The Constitutional Law of Money

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Discussion Questions for Class 3

Money: the Modern Design (a very brief introduction)

Readings:

Andrew Jackson and Ben Dyson, "The Current Monetary System," in *Modernizing Money* 47-80 (London: Positive Money, 2013).

Federal Reserve System, Board of Governors. "Conducting Monetary Policy," in *Purposes and Functions (*2016) https://www.federalreserve.gov/pf/pf.htm.

Optional: C. Desan, A Note on the Federal Reserve's Power to Power Money, 12-16

Background:

According to the modern design, a central bank produces base or high-powered money when it buys public debt in return for cash. That cash is, in fact, the liability or debt of the central bank. (Check out the text on a dollar.) In fact, we can think of the central bank's notes as small-denomination sovereign liabilities: the bank has atomized the public debt into tiny, circulating IOUs on behalf of the government.

Instead of issuing cash, the central bank can also credit a commercial bank with reserve units of the same amount. (Think of reserves as virtual currency held by the bank.) Commercial banks then expand the money supply. There are competing models of the way they do that, including the endogenous credit model and the fractional reserve model. They are described in the Jackson and Dyson reading. Many economists on the Bank of England's staff appear to agree that the endogenous credit model more accurately describes the contemporary situation, as do many commentators on central banking in the U.S. We'll then discuss the way the Federal Reserve describes its own policy tools, and consider the Federal Reserve and the commercial banks interact.

Discussion Questions:

1. Where does the cash in circulation come from? What determines how many units of currency can be issued?

2. Can you analogize the money held as reserves by banks in the Fed to cash in circulation? How are reserves at the Fed created?

3. According to Dyson and Johnson, how do banks issue deposits for borrowers? What's the business model they are following and why is it profitable?

4. How do banks answer sudden surges of demand that may occur when those holding claims upon their bank want to cash out?

5. If the clearing medium held by the central bank were constant, how would it affect the operation of the commercial banks?

6. The Fed's *Purpose and Functions* identifies its mandate as promoting effectively "the goals of maximum employment, stable prices, and moderate long-term interest rates." As the Fed publication then proceeds to explain its mandate, it focuses more heavily on stable prices. Why?

7. In turn, the Fed identifies the interest rate that banks charge each other for funds (the federal funds rate) as the target for monetary policy. Why?

8. Please identify four tools according to which the Fed can use to control the amount of lending done by banks.

9. Why has the Fed added "large scale asset purchases" (or quantitative easing) to its set of tools?