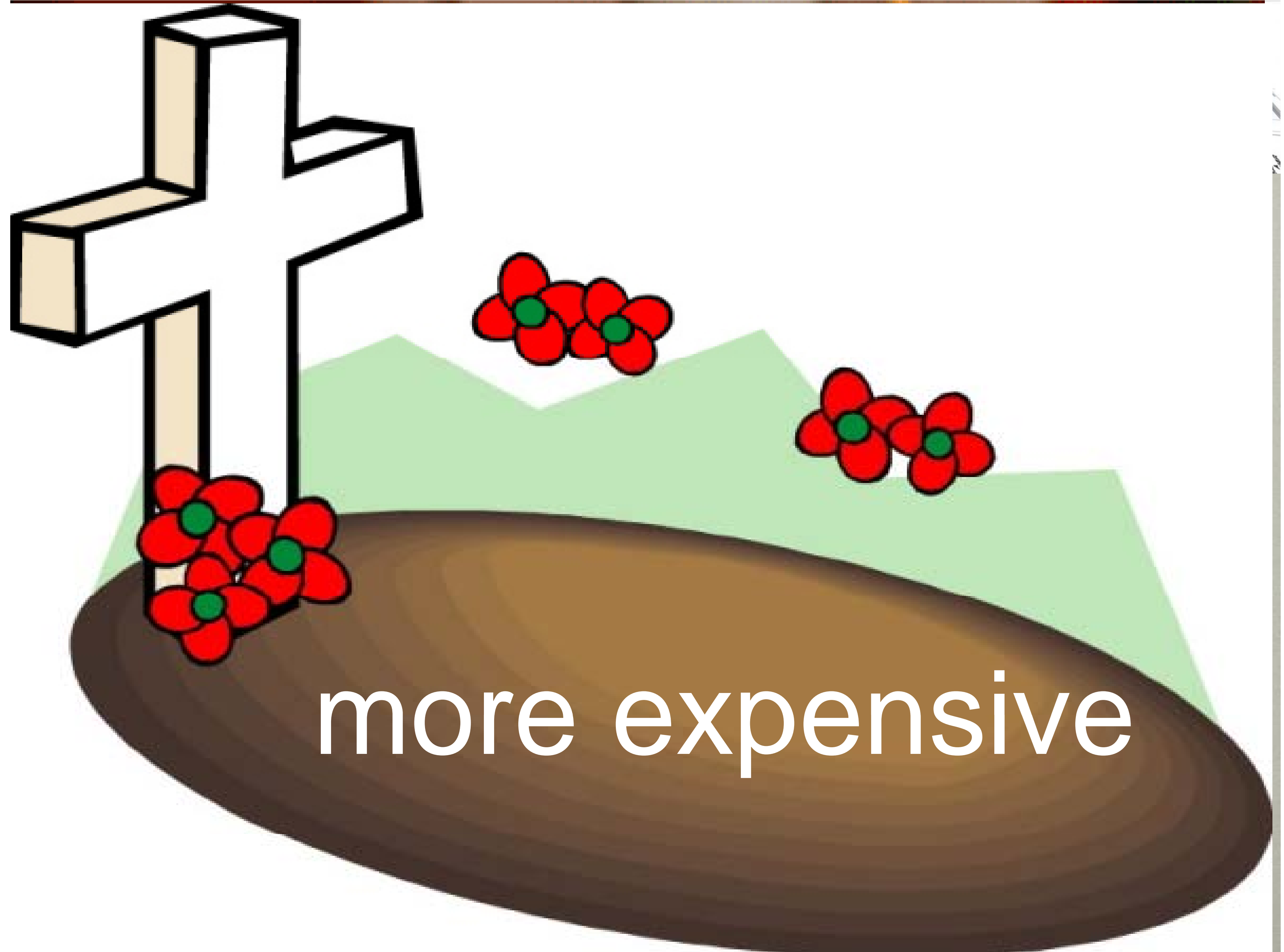
MONETARY POLICY:

THEORY, APPLICATION During Financial Crises , AND ANALYSIS

- Space, Portia , May, and Ben

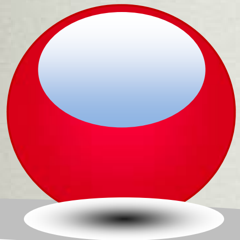
short play——

Fudan News

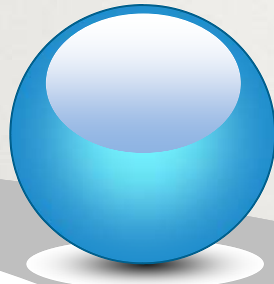

more expensive

Framework of Monetary policy

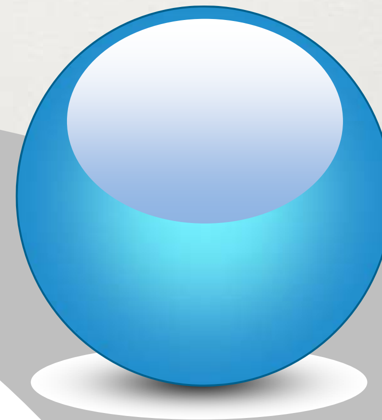
Objectives



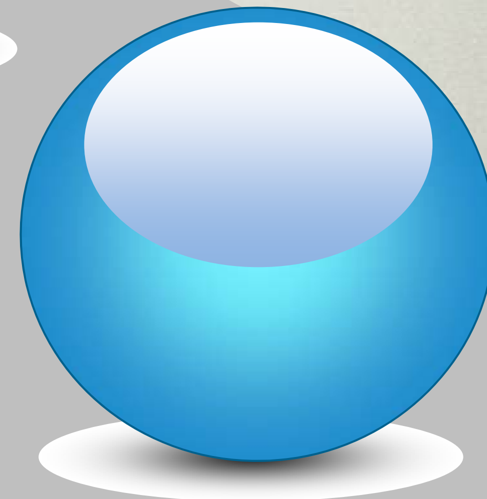
Intermediate targets



Operating targets



Instruments



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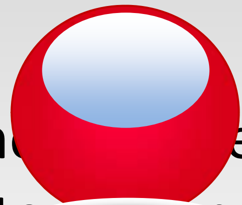


Th e of
inte nal trade

Full employment

Economic growth

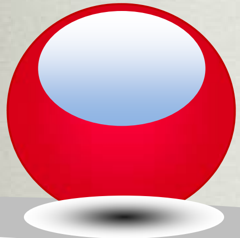
Interest rate
stability

Price stability

Financial stability

Framework of Monetary policy

Objectives



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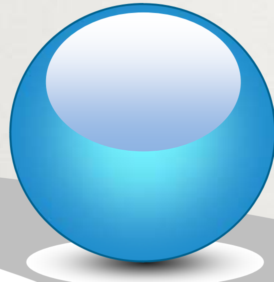

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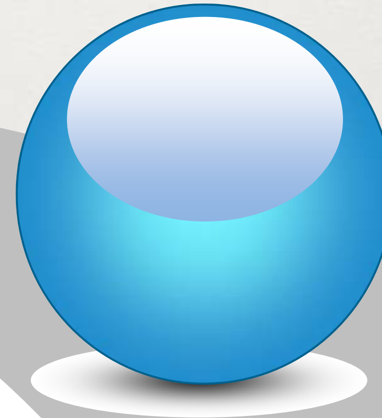

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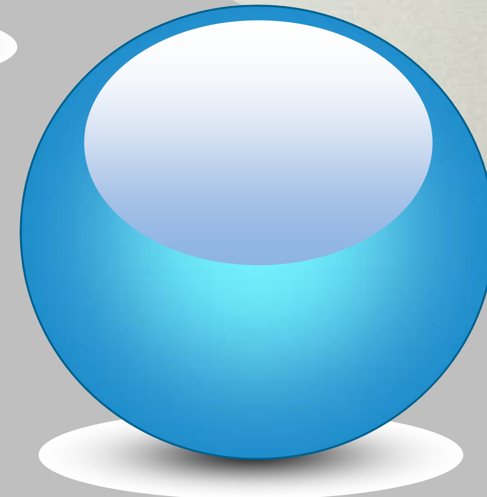

