Mishkin ch.14: The Money Supply Process

- **Objective:** Show *how* the Fed controls stocks of money; focus on M1.
  - Macro theory simply assumes that the Fed can set “M” via open market operations.
  - Point here: control is indirect – relies on assumptions about banks and depositors.

- **Focus on M1:** *Money = Currency + Deposits*  
  
  \[ M1 = C + D \]

  1. Show that the Fed can control the monetary base
   
   \[ \text{Monetary Base} = \text{Currency} + \text{Reserves} \]
   
   \[ MB = C + R \]

  2. Derive a *money multiplier* so that
   
   \[ M1 = \text{Multiplier} \cdot \text{Monetary Base} \]
   
   \[ M1 = m \cdot MB \]

  - Message: Fed can control M1 by controlling MB, but not perfectly.
  - Assumes “normal” conditions: interest rates > 0. Later examine crises.

- **Add extensions and prepare for Fed Funds market analysis:**
  
  - Show how the Fed can control balance sheet items other than MB.
  - Introduce distinction between dynamic and defensive open market operations.
  - Derive a money multiplier for M2.
  - Case studies: the Great Depression and the 2007-09 crisis.
**Balance Sheet Analysis: Monetary Aggregates at Banks and at the Fed**

- **Balance Sheet of the Banking System:**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>D Checkable Deposits</td>
</tr>
<tr>
<td>Securities</td>
<td>Time Deposits etc.</td>
</tr>
<tr>
<td>R Reserves</td>
<td>BR Borrowed Reserves</td>
</tr>
</tbody>
</table>

- **Balance Sheet of the Federal Reserve:** includes all of MB but only part of M1.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>C Currency</td>
</tr>
<tr>
<td>BR Discount loans</td>
<td>R Bank reserves</td>
</tr>
<tr>
<td>Gold</td>
<td>Treasury Dep.</td>
</tr>
<tr>
<td>Check Float</td>
<td>Foreign CB Dep.</td>
</tr>
</tbody>
</table>

- **Money stock M1** = Sum of monetary aggregates C+D from both balance sheets.
  [Similar for M2. Note that currency includes Treasury coins – small amount ignored to simplify.]

- **Monetary base MB = C+R:** exclusively on the Fed balance sheet.

- **Linkages:**
  - R = Bank Reserves = Banks’ deposits at Fed + Vault cash
  - BR = Borrowed Reserves = Discount loans from Fed

[Notes on Mishkin Ch.14 - P.2]
Open Market Operations (OMO) and the Monetary Base

Examine with numerical examples

**Initial Fed Balance Sheet** (normal: assets mostly securities; liabilities mostly currency)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>99</td>
</tr>
<tr>
<td>Discount Loans</td>
<td>1</td>
</tr>
<tr>
<td>Currency</td>
<td>90</td>
</tr>
<tr>
<td>Reserves</td>
<td>5</td>
</tr>
<tr>
<td>Treasury/CB Dep.</td>
<td>5</td>
</tr>
</tbody>
</table>

⇒ MB = 95

Example 1: Purchase of securities with payment to a bank’s reserve account:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>+1</td>
</tr>
<tr>
<td>Reserves</td>
<td>+1</td>
</tr>
</tbody>
</table>

New Fed Balance Sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>100</td>
</tr>
<tr>
<td>Discount Loans</td>
<td>1</td>
</tr>
<tr>
<td>Currency</td>
<td>90</td>
</tr>
<tr>
<td>Reserves</td>
<td>6</td>
</tr>
<tr>
<td>Treasury/CB Dep.</td>
<td>5</td>
</tr>
</tbody>
</table>

⇒ MB = 96

Find: Open market purchases increase the monetary base one-for-one.
**Example 2**: Sale of securities with payment from a bank’s reserve account:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>-1</td>
</tr>
<tr>
<td>Reserves</td>
<td>-1</td>
</tr>
</tbody>
</table>

New Fed Balance Sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>98</td>
</tr>
<tr>
<td>Currency</td>
<td>90</td>
</tr>
<tr>
<td>Discount Loans</td>
<td>1</td>
</tr>
<tr>
<td>Reserves</td>
<td>4</td>
</tr>
</tbody>
</table>
| Treasury/CB Dep. | 5            | $\Rightarrow MB = 94$

