

Monetary Policy

Pushing and Pulling a String

Tools of Monetary Policy (in order of importance)

1. Interest on Reserve Balances – since 2008; lower rates loosen, higher rates tighten [Fed's main tool since Q3 2021 – not in your textbook!]
2. Open-Market Operations – formerly the bread and butter of monetary policy: buying assets loosens, selling assets tightens
3. Req'd Reserves – Lower requirement loosens, higher tightens, not in effect since 03/15/2020, when the rate fell to 0%
4. Discount rate – Lower rate loosens, higher rate tightens, this is not useful since the banking system is awash in reserves

Why Use Monetary Policy?

Expansionary policy puts **upward** pressure on the **price level** and on **real output**. This is useful to **stimulate** the economy and **alleviate** recessions.

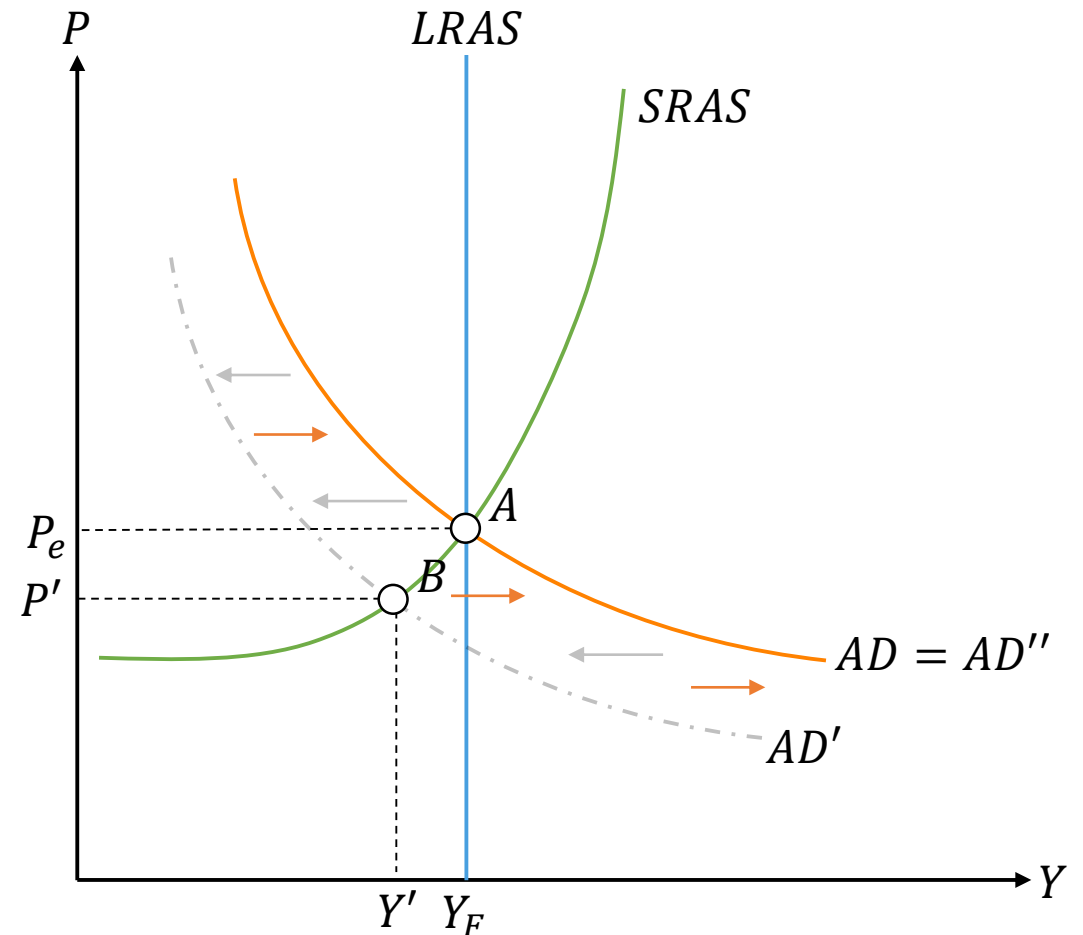
Contractionary policy puts **downward** pressure on the **price level** and **real output**. This would be useful only to reign in an economy above potential GDP (Y_F) or during **sustained inflationary periods**.