Framework of Monetary policy

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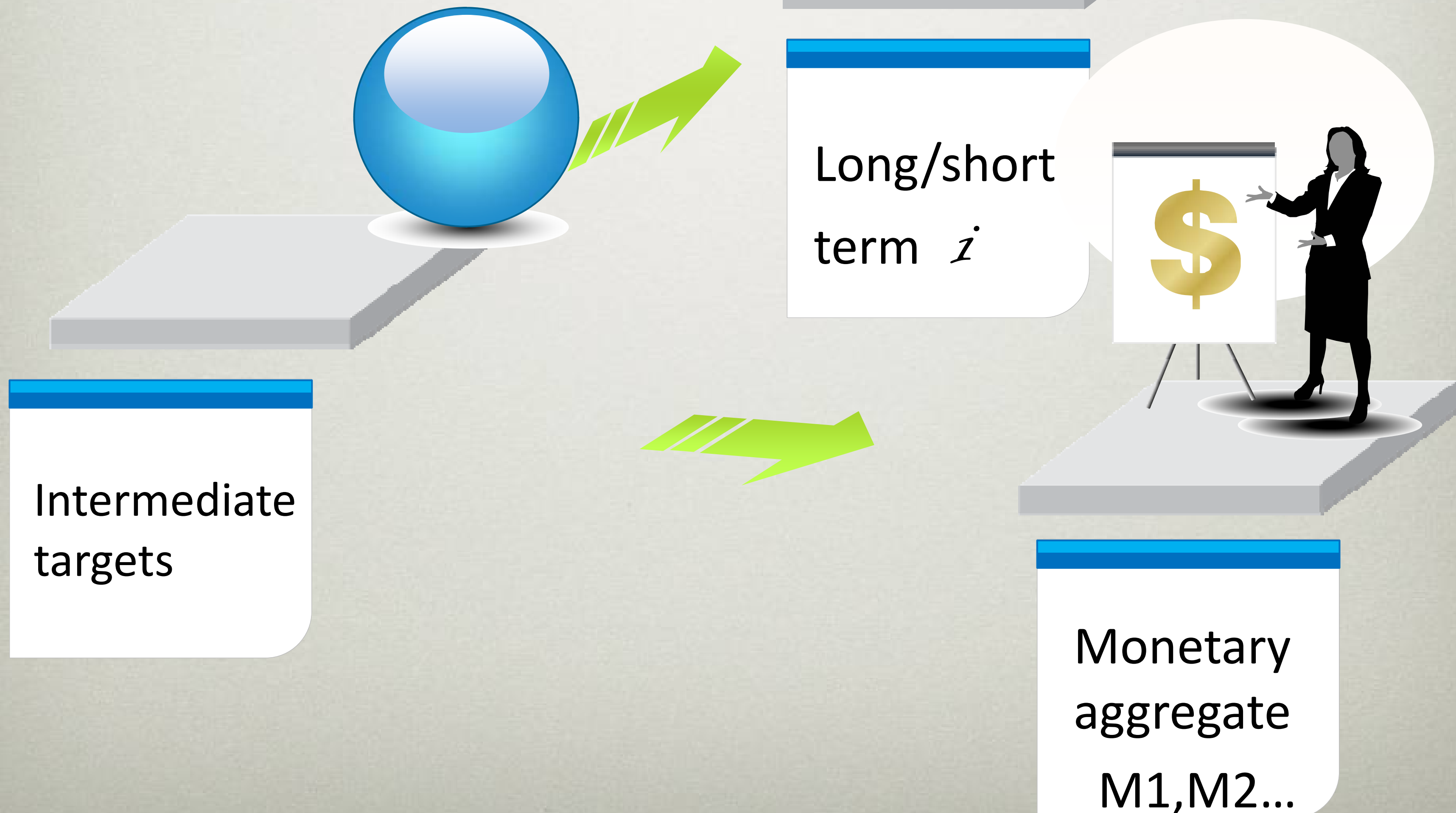
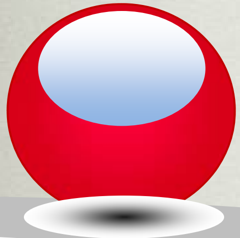
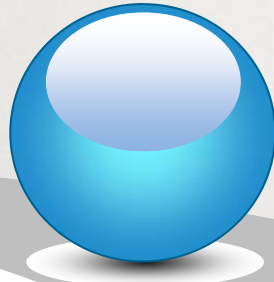
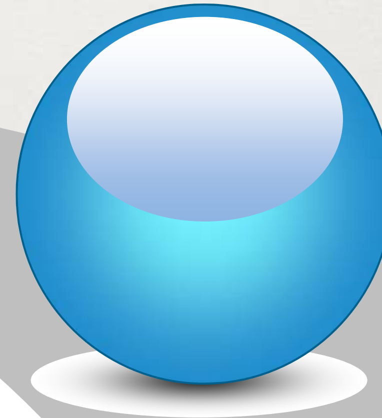
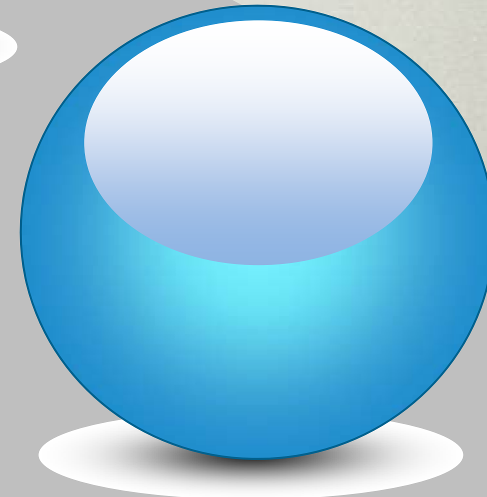


Framework of Monetary policy









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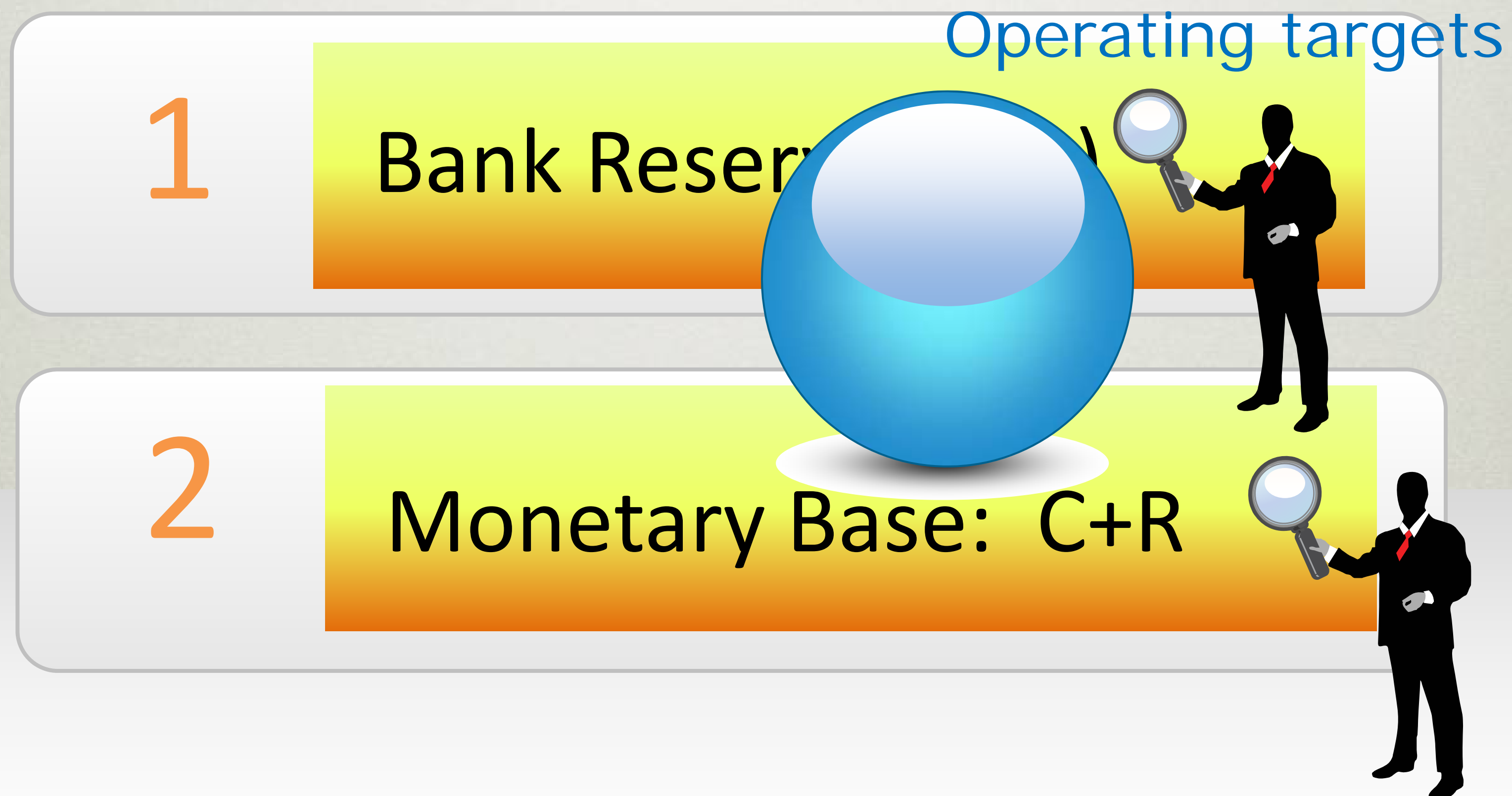