**Find**: Open market sales reduce the monetary base one-for-one.

**Example 3**: Purchase of securities with currency issued to the public

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>+1</td>
</tr>
<tr>
<td>Currency</td>
<td>+1</td>
</tr>
</tbody>
</table>

New Fed Balance Sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>100</td>
</tr>
<tr>
<td>Currency</td>
<td>91</td>
</tr>
<tr>
<td>Discount Loans</td>
<td>1</td>
</tr>
<tr>
<td>Reserves</td>
<td>5</td>
</tr>
</tbody>
</table>
| Treasury/CB Dep. | 5            | $\Rightarrow MB = 96$

**• Conclude**: Open market operations change MB one-for-one, regardless how the Fed pays for them. (Settlement is almost always with reserves.)

$\Rightarrow$ Tool for the Fed to change the monetary base – at will and at short notice.
Open Market Operations and Bank Reserves

Why focus on MB and not bank reserves?

- Open market operations with banks also change R one-for-one.
- Argument for using MB: R changes when the public demands currency.

Example 4: Bank customers withdraw currency from checking accounts.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency</td>
<td>+1</td>
</tr>
<tr>
<td>Reserves (vault cash)</td>
<td>- 1</td>
</tr>
</tbody>
</table>

New Fed Balance Sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>99</td>
</tr>
<tr>
<td>Discount Loans</td>
<td>1</td>
</tr>
<tr>
<td>Currency</td>
<td>91</td>
</tr>
<tr>
<td>Reserves</td>
<td>4</td>
</tr>
<tr>
<td>Treasury/CB Dep.</td>
<td>5</td>
</tr>
</tbody>
</table>

⇒ MB = 95

Find: Changes in the composition of money demand (C vs. D within M1) have no effect on the monetary base.

- Counterargument: R is also controllable because the Fed can monitor currency withdrawals and execute offsetting open market operations immediately.
- Analysis of the Fed funds market commonly assumes the Fed can control R
Discount Loans: An instructive complication

Example 5: Bank takes out a discount loan. (Note: Loans require Fed approval, but approval is routine, so bank effectively determine BR.)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount Loans</td>
<td>+1</td>
</tr>
<tr>
<td>Reserves</td>
<td>+1</td>
</tr>
</tbody>
</table>

New Fed Balance Sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>99</td>
</tr>
<tr>
<td>Currency</td>
<td>90</td>
</tr>
<tr>
<td>Discount Loans</td>
<td>2</td>
</tr>
<tr>
<td>Reserves</td>
<td>6</td>
</tr>
<tr>
<td>Treasury/CB Dep.</td>
<td>5</td>
</tr>
</tbody>
</table>

⇒ MB = 96

Find: Discount loans increase the monetary base one-for-one.

- How can the Fed avoid losing control over MB?
  - Answer: quickly do offsetting OMO; works because Fed knows BR.
  - Here: if MB target is 95 and BR increases, do open market sale => MB=95.

- Distinction: Defensive versus Dynamic open market operations
  - Dynamic = intended to change a variable targeted by monetary policy
  - Defensive = intended to prevent or offset a change in a targeted variable
Non-Borrowed MB and Non-Borrowed Reserves

- Standard way of handling discount loans:
  - Define: $\text{MB}_n = \text{MB} – \text{BR} = \text{non-borrowed monetary base}.$
  - Note in the Example: $\text{MB}_n = 94$ remains unchanged. Suggests that $\text{MB}_n$ is easier to control than MB.

=> Approach in Mishkin:
  - Write $\text{MB} = \text{MB}_n + \text{BR}$. Treat $\text{MB}_n$ as completely under Fed control
  - Assume BR is controlled by banks, so changes in BR require defensive open market operation to control MB.

- Analogous approach for the Fed funds market:
  - Define: $\text{NBR} = \text{R} – \text{BR} = \text{non-borrowed reserves}.$
  - In Example 5: $\text{NBR} = 4$, remains unchanged as BR changes
  - In Example 4: Currency outflow reduces R and NBR. But again, Fed can control NBR using defensive open market operations.

