical Use of Discount Window
• A particular bank is in trouble. It goes to the Fed.
  – As a general policy, the Fed will lend the money.
  – There are national troubles. The Fed throws the discount window open.
    – October, 1987
    – September 11
  • DJIA went from 2,200 to 1,700 in one day.

Other Policy Instruments of the Federal Reserve System
October, 1987

• DJIA went from 2,200 to 1,700 in one day.
• 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.

Other Policy Instruments of the Federal Reserve System

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

• DJIA went from 2,200 to 1,700 in one day.
• 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.

KSU has its bank (Huntington?) wire $1,000 of reserves to Key Bank with orders to transfer to my account.

Huntington deducts $1,000 from KSU’s account. The Federal Reserve Bank of Cleveland deducts $1,000 from Huntington’s account and adds $1,000 to Key Bank’s account.

Key then adds $1,000 to my account.

September 11, 2001

• September 11 adversely affected the Federal Funds Wire.

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September 11, 2001

• September 11 adversely affected the Federal Funds Wire.
• Many banks had payments due, and were relying on payments from other banks, which could not be made.
September 11, 2001

- September 11 adversely affected the Federal Funds Wire.
- 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.