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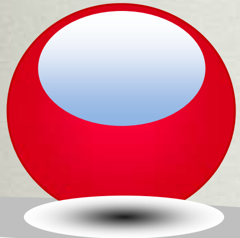

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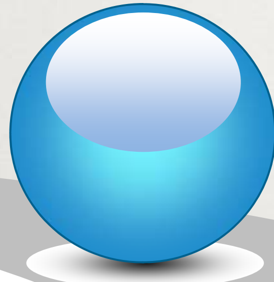
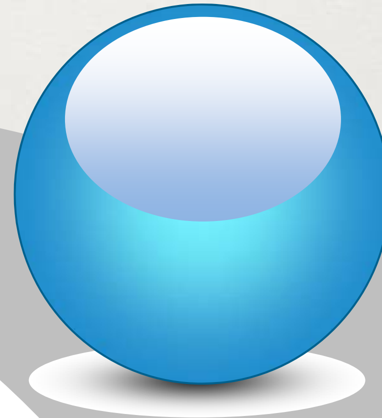


Operating targets



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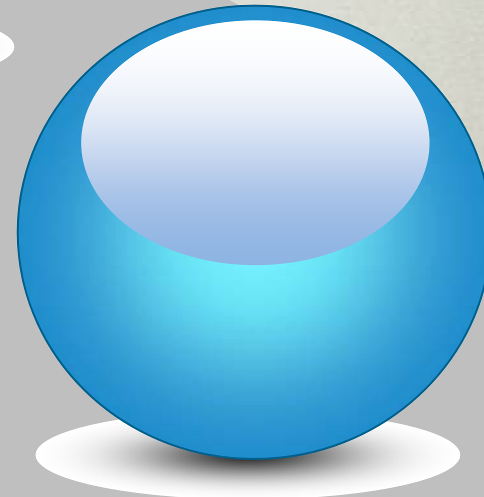
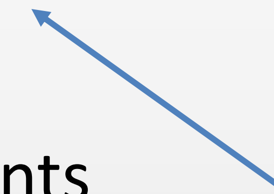


Framework of Monetary policy

- general instrument
  - central bank refinance rates
  - statutory reserve requirements
  - open market operation
- special instrument
  - preferential interest rate
  - moral suasion
  - …



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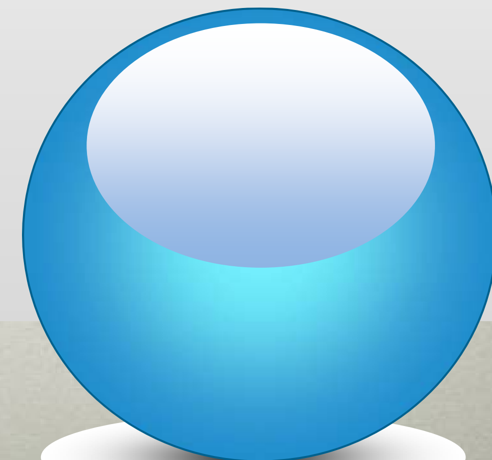

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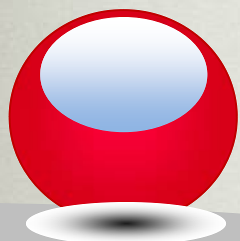

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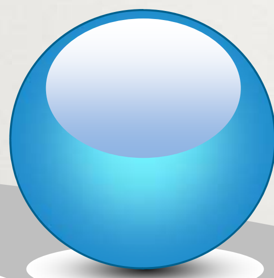

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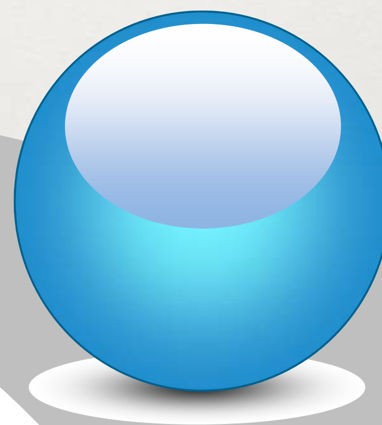

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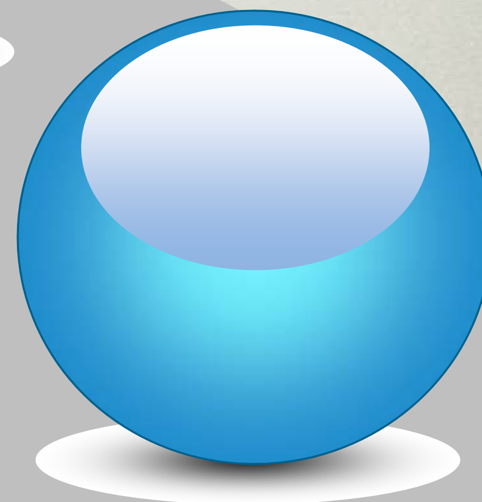
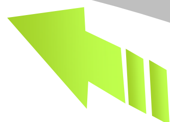
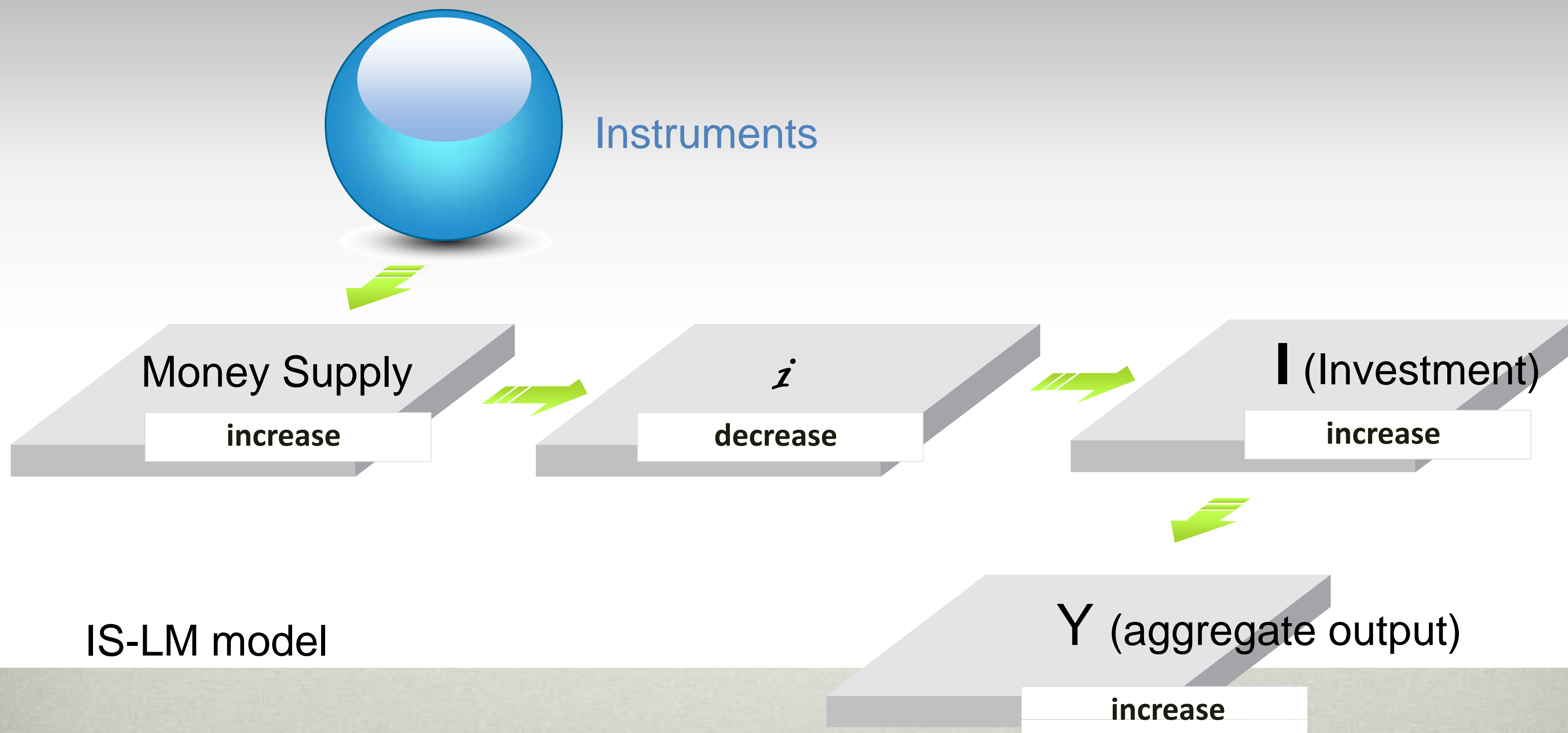