- General insight: Defensive open market operations can be used to control any single variable that (a) responds to OMOs and (b) the Fed can observe.
  - Caveat: controlling one variable means giving up control of others.
The Multiplier Idea

- Motivation: Fed cannot directly control M1. Bank deposit volume depends on bank customers’ decisions how to allocate their wealth.

- Fed has authority to impose reserve requirements on checkable deposits:
  - Reserve ratio = \( \text{rr} \). (Fed policy since 1990s: \( \text{rr} = 10\% \).)

\[
\text{Reserves} \geq \text{rr} \cdot \text{Deposits} \quad \Rightarrow \quad \text{Deposits} \leq (1/\text{rr}) \cdot \text{Reserves}
\]

- Find: Reserve requirements impose an upper bound on deposit volume.

- Complications:
  - What if \( \text{R} > \text{rr} \cdot \text{D} \)? Define \( \text{RR} = \text{rr} \cdot \text{D} \), \( \text{ER} = \text{R} - \text{RR} \). Argue that excess reserves are costly under normal conditions \( (i > i_{er}) \), hence small.
  - Currency: if \( \text{C}/\text{M1} \) is small, then \( \text{M1} \approx \text{D} \) and \( \text{MB} \approx \text{R} \), so \( \text{M1}/\text{MB} \approx \text{D}/\text{R} \approx 1/\text{rr} \); if \( \text{D}/\text{M1} \) is small, then \( \text{M1} \approx \text{C} \) and \( \text{MB} \approx \text{C} \), so \( \text{M1}/\text{MB} \approx 1 \).

- Find: For given \( \text{MB} \), \( \text{M1} \) depends on how money demand divides into \( \text{C} \) and \( \text{D} \). Upper bound on \( \text{D}/\text{R} \) implies an upper bound on \( \text{M1}/\text{MB} \).

- Systematic approach: find conditions for constant multiple \( \text{M1}/\text{MB} = \text{m} \).

Start with simple case, then generalize.
The Deposit Multiplier

- Simple math combining definitions and assumptions:
  - Definition of required reserves: \( RR = rr \cdot D \)
  - Assumption of no excess reserves: \( ER = 0 \) (assuming \( i > 0 \))
  - Definition of total reserves: \( R = RR + ER \)

\[ R = rr \cdot D \quad \text{(with equality, not} \geq \text{)} \]

\[ \Rightarrow \quad \text{Invert:} \quad D = (1/rr) \cdot R \]

- Define: Deposit multiplier = \( 1/rr \)
  - If \( rr = 10\% \): Deposit multiplier = 10

- Key assumption: No excess reserves => When Fed increases MB, banks will create deposits whenever they can: \( \Delta D = (1/rr) \cdot \Delta R \)

- Don’t confuse the deposit multiplier with the general money multiplier (next):
  - Money includes currency: Different answers if customers withdraw currency.
- Textbook distinction between banking system and a single bank: Single bank is limited to own excess reserves, not a multiple. Outdated: Banks can borrow Fed Funds.
The M1 Money Multiplier

- Include currency and non-zero excess reserves in a simple way. Define:
  \[ c = \frac{C}{D} = \text{Currency-deposit ratio} \]
  \[ e = \frac{ER}{D} = \text{Excess reserves-deposit ratio} \]
- Assume both ratios are constant.
- Modify the derivation of the deposit multiplier.

- Step 1: Reserves are a fixed fraction of deposits:
  - Definition of total reserves: \[ R = RR + ER \]
  - Definition of required reserves: \[ RR = rr \cdot D \]
  - Assumption about excess reserves: \[ ER = e \cdot D \]
  \[ \Rightarrow \quad R = rr \cdot D + e \cdot D = (rr+e) \cdot D \]

- Step 2: Monetary base is a fixed fraction of deposits:
  - Definition of monetary base: \[ MB = R + C \]
  - Assumption about currency: \[ C = c \cdot D \]
  - Know reserve-deposit relation: \[ MB = (rr+e+c) \cdot D \]
  \[ \Rightarrow \text{Invert:} \quad D = MB/(rr+e+c) \]
• Step 3: M1 is currency plus checkable deposits:

\[ M1 = C + D = (1+c) \cdot D = \frac{(1+c)}{(rr+e+c)} \cdot MB \]

