

The Fed and Monetary Policy: Key

1. There are two major reasons. First, Congress hoped that an independent Central Bank would be more likely to avoid inflationary policies that boost output in the short-run. This is an example of trying to fix *short-sightedness* a possible market failure. Second, Congress wanted the Fed to act as a lender of last resort. This entails making loans during periods of economic and financial distress to prevent unnecessary business failures. Unnecessary business failure have made many past recessions worse.
2. By lowering interest rates, the Fed was trying to lower the coast of borrowing. This would encourage consumption and investment, as well as making it easier for borrowers to get loans to make it through the crisis.
3. False. The Federal Funds rate is the rate at which banks loan reserves to each other. It is set by the market. The Fed chooses a target and then intervenes in financial markets to try to make the actual interest rate equal this target. While it is usually effective at doing so, there are times when the actual Federal Funds rate is significantly different than its target.
4. It did so primarily through open market operations. Here, during open market purchases the Fed exchanged electronic reserves for bonds. These electronic reserves were typically lent out, leading to an increase in the money supply. The opposite process worked for open market sales.
5. Since 2008, banks have been more reluctant to lend out reserves at the Fed. This has weakened the relationship between the monetary base and the money supply. The Fed has thus resorted to new measures. Paying interest on reserves and borrowing through reverse-repo loans are the two most prominent examples.
6. Quantitative easing refers to the massive purchases of long-term debt that Fed and other Central Banks have made, even though short-term interest rates are close to zero. The Fed hopes that by making these purchases, the will drive up the price of these bonds, and thus reduce the associated interest rate.
7. Suppose that a bond promises to pay \$100 in one year. If the price of this bond is P_b then the borrower will end up paying $(\$100 - P_b)$ in interest. The interest rate is then $\frac{(\$100 - P_b)}{P_b}$. Notice that as bond prices go up, the interest paid goes down, as does the interest rate.

8. Higher interest rates reduce aggregate demand. From our AS/AD model, this leads to lower inflation.

9. Lower interest rates increase aggregate demand. From our AS/AD model, this leads to higher output. From our model of the labor market, more output requires more labor which reduces unemployment.

10. The Fed interprets price stability as inflation averaging 2% over time and never deviating too substantially from 2% at any point in time..

11. Forward guidance refers to providing information about the future path of monetary policy. If, for example, the Fed promises to keep rates low for an extended period of time, then this promise might create a more favorable borrowing climate right away.

12. The inflation target is part of the neutral interest rate, the interest rate that the economy will achieve when the labor market is at full employment and when inflation is at target. By setting it at 2% instead of 0, it gives the Fed more room to cut interest rates when needed. A higher target may thus give the Fed more room to act in future recessions. Inflation does, however, have social costs. A higher target could amplify these.