Monetary Transmission Mechanism

Monetary Transmission Mechanism

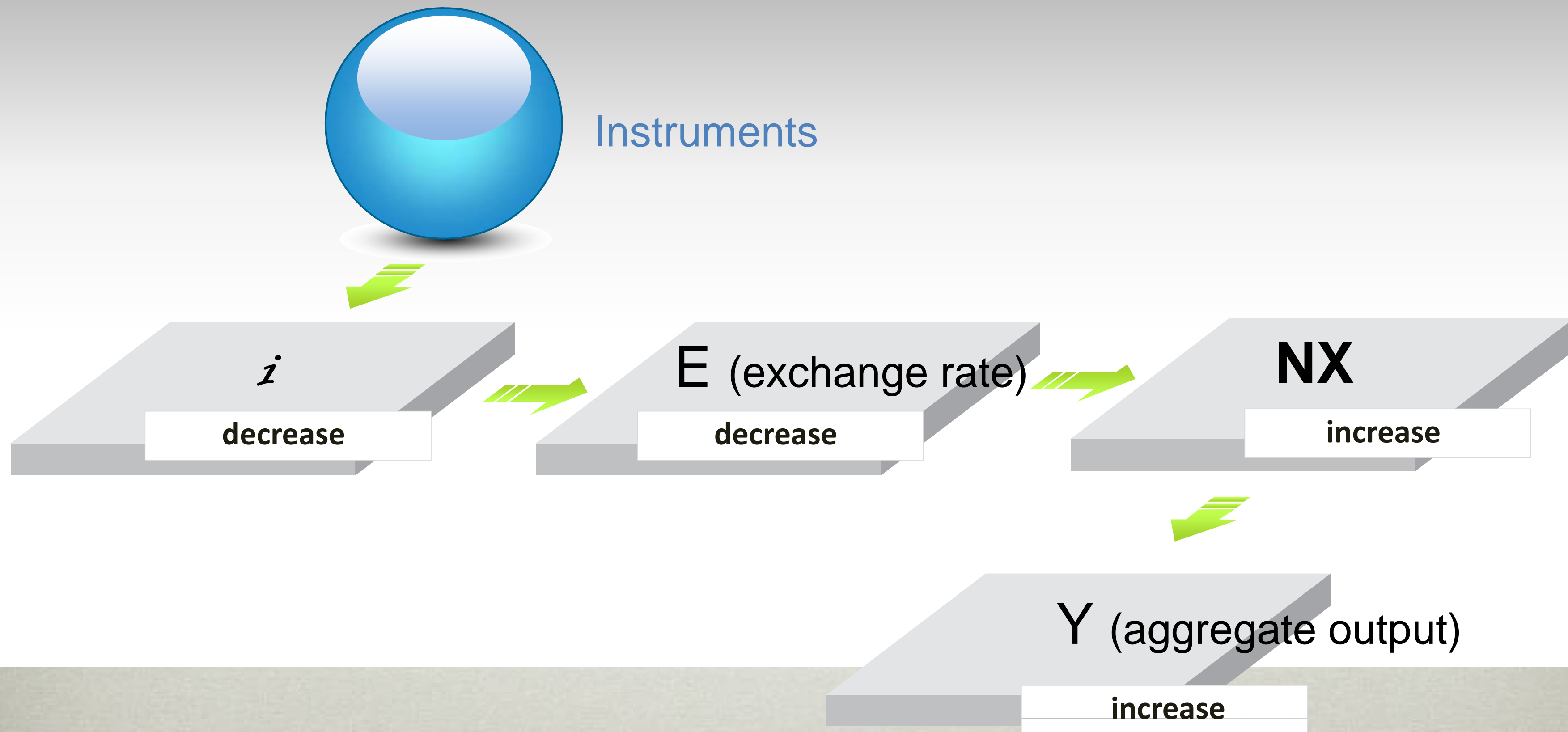
1) Interest rate channel



IS-LM model

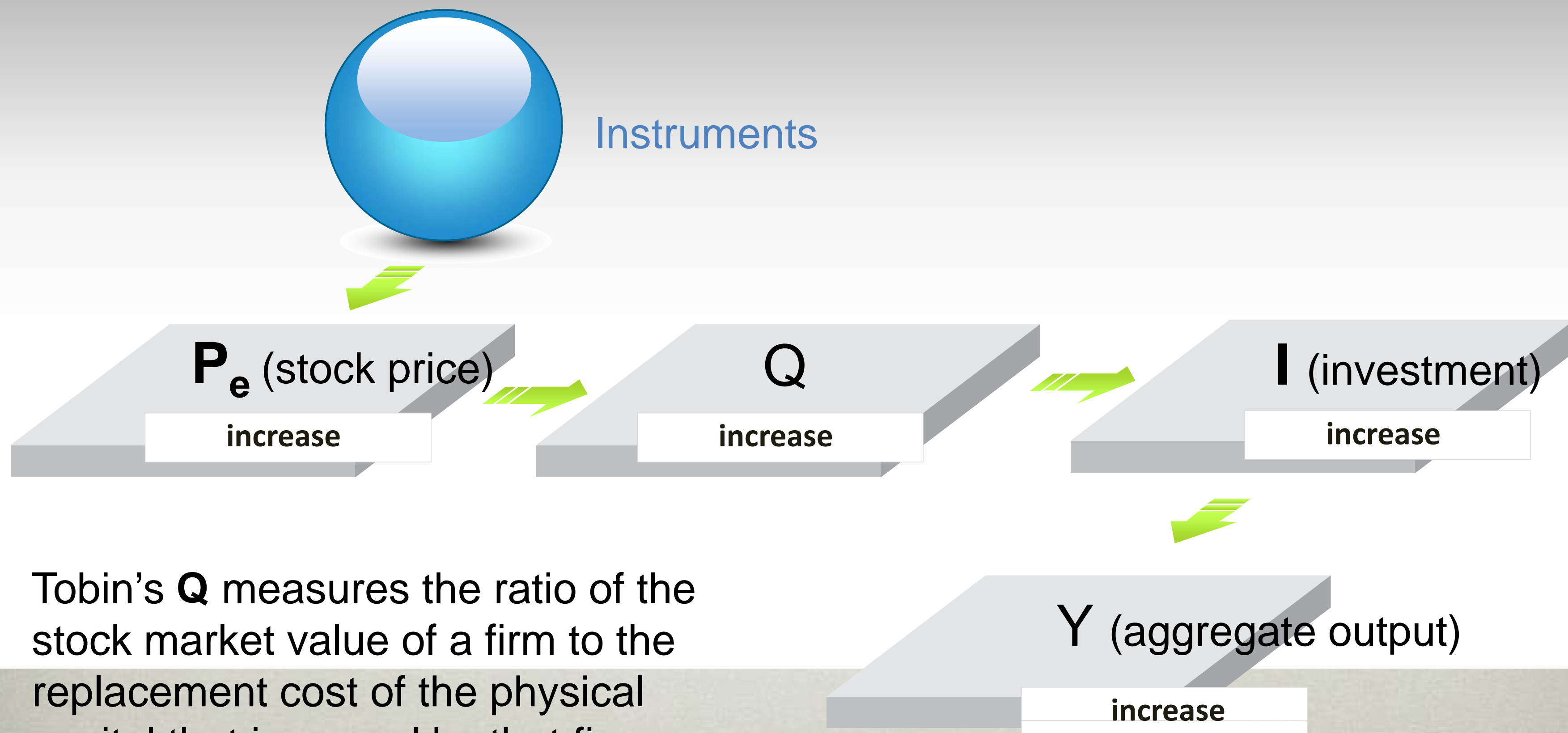
Monetary Transmission Mechanism

2) Foreign exchange rate channel



Monetary Transmission Mechanism

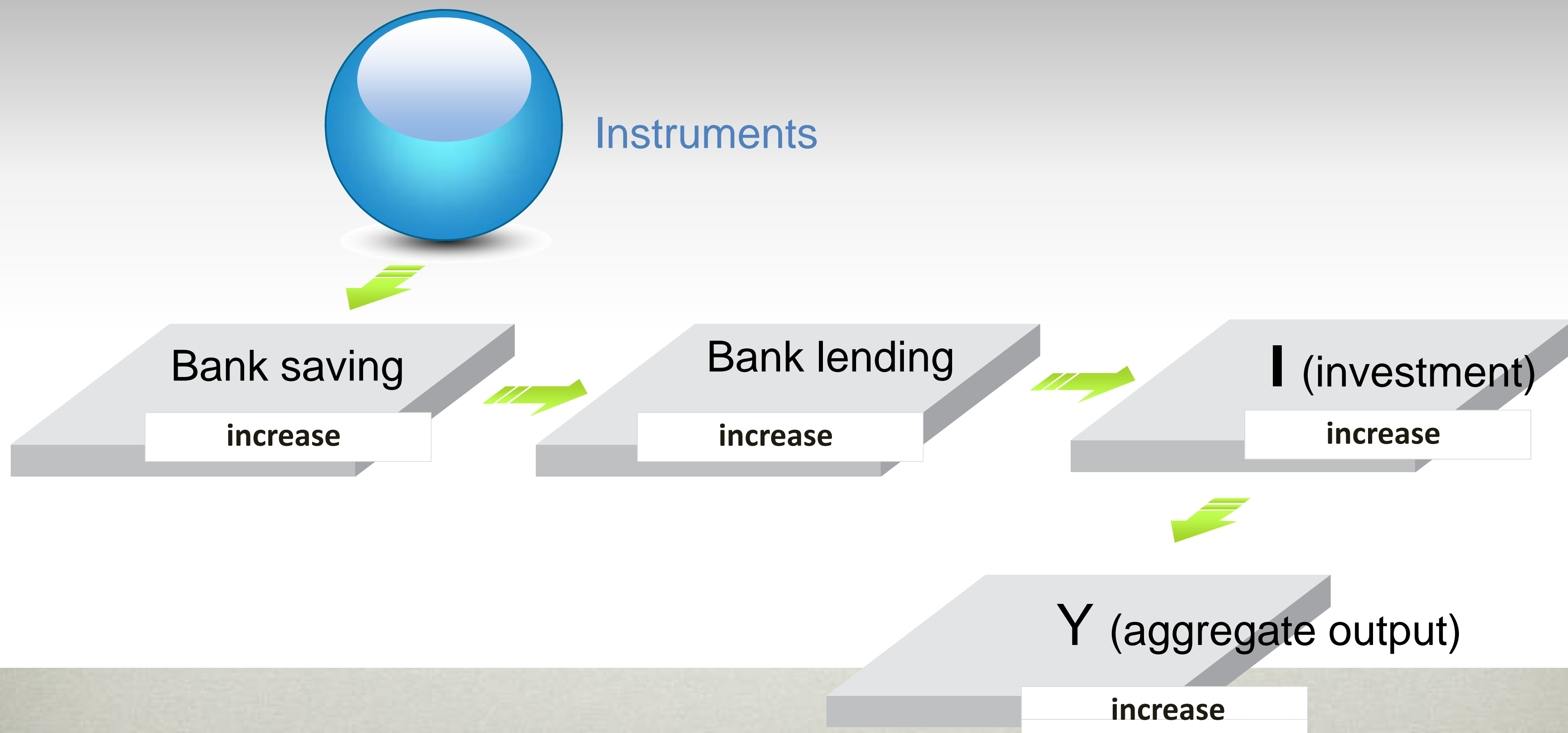
3) Asset price channel (wealth effect & Tobin's Q)