• Result: The M1 money multiplier

\[ m = \frac{(1+c)}{(rr+e+c)} \]

• Economic reasoning:
  1. Money multiplier = Ratio of \( M = D + C \) to \( MB = R + C \).
     - Ratio of \( D \) to \( R \) is \( 1/(rr+e) \) ~ 10. Ratio of \( C \) to \( C \) is 1.
     => Ratio of \( M \) to \( MB \) normally between 1 and 10.
  2. If the Fed increases reserves, banks seek to expand deposits until
     - Bank customers withdraw currency (c)
     - Reserves are tied down as required reserves (rr)
     - Reserves are held as targeted excess reserves (e)
  3. Derivation: All quantities are proportional to deposits.
The M2 Money Multiplier

- Same idea with more components – practically relevant.
- Use same approach as for M1. See Mishkin’s online appendix14#2

  Simplified definition:

  \[
  M2 = D + C + T + \text{MMF}
  \]

  where \( T = \text{time and savings deposits} = t \cdot D \)

  \( \text{MMF = money market funds etc.} = mm \cdot D \)

  \[
  \Rightarrow \quad m_2 = \frac{(1+c+t+mm)}{(rr+e+c)}
  \]

- Find: If \( m_2 \) is constant, \( \Delta M2 = m_2 \cdot \Delta MB \), is controllable by the Fed.

- Conclude: Multiplier idea works for any concept of money, if bank and customer behavior is stable – if “everything is proportional to D” applies.

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- Applications will focus on M1 to avoid duplication
- **Summary:** TABLE 1 of Ch.14 …
### Summary: Determinants of the M1 Money Supply

<table>
<thead>
<tr>
<th>Player</th>
<th>Variable</th>
<th>Change in Variable</th>
<th>Money Supply Response</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve System</td>
<td>Nonborrowed monetary base, $MB_n$</td>
<td>$↑$</td>
<td>$↑$</td>
<td>More $MB$ for deposit creation</td>
</tr>
<tr>
<td></td>
<td>Required reserve ratio, $rr$</td>
<td>$↑$</td>
<td>$↓$</td>
<td>Less multiple deposit expansion</td>
</tr>
<tr>
<td>Banks</td>
<td>Borrowed reserves, $BR$</td>
<td>$↑$</td>
<td>$↑$</td>
<td>More $MB$ for deposit creation</td>
</tr>
<tr>
<td></td>
<td>Excess reserves</td>
<td>$↑$</td>
<td>$↓$</td>
<td>Less loans and deposit creation</td>
</tr>
<tr>
<td>Depositors</td>
<td>Currency holdings</td>
<td>$↑$</td>
<td>$↓$</td>
<td>Less multiple deposit expansion</td>
</tr>
</tbody>
</table>

*Note: Only increases (↑) in the variables are shown. The effects of decreases on the money supply would be the opposite of those indicated in the “Money Supply Response” column.*
Applications of Multiplier Analysis

• Clarify the *objective*: Control M1. If m is constant, open market operations should translate into predictable, proportional changes in M1:

\[ \Delta M1 = m \cdot \Delta MB \]

where \( m = \frac{1+c}{rr+e+c} \) and \( \Delta MB = \Delta MB_n + \Delta BR \)

• Fact: M1 also changes when \( m \) or \( BR \) change. These are *complications*.