Best Case Scenarios for Monetary Policy

Case 1: *AD* Drop

A fall in *AD* moves the economy to a lower price level and a recessionary output level.

Monetary policy could expand *AD* back to where it was, restoring the price level and GDP to potential GDP.

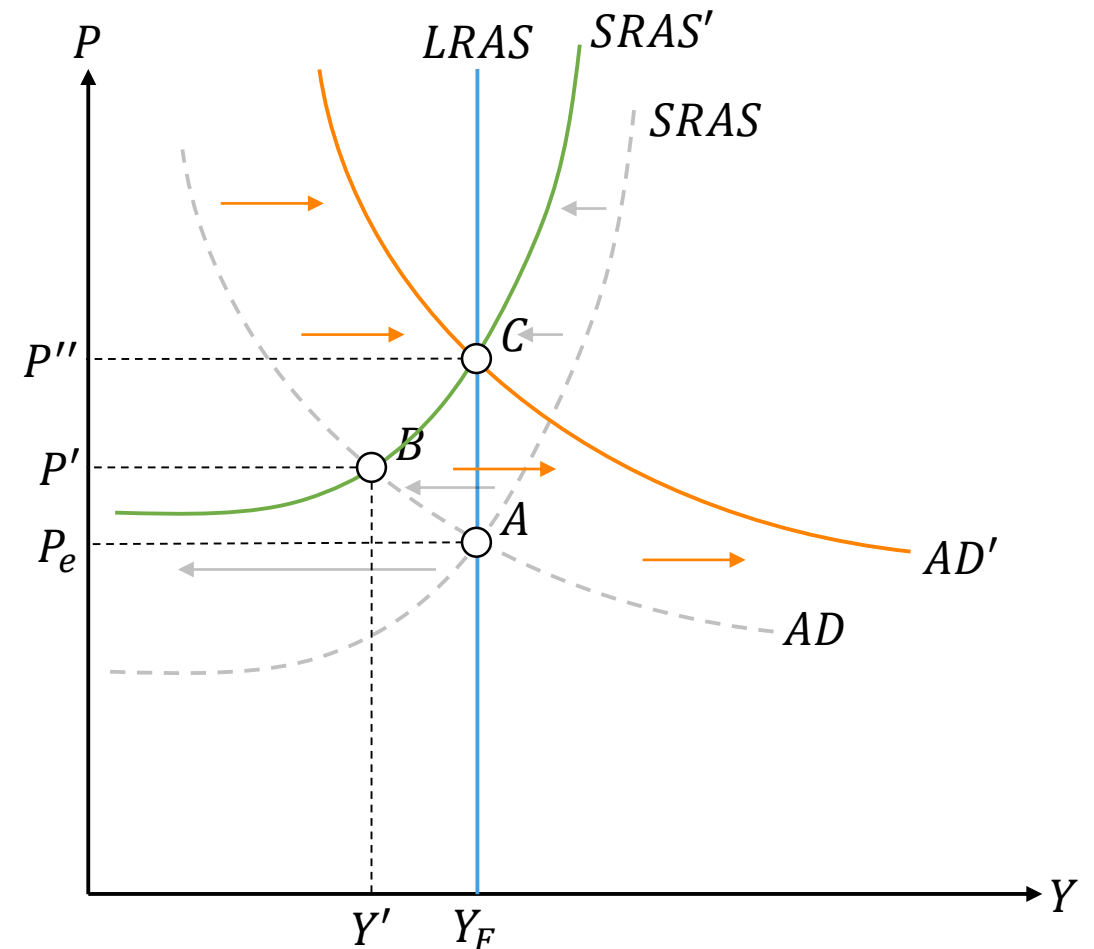


Best Case Scenarios for Monetary Policy

Case 2: *SRAS* shift

A decrease in *SRAS*, perhaps because of resource prices, raises the price level but pushes current output below potential—a recession.