Tobin's **Q** measures the ratio of the stock market value of a firm to the replacement cost of the physical capital that is owned by that firm.

Monetary Transmission Mechanism

4) Bank lending channel



Monetary Transmission Mechanism

5) Balance-sheet channel

a) Instruments → M ↑ → P_e ↑ → as↓ , mh↓

→L ↑ → I ↑ → Y ↑

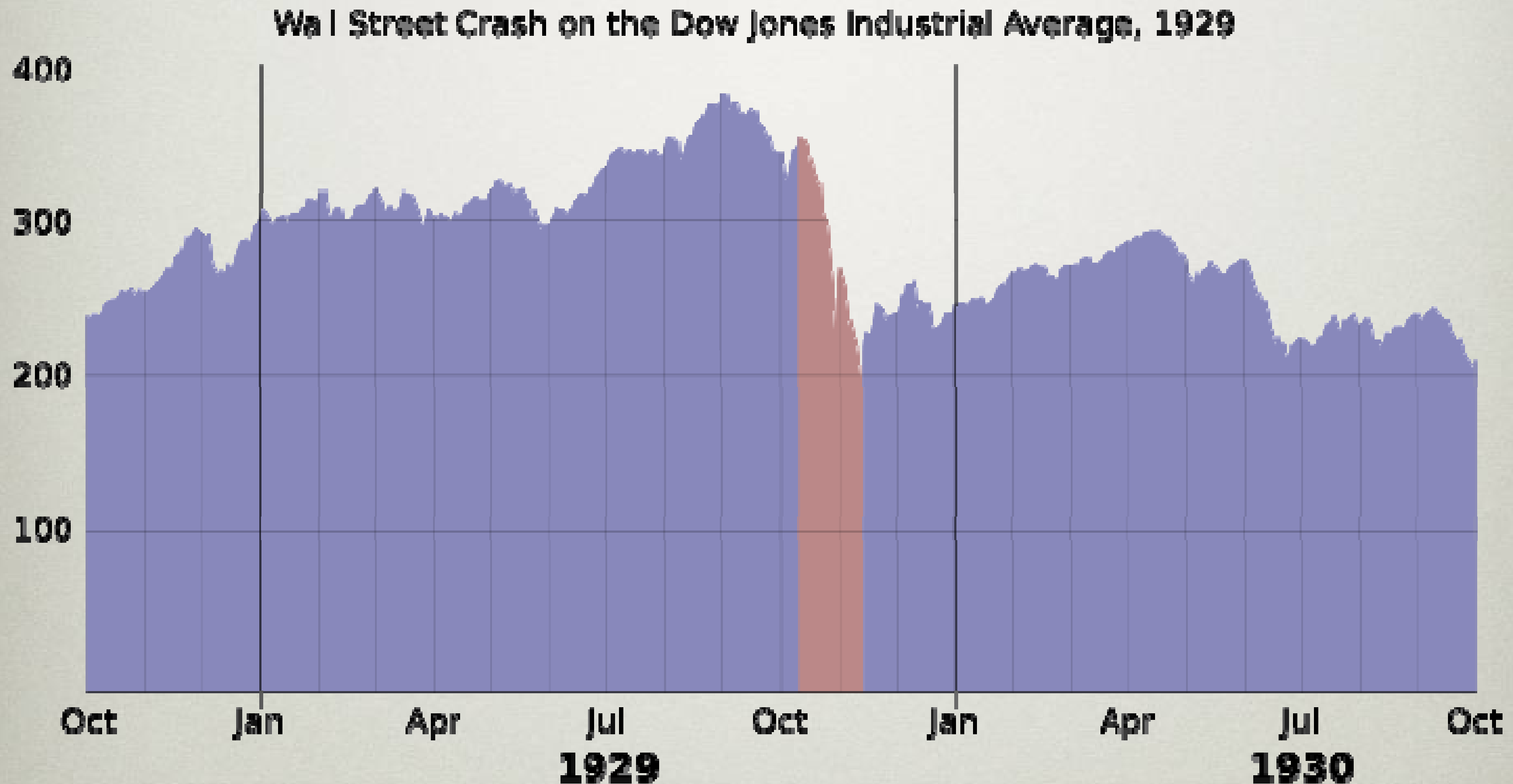
b) Instruments → M ↑ → i ↓ → CF↑ → as↓ , mh↓