**Money Multiplier Example #1: Normal Conditions (2007)**

• Data ($bill): \( C=760, D = 620, R = 64.5, BR=0.1 \) all in
  - Implies: \( M1 = 1380, MB = 824.5, MB_n= 824.4, NBR= 64.4, RR=62, ER=2.5 \)
  - Ratios: \( c = \frac{760}{620} =1.2258, e = 0.0040, rr = 0.10. \)
• Multiplier: \( m = \frac{1+c}{rr+e+c} = \frac{1+1.2258}{0.1+0.004+1.2258} = \frac{2.2258}{1.3298} = 1.6738 \)
  - Verify: \( M1 = 1.6738 \cdot 824.5 = 1380 \)
  - Lesson: $1 open market purchase/sale should raise/reduce M1 by $1.67.
Case Study #1: The Great Depression
Series of Bank Runs

[Graph showing the series of bank runs from 1929 to 1933 with significant spikes in deposits indicated by annotations for the start and end of the first banking crisis and another for the end of the final banking crisis.]
Currency and Excess Reserve Ratios

[Note on 2008: Rise in $e$ but stable $c$. FDIC has prevented bank runs!]

[Notes on Mishkin Ch.14 - P.16]
Money and the Monetary Base

- Conclusion by Milton Friedman and Anna Schwartz: The Fed should have stabilized M1. Policy mistake made the Great Depression worse.
- General lesson: The money stock must be monitored in problem situations, e.g., during financial crises; also, in financially unstable countries.

[Notes on Mishkin Ch.14 - P.17]
Case Study #2: The Financial Crisis of 2007-2009

- No shift to currency (Difference to Great Depression: FDIC insurance.)
- Huge increase in excess reserves.
Policy Responses to the Financial Crisis

- Federal Reserve liquidity programs (2007-early 2009)
  Term Auction Facility (TAF) – December 2007. 28-day discount loans.
  Emergency lending to non-banks – to Primary Dealers – March 2008, to

- Support for specific institutions (Treasury, Federal Reserve, & FDIC)
  Bear Stearns (Mar.08); AIG (Sept.08); Citigroup (Nov. 08); Bank of America (Jan.09)

- Expansionary Open Market Operations; a.k.a. Quantitative Easing (QE)
  - Buying MBS and Treasury securities (2009-11).
  - Focus on troubled market segments a.k.a “Credit Easing”
  - Extending maturities from short to long – “Operation Twist” (2011-12)
    Supplemented by “forward guidance” – stated intent to keep Fed funds rate low for
    an extended time => reducing long-term rates through term structure logic
  - Additional rounds of QE until Nov. 2014. Result: Massive expansion of Fed assets,
    massive expansion of MB, banks holding enormous excess reserves.
# The Federal Reserve Balance Sheet: Credit

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Bills</td>
<td>277.0</td>
<td>227.8</td>
<td>21.7</td>
<td>18.4</td>
<td>18.4</td>
</tr>
<tr>
<td>Treasury Bonds&amp;Notes</td>
<td>513.5</td>
<td>512.8</td>
<td>457.1</td>
<td>457.5</td>
<td>* 758.2</td>
</tr>
<tr>
<td>MBS &amp; Agency Debt *</td>
<td></td>
<td></td>
<td></td>
<td>20.3</td>
<td>* 1069.5</td>
</tr>
<tr>
<td>Repurchase Agreements</td>
<td>27.2</td>
<td>39.8</td>
<td>110.3</td>
<td>80.0</td>
<td>0.0</td>
</tr>
<tr>
<td>TAF credit</td>
<td></td>
<td></td>
<td>40.0</td>
<td>150.0</td>
<td>450.2</td>
</tr>
<tr>
<td>Discount loans</td>
<td>0.2</td>
<td>5.8</td>
<td>15.0</td>
<td>86.6</td>
<td>19.7</td>
</tr>
<tr>
<td>Other loans (PD, AIG, TSLF)</td>
<td></td>
<td></td>
<td>1.7</td>
<td>101.2</td>
<td>68.4</td>
</tr>
<tr>
<td>Commercial Paper Funding</td>
<td></td>
<td></td>
<td></td>
<td>332.4</td>
<td>14.1</td>
</tr>
<tr>
<td>Maiden Lane I-III</td>
<td></td>
<td></td>
<td>24.0</td>
<td>62.0</td>
<td>553.2</td>
</tr>
<tr>
<td>Central Bank Swaps</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other assets (incl. Float)</td>
<td>39.4</td>
<td>41.6</td>
<td>42.3</td>
<td>71.7</td>
<td>95.4</td>
</tr>
<tr>
<td>Total Reserve Bank Credit</td>
<td>857.3</td>
<td>891.7</td>
<td>890.0</td>
<td>2246.5</td>
<td>2219.9</td>
</tr>
</tbody>
</table>

