

**Lecture #8**  
**Chapter 17**

**Tools of Monetary Policy**

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**Open Market Operations**

**2 Types**

1. Dynamic:

*Meant to change MB*

2. Defensive:

*Meant to offset other factors affecting MB, typically uses repos*

**Advantages of Open Market Operations**

1. Fed has complete control

2. Flexible and precise

3. Easily reversed

4. Implemented Quickly

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**Discount Loans**

**3 Types**

1. Adjustment Credit

2. Seasonal Credit

3. Extended Credit

**Lender of Last Resort Function**

1. To prevent banking panics

*FDIC fund not big enough*

*Examples:* Continental Illinois and Franklin National

2. To prevent nonbank financial panics

*Examples:* 1987 stock market crash

**Announcement Effect**

1. Problem: False signals

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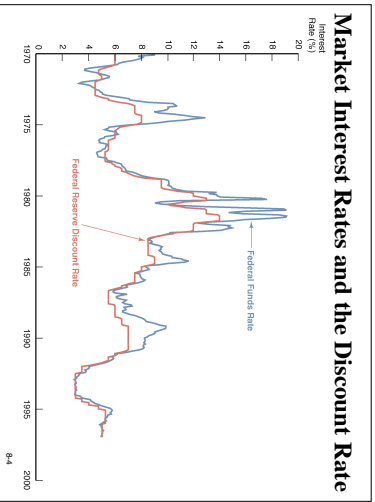
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### Proposed Reforms of Discounting

**Advantages**

1. Lender of Last Resort Role

**Disadvantages**

1. Confusion interpreting discount rate changes
2. Fluctuations in discount loans cause unintended fluctuations in money supply
3. Not fully controlled by Fed

**Proposed Reforms**

1. Abolish discounting (Milton Friedman)
  - A. Eliminates fluctuations in  $M^1$
  - B. However, lose lender of last resort role
2. The discount rate to market rate
  - A.  $i - i_d = \text{constant}$ , so less fluctuations of DL, and  $M^1$
  - B. Easier administration
  - C. No false announcement signals

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### Reserve Requirements

**Advantages**

1. Powerful effect

**Disadvantages**

1. Small changes have very large effect on Ms
2. Raising causes liquidity problems for banks
3. Frequent changes cause uncertainty for banks
4. Tax on banks

**Proposed Reforms**

1. Abolish reserve requirements
2. 100% reserve requirements (Milton Friedman)
  - A. Advantage: complete control of Ms
  - B. Disadvantage: Fed controls official Ms but not economically relevant Ms

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