→L ↑ → I ↑ → Y ↑

c) Instruments → M ↑ → **UP**↓ → as↓ , mh↓

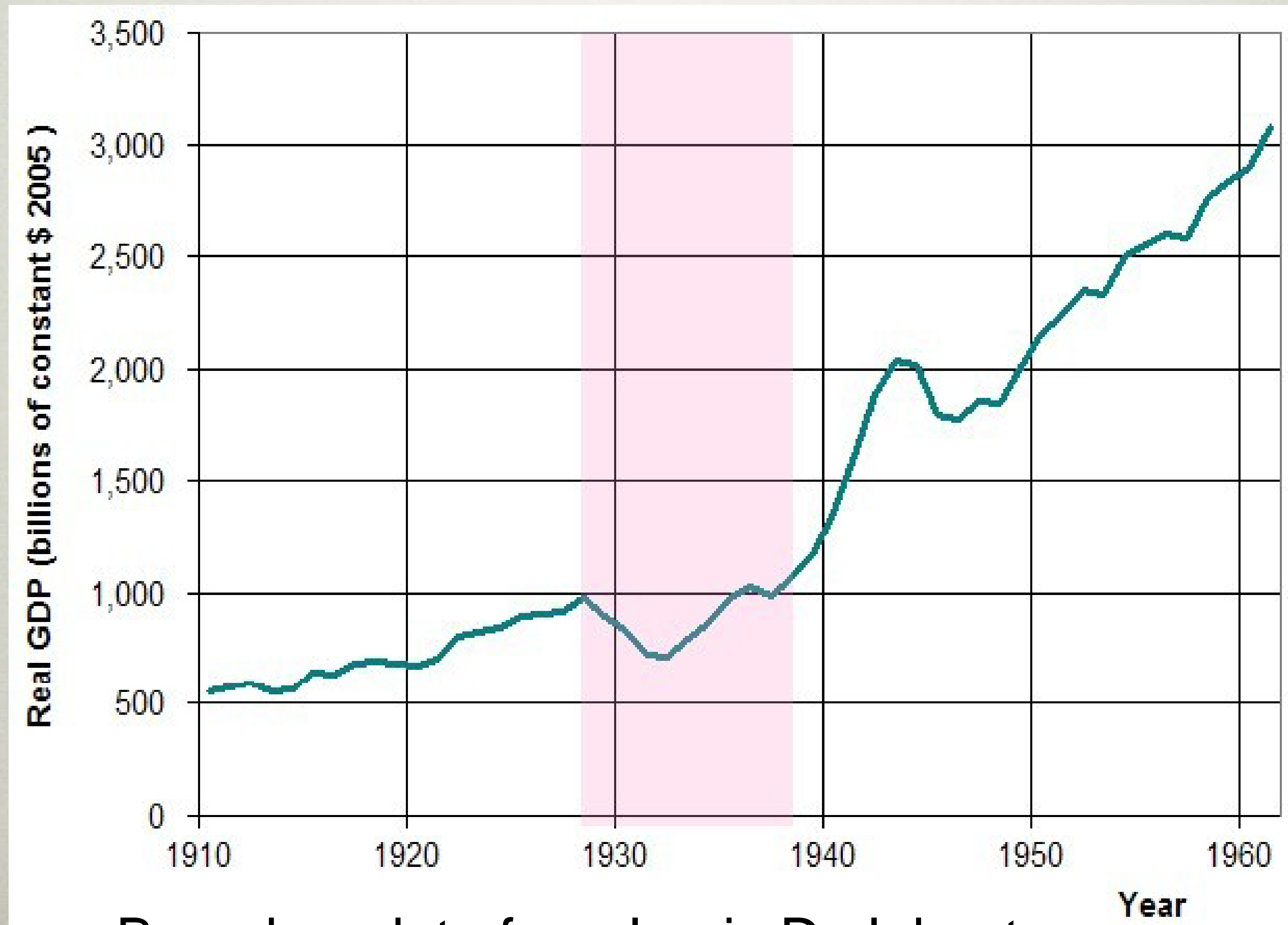
→L ↑ → I ↑ → Y ↑

Case Study



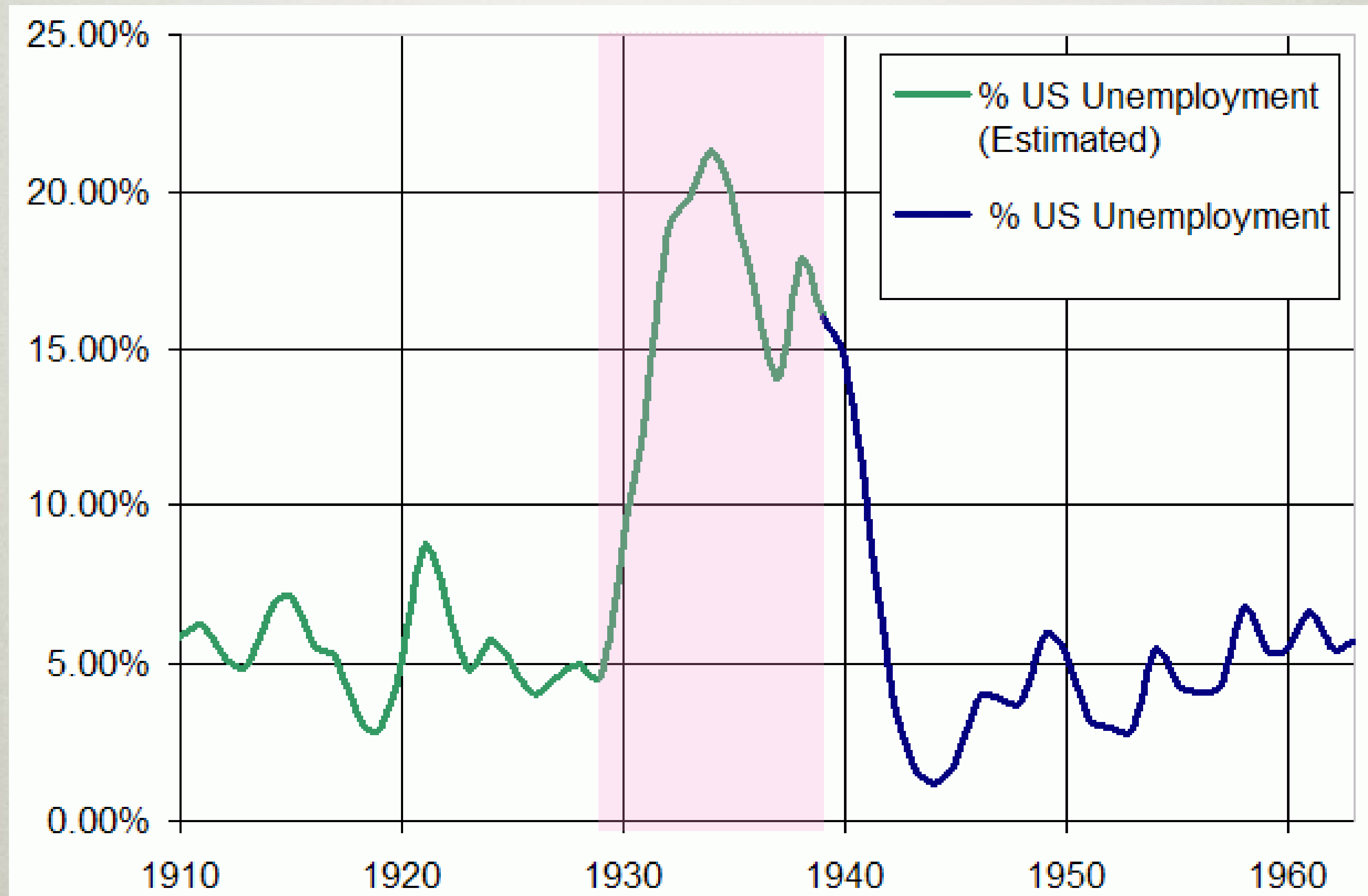
Graph of the 1929 Wall Street crash in a timeline from Oct 1928 - Oct 1930. Source:wikipedia.org

USA annual GDP from 1910-60, in billions of constant 2005 dollars, with the Great Depression (1929-1939) highlighted.



Based on data from Louis D. Johnston

U.S. Unemployment rate from 1910-1960, during the years of the Great Depression (1929-1939) highlighted.



