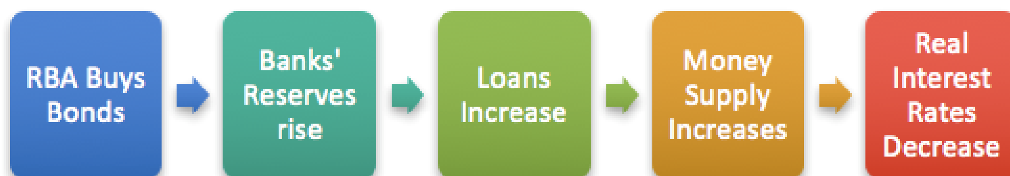
Modern Monetary Policy (GFC and Assets)

The Mechanics of MP

How central banks can manipulate market interest rates

1. **Traditional/Standard Method - Open Market Operations (OMO)**
    - The buying and selling of bonds by the central bank. Bank reserves and their ability to lend and create deposits are affected
    - To **increase** the money supply, the central bank **buys** bonds (expansionary)
    - To **decrease** the money supply, the central bank **sells** bonds (contractionary)
    - Bonds are government debts, promises to pay interest.
        - Usually a fixed nominal amount (leading to an inflation risk)
        - Some are indexed to inflation to guarantee a real rate of return to the holder

    Eg. For Expansionary Policy…
    RBA buys bonds to make funds more available



2. **Modern Method**
    - The official cash rate, the price of overnight inter-bank loans
        - Banks lend each other any spare reserves
    - RBA set their target cash rate monthly (excluding January)
    - RBA **cuts** the cash rate to encourage **more** spending
    - RBA **raises** the cash rate to encourage **less** spending
    - This cash rate broadly flows through to commercial banks and their interest rates to customers - depending on the degree of competition between banks

    Eg. For Expansionary Policy…
    RBA lowers the official cash rate

Government Bonds

Bonds are highly speculative even when payments are guaranteed

- When interest rates rise, bond prices fall
- When interest rates fall, bond prices rise