Chapter 14
The Monetary Policy Approach to Stabilization

Learning Objectives

- Explain how the Fed can create loose or tight monetary policies.
- List and explain the three traditional tools of monetary policy.
- Compare the direct versus the indirect effect of monetary policy on aggregate demand.
- Outline the relationship between the rate of growth of the money supply and the rate of inflation.
- Contrast the Keynesian and monetarist views of the transmission mechanism of monetary policy.

Monetary Policy of the Fed

- **Monetary policy** involves changing the amount of money in circulation in order to affect interest rates.

Loose Monetary Policy

- If the Fed implements a **loose monetary policy** (often called expansionary), the supply of credit increases and its cost falls.
- A loose money policy is often implemented as an attempt to encourage economic growth.
Tight Monetary Policy

- If the Fed allows a **tight monetary policy**, the supply of credit decreases and its cost increases.
- Why would any nation want a tight money policy?
  - In order to control inflation

Figure 14-1: The Two Faces of Monetary Policy

1. Borrowing is difficult
2. Consumers buy less
3. Businesses postpone expansion
4. Unemployment increases
5. Production is reduced

The Traditional Tools of Monetary Policy

- The Fed has at its disposal a number of tools that it can use to engage in monetary policy. We will study:
  - Open market operations
  - The discount rate
  - Reserve requirements

Open Market Operations

- This term refers to the Fed changing the amount of reserves in the banking system by its purchases and sales of government securities issued by the U.S. Treasury.
The Discount Rate

- The **discount rate** is the interest rate the Fed charges on loans to member banks.
- Alternatively, banks can go to the **federal funds market**, in which banks can borrow reserves from other banks that want to lend them and pay the **federal funds rate**.

Reserve Requirements

- The Fed rarely uses changes in reserve requirements as a form of monetary policy.
- Most recently it did so in 1992, when it decreased reserve requirement on checkable deposits to 10 percent.

Changes in Money Supply affect Aggregate Demand

- The **direct effect** of an increase in the money supply refers to people purchasing more goods and services because they have more money or cash balances than they desire.

Changes in Money Supply affect Aggregate Demand (cont.)

- The **indirect effect** of an increase in the money supply occurs when such a monetary policy leads to a decrease in interest rates, which then lead to higher levels in desired borrowing by individuals and businesses.
Changes in Money Supply affect Equilibrium Real GDP

- When the Federal Reserve System engages in *contractionary monetary policy*. The Fed does so by taking money out of the banking system.
- The result is that aggregate demand is reduced.
- Consequently, the equilibrium level of real GDP per year falls.

Example: The Great Depression

- The *Great Depression* during the 1930s was one of the most disastrous episodes in this nation’s economic history.
- During this time, the money supply in circulation dropped by one-third!
- Certainly, the result was a decrease in aggregate demand.

Monetary Policy and Inflation

- In the *short run* (several months to a year), many factors can affect inflation beside monetary policy.
- In the *long run*, empirical studies show, there is a relatively stable relationship between excess growth in the money supply and inflation.

International Example

- There is considerable evidence of the empirical validity of the relationship between high monetary growth and high rates of inflation.
- Figure 14-4, next, shows the correspondence between *money supply growth* and the *rates of inflation* in various countries around the world.
The Keynesian Money Transmission Mechanism

- Keynesian economists believe that the *indirect effect* of monetary policy is the most important of the two effects.
- According to this view, changes in the money supply change the interest rate, which in turn changes the desired rate of investment.

The Monetarists’ Transmission Mechanism

- Monetarists contend that monetary policy works its way more directly into the economy.
- They believe that changes in the money supply lead to changes in equilibrium real GDP in the same direction, in the short run.
The Monetarists' Transmission Mechanism (cont.)

- If the economy is starting out at its long-run equilibrium level of real GDP, there can only be a short-run increase in real GDP due to an expansionary monetary policy.
- Ultimately the public cannot buy more of everything; people simply bid up prices so the price level rises.

Criticism of Monetary Policy

- Some monetarists argue that although monetary policy can affect output (and employment) in the short run, the length of time required before money supply changes take effect is so long and variable that such policy is difficult to conduct.

One Alternative Monetary Policy: Following a Monetary Rule

- According to some monetarists, policymakers should follow a monetary rule: Increase the money supply smoothly at a constant rate consistent with the economy’s long-run potential growth rate.
- For instance, increase the money supply smoothly at 3.5 percent per year.

Another Alternative Monetary Policy: Inflation Targeting

- Some countries have taken another policy route, inflation targeting.
- This involves setting a goal, or target, that concerns the measured rate of inflation.
- For example, the target could be inflation of no more than 2 percent a year.
The Way Federal Reserve Policy Is Currency Announced

• The Fed makes current monetary policy known by making announcements concerning the federal funds rate target.

• If the Fed talks about changing interest rates, it can do so by actively entering the market for federal government securities.

Key Terms and Concepts

• discount rate
• federal funds market
• federal funds rate
• inflation targeting
• loose monetary policy

• monetarists
• monetary rule
• open market operations
• tight monetary policy