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How does conventional monetary policy work?

- the central bank sets the short-term (overnight) interest rate, the rate at which banks lend reserves to, and borrow reserves from, other banks
- important background fact: before the financial crisis, the Fed (and most other central banks) did not pay interest on reserves
- given ^{1} BK and ^{1} GD, the central bank adjusts R so that the actual level of reserves is in line with “required reserves” (set by the central bank)
- given its control of the level of reserves, the central bank can push the interest rate up or down, as it chooses, by creating a shortage or surplus
- if the economy is overheating, it raises the interest rate; if the economy is flagging, it lowers the interest rate
- the central bank can influence medium- to long-term interest rates (the ones that count) via the expectations