## Summary:

**Securities:** Treasury  
- **New:** MBS etc.  
  - Total: 20.3 * 1069.5

**Discount Lending:** regular  
- **New:** TAF & CB swaps  
- **New:** Loans to Non-banks  
  - Loans up, T-bills down  
  - Loans UP, Total UP

**Memo:** Fed Funds Rate  
- Pre-crisis Discount  
- Loans up, Loans UP, Start of QE

* Exceptional Lending  
* Quantitative Easing (QE)
Emergency Loans and Quantitative Easing
Phases: Exceptional Lending (using BR); then Quantitative Easing (NBR)
Money Multiplier Example #2 (Spring 2009, Peak of Crisis)

- **Data:** C=860, D = 740, R = 765, BR = 404 (crisis: huge BR)
  - Implies: M₁ = 1600, MB = 1625, MBₙ = 1221, NBR = 361, RR = 74, ER = 691
  - Ratios: c = 860/740 =1.1622, e = 0.9338, rr = 0.10.

- **Multiplier:** \( m = \frac{1+c}{rr+e+c} = \frac{1+1.1622}{0.1+0.9338+1.1622} = \frac{2.1622}{2.196} = 0.9846 \)
  - Verify: M₁ = 0.9846 \( \cdot \) 1625 = 1600.

- **Compare to M₁=1380 in 2007:** In contrast to the Great Depression, Fed did not allow M₁ to decline, and instead increased R to offset the decline in m.

- **Question 1:** What if the Fed had refused to ease? Example: keep MB=880 as in 2007
  => M₁ = 0.9846 \( \cdot \) 880 = 866. Suggests reduction in M₁, deflation.

- **Question 2:** Should one worry about the monetary expansion causing inflation?
  - Public concerns in 2009: If e returns to normal, M₁ would rise sharply.
    Math: if \( e \downarrow 0 \), \( m = \frac{1+c}{rr+e+c} = \frac{1+1.1622}{0.1+0+1.1622} = 1.713, \) so \( M₁ = 1.713 \cdot 1625 = 2874 \).
  - Counterargument: if \( e = 0 \), Fed could stop lending, so \( BR \downarrow 0 \), which would quickly reduce MB to \( MB \downarrow MBₙ = 1221 \), so \( M₁ = 1.713 \cdot 1221 = 2165 \).
  - Lesson: MB-expansion through discount loans can be reversed quickly, mitigates concerns about inflation.
Money Multiplier Example #3 (Fall 2010, Recovery)

- Data: C=910, D = 850, R = 1060, BR = 70 (Era of QE; reduced BR)
  - Implies: M1 = 1760, MB = 1970, MBn= 1900, NBR= 990, RR=85, ER=975
  - Ratios: c = 910/850 =1.0706, e = 1.1471, rr = 0.10.
- Multiplier: 
  \[ m = \frac{1+c}{rr+e+c} = \frac{1+1.0706}{0.1+1.1471+1.0706} = \frac{2.0706}{2.3177} = 0.8934. \]
  - Verify: M1 = 0.8934 \cdot 1970 = 1760

- Questions:
  1. Should one worry about the monetary expansion causing inflation?
     If \( e \downarrow 0 \), 
     \[ m = \frac{1+c}{r+e+c} = \frac{1+1.1471}{0.1+1.1471} = 1.66, \] so M1 = 1.66 \cdot 1970 = 3270.
     Potential for high money growth. Consistent with QE goal to increase expected inflation.
  2. Could an increase in M1 be reversed by reduced discount loans? No, BR is small.
     If \( BR \downarrow 0 \) and \( e = 0 \), MB = MBn= 1900 and M1 = 1.66 \cdot 1900 = 3154.
     Getting to M1\sim1600 would require huge open market operations.
  3. Can the Fed still control M1? Questionable if $1 open market sale would reduce M1 by $0.89. Banks could reduce ER instead, so \( m \uparrow \).
     => Need to reconsider how M1 is determined. Next: the Fed funds market.
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