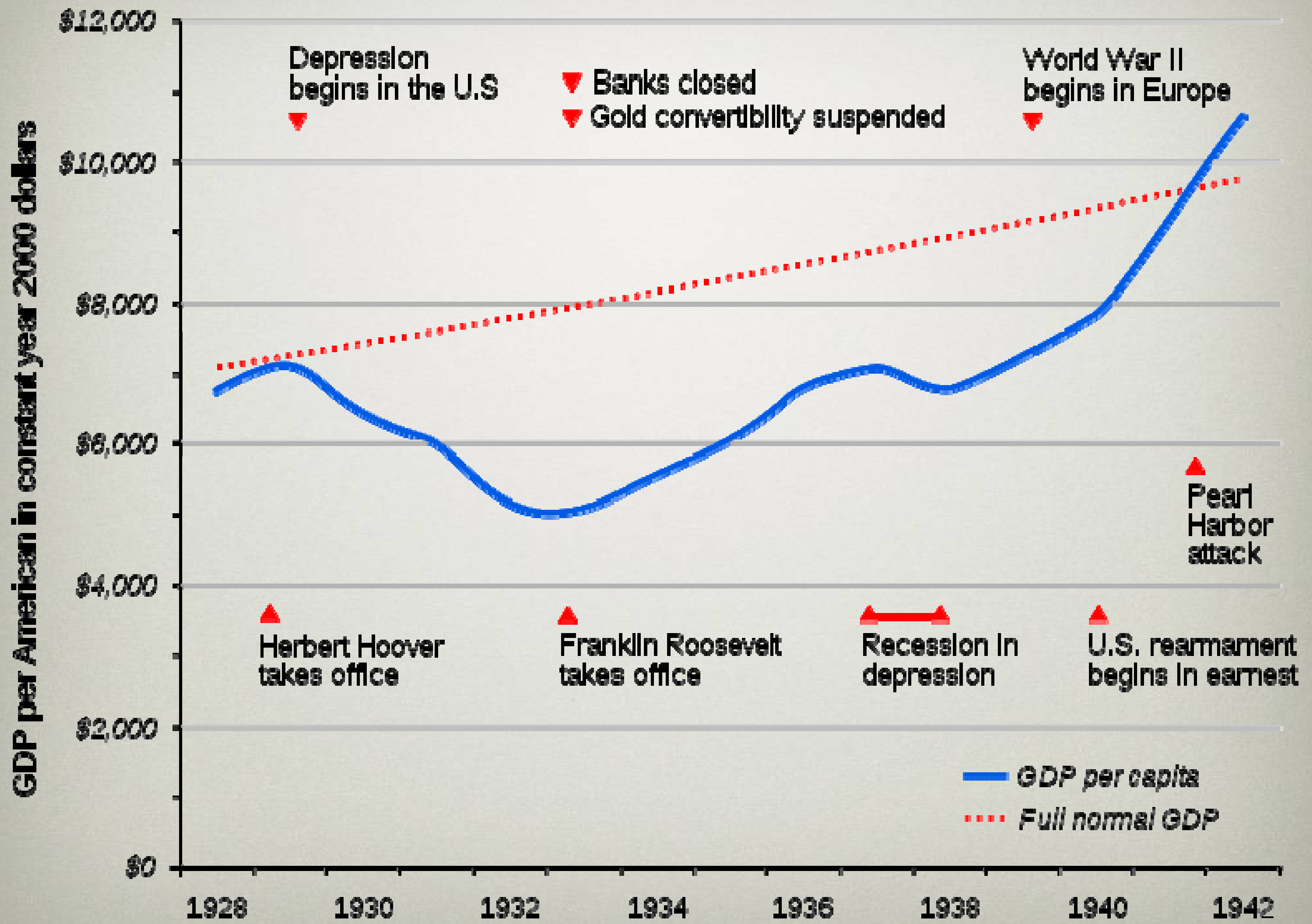
Data for 1910-1930 from Christina Romer (1986), "Spurious Volatility in Historical Unemployment Data", The Journal of Political Economy, 94(1): 1-37. Data for 1930-1940 from Robert M. Coen (1973). "Labor Force and Unemployment in the 1920's and 1930's: A Re-Examination Based on Postwar Experience", The Review of Economics and Statistics, 55(1): 46-55. Data for 1940-1960 from the US Bureau of Labor Statistics, Employment status of the civilian noninstitutional population, 1940 to date ftp://ftp.bls.gov/pub/special.requests/lf/aat1.txt, retrieved March 6, 2009.

Case Study: The Great Depression

1929-1933
Herbert Hoover’s
Policies

- 1933-1941

Franklin Roosevelt’s
policies



GDP per American in constant year 2000 dollars
$12,000
$10,000
$8,000
$6,000
$4,000
$2,000
$0
1928
1930
1932
1934
1936
1938
1940
1942
Depression begins in the U.S
Banks closed
Gold convertibility suspended
World War II begins in Europe
Pearl Harbor attack
Herbert Hoover takes office
Franklin Roosevelt takes office
Recession in depression
U.S. rearmament begins in earnest
GDP per capita
Full normal GDP

Reason for the Depression

- Monetarists argue that the Great Depression was mainly caused by monetary contraction, the consequence of poor policymaking by the American Federal Reserve System and continued crisis in the banking system.

Herbert Hoover’ s Policies

- Contractionary Monetary Policy

  Increased rediscount rate from 3% to 5%

  Sell government bonds

- Against speculation

  Tightened credit and prohibited any payment for the stock market speculation or to maintain the operation of the existing speculative capital

Effects and Implications

- Succeeded in impeding the fight against speculation, but hindered economic growth
- The introduction of each policy doesn’t just affect one aspect of the economy
- A poorly conceived policy will destroy a good foundation for the development of economic growth cycle in a very short period of time.

Franklin Roosevelt’ s policies
New Deal

- Expansionary Monetary Policy

  Increased money supply to solve the shortage of bank money
- To deal with deflation, the nation went off the gold standard and depreciated dollar

Effects and Implications

- Restored public confidence in banks and stabilized the situation
- The economy had hit bottom in March 1933 and then started to expand.
- The Recession of 1937 was a temporary downturn. Private sector employment, especially in manufacturing, recovered to the level of the 1920s but failed to advance further until the war.

Ramifications of the new deal

- During the New Deal period, the federal government evolved into an arbitrator in the competition among elements and classes of society, acting as a force to help some groups and limit the power of others. This elevated and strengthened newer interest groups which allowed these to compete more effectively.

Critique

- Some critics have complained that he enlarged the powers of the federal government, built up labor unions, slowed long-term economic growth, and weakened the business community.

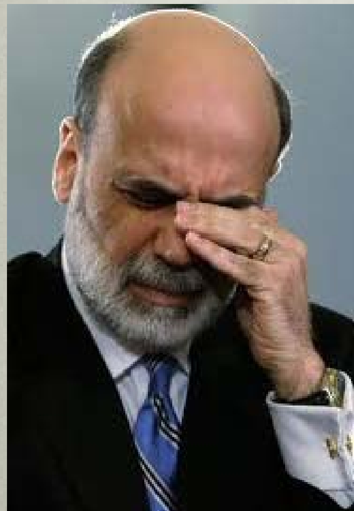
Monetary Policy During the Financial Crisis of 2007-2010

- The 2007 Financial Crisis was characterized by:
  - large scale unemployment
  - failing financial institutions
  - dangerously low liquidity in the market
- The U.S. Federal Reserve enacted traditional expansionary policies used to combat recession as well as some riskier maneuvers.

Basic O.M.O.s

- The Fed, in conjunction with the European Central Bank (and other smaller central banks), purchased a total of USD$2.5 trillion worth of government debt and private assets from a number of banks worldwide.
- The Fed reduced the **federal funds rate** and the **discount rate,** to facilitate lending between banks and make it easier for banks to take out short term loans from the Fed itself.

