Fed Unfiltered

TUTORIAL - M.Policy 3/27/23

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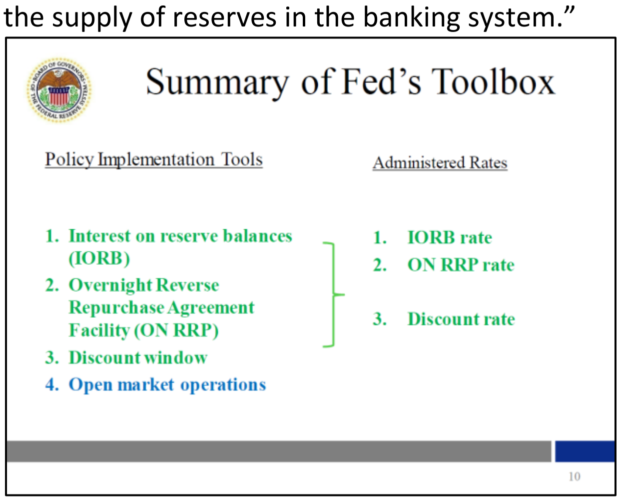
__Fed:__ "Research and analysis about consumers, their financial experiences, and the communities in which they live inform Federal Reserve policymaking." – Fed Board

__Fed Unfiltered:__ Each week we'll read through and outline the most relevant information for your decision-making.

__Implementation of Monetary Policy:__ Philip Jefferson talks about the specific actions the Fed takes and the tools the Fed uses to implement monetary policy.

Philip Jefferson – The Four Tools to Implement M.P.

- "I've talked about how the Fed has four tools in its toolbox to implement monetary policy. Three of the tools and their associated administered rates, shown in green text on slide 10, are used to steer the market-determined federal funds rate into the FOMC's target range. These tools also interact with other short-term market interest rates through arbitrage relationships. The fourth tool, shown in blue text, is open market operations—the purchase and sale of government securities—which is used to adjust the supply of reserves in the banking system."



Implementation Tool 1: Discount Window Rate Sets a Ceiling

- "At the top of the demand curve, we see the discount rate, which is the interest rate the Fed charges when it lends money to banks. The discount rate is an administered rate, or a rate set by the Fed, and it is one of the tools the Fed uses to implement monetary policy. It sets a ceiling for the federal funds rate because banks, if they are in good standing and have collateral for the discount window loan, can always borrow overnight funds at the discount rate from the Fed. Therefore, they are not willing to pay a higher rate to borrow funds."

Implementation Tool 2: Interest on Reserve Balances

- "Close to the bottom of the demand curve is the interest on reserve balances rate denoted by IORB rate in figure 2. This is the interest rate the Fed pays on reserves *eligible institutions* keep at Federal Reserve Banks.[8] This interest rate is the *primary* tool the Fed uses currently to implement monetary policy.[9] In the graph, observe that the federal funds rate is close to this rate. The economic force that keeps these two rates close to each other is called arbitrage, the simultaneous purchase and sale of funds (or goods) to profit from a difference in price. Arbitrage keeps prices of financial instruments with similar payoffs close to each other.[10] I will illustrate how arbitrage works with an example that makes it clear why the federal funds rate cannot be much lower nor much higher than the interest on reserve balances rate."

Implementation Tool 3: Overnight Reverse Repurchase Agreement

- "So far, I have talked about two of the Fed's administered rates; the discount rate, and the interest on reserve balances rate. Now, I will talk about the third key administered rate, the overnight reverse repurchase agreement rate denoted by ON RRP in figure 2. Not all institutions that lend money in the federal funds market and who are key players in short-term money markets are eligible to receive interest on reserves. Consider, for example, Federal Home Loan Banks. They were set up in the 1930s to support mortgage lending. Today, they manage about $1.5 trillion in assets. They are major lenders in the federal funds market, but they are ineligible to receive interest on reserves. Therefore, they may have an incentive to lend funds at a much lower rate than the interest rate on reserves rather than earn zero interest on idle cash balances. To ensure that these and other institutions do not charge an interest rate much lower than the interest rate on reserves, the Fed uses an overnight reverse repurchase agreement facility as a supplementary policy tool to help control the federal funds rate."

Implementation Tool 4: Open Market Operations

- "So far, I have talked about how the Fed influences the demand curve by changing its administered rates. Now, I will talk about how the Fed shifts the supply of reserves in the system. It does so by buying or selling securities, so-called open market operations. When the Fed purchases securities, it pays for them by depositing cash into the appropriate banks' reserve balance accounts, adding to the overall level of reserves (cash) in the banking system."

[Philip Jefferson, Speech: Implementation and Transmission of Monetary Policy]() 3/27/23