Ben Bernanke on the aims of the FED

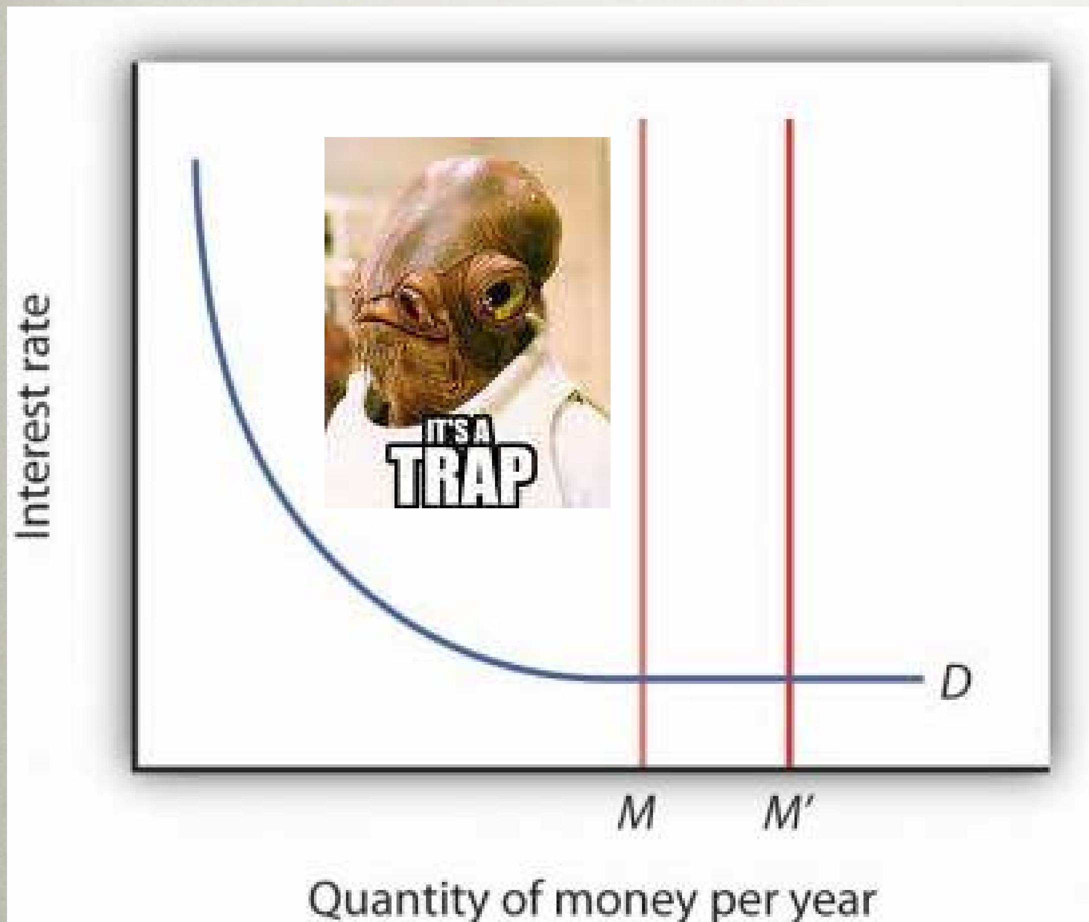


- In early 2008- "Broadly, the Federal Reserve's response has followed two tracks: efforts to support market liquidity and functioning and the pursuit of our macroeconomic objectives through monetary policy." ^ a b Ben S. Bernanke. "Financial Markets, the Economic Outlook, and Monetary Policy" Washington, D.C. (2008-01-10). Retrieved on 2010-12-19.
- On the use of Quantitative Easing- "our economy is very weak and inflation is very low. When the economy begins to recover, that will be the time that we need to unwind those programs, raise interest rates, reduce the money supply, and make sure that we have a recovery that does not involve inflation." ^ Bernanke-60 Minutes Interview

Were Traditional O.M.O. effective in combating recession?

- The Fed is limited by the time it takes for their policies to produce results.
- An even larger problem was that the Fed reached a point where it could not decrease interest rates any further...

“Liquidity Traps”



- Conventional O.M.O.s fail to stimulate the economy, interest rates cannot be lowered any more.
- Here we see that, when aggregate demand is perfectly inelastic, the money supply will have no effect on output or price levels.

A Last Resort: Quantitative Easing

- **Q**uantitative **E**asing is a method in which the Fed “creates” money electronically, using it to purchase government bonds or other financial assets to increase the money supply.
- In November of 2008 the Fed used **QE**, creating $600 billion to lend to banks with the hope that they would start lending again.

Quantitative Easing... Doesn’ t work perfectly

- It is not necessarily in banks’ interest to lend that money out to American consumers.
- Often banks prefer to make “smarter” investments abroad and in foreign currencies.

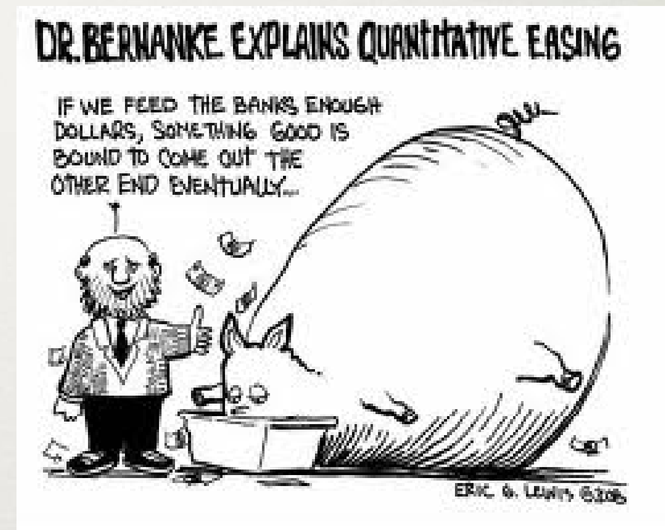
Bailing Out Bear Stearns

- Perhaps the Fed's most controversial move was to arrange Bear Stearns' buyout from J.P. Morgan.
- J.P. Morgan bought out Bear Stearns at $2 a share, formerly at $98 two days earlier!

Reactions

"They're[The Fed] thinking the interest rate is a dial you can set and by setting that dial, you can regulate the economy... All the literature about how monetary policy operates in normal times is pretty irrelevant to this situation." - Joseph Stiglitz, October 2010
http://www.washingtonpost.com/wp-dyn/content/article/2010/10/30/AR2010103004612.html

"If they're too big to fail, they're too big," -Alan Greenspan ^ "Greenspan Says U.S. Should Consider Breaking Up Large Banks" (in en). Bloomberg. 2009-10-12. Retrieved 2010-02-05.

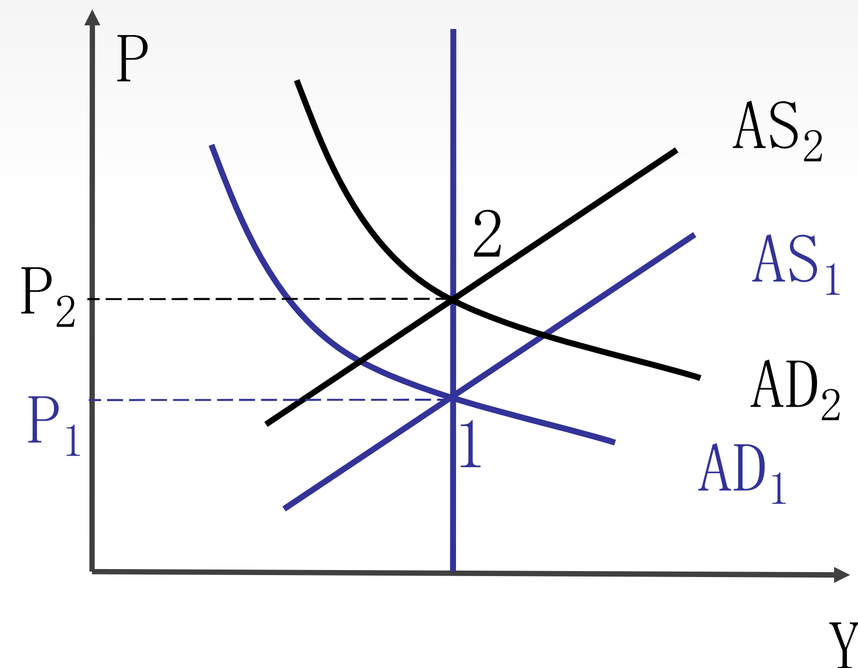


Assessing the Effectiveness of Monetary Policy

Determined by:

1) Time lag
   a) recognition lag
   b) decision lag

2) Rational expectation



Conclusions

- Clearly the Fed did all in it’ s power to lessen the effects of the recession: the problem is that it may have reached too far outside its own boundaries when it began to bail out private firms.
- Normally, fiscal policy can compensate for these shortcomings of monetary policy.