Monetary policy could end the recession at the cost of higher inflation.

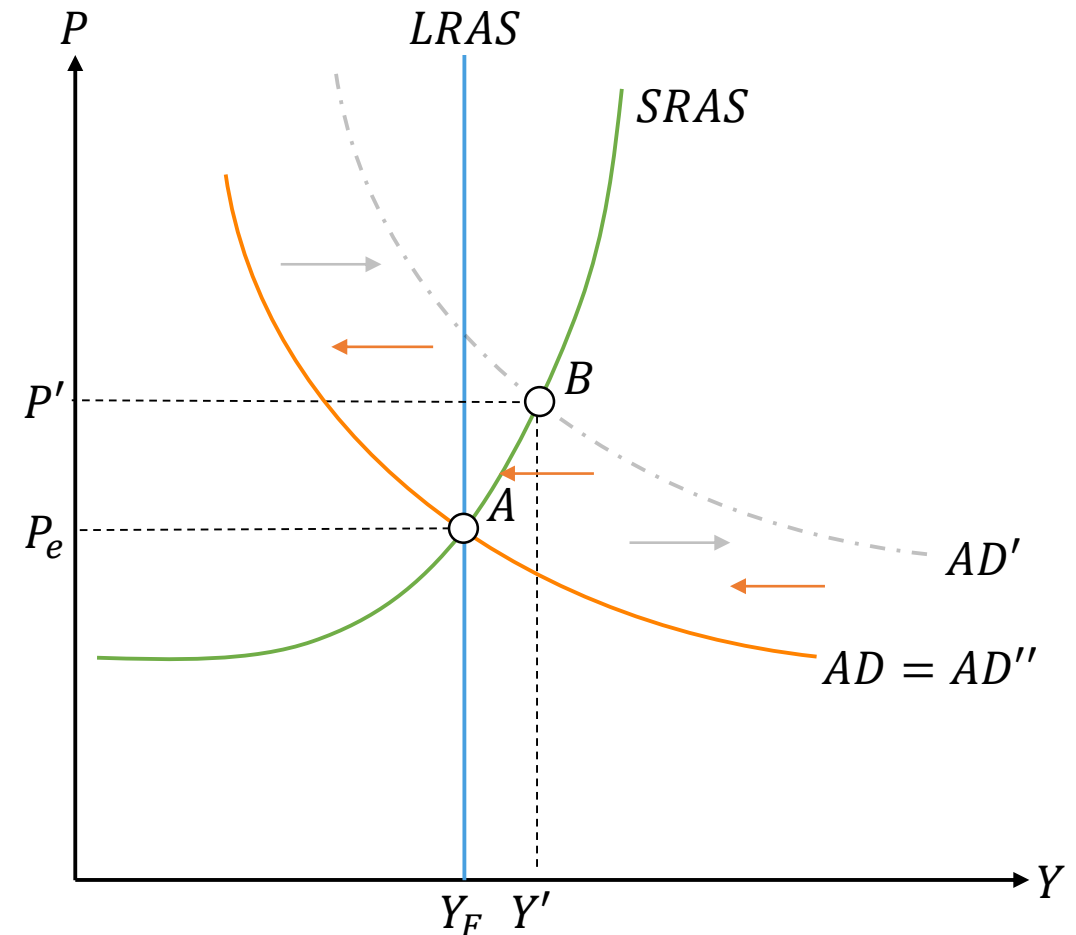


Best Case Scenarios for Monetary Policy

Case 3: *AD* Rise

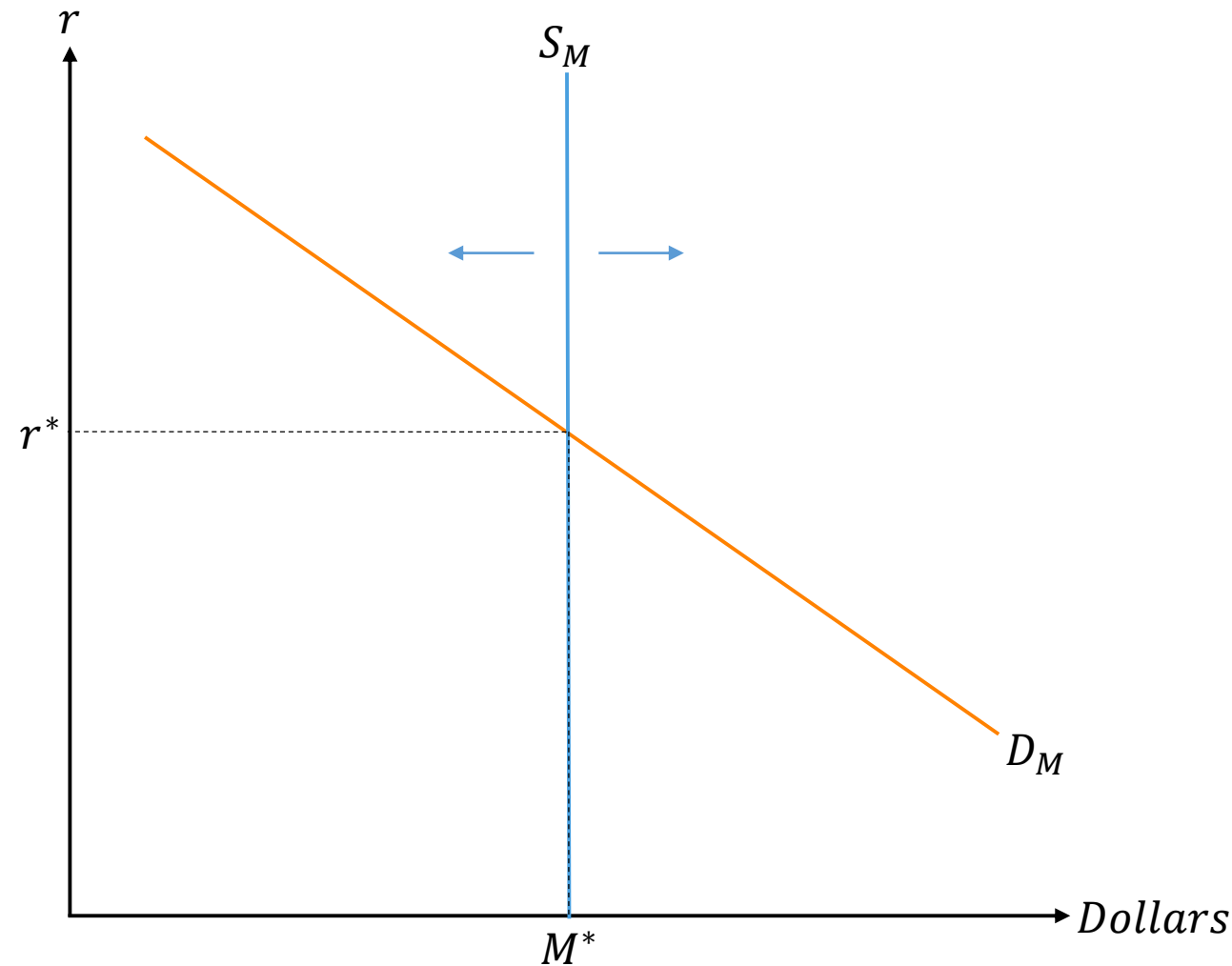
An increase in *AD* moves the economy to a higher price level and an unsustainable output level.

Monetary policy could contract *AD* back to where it was, restoring the price level and GDP to long-run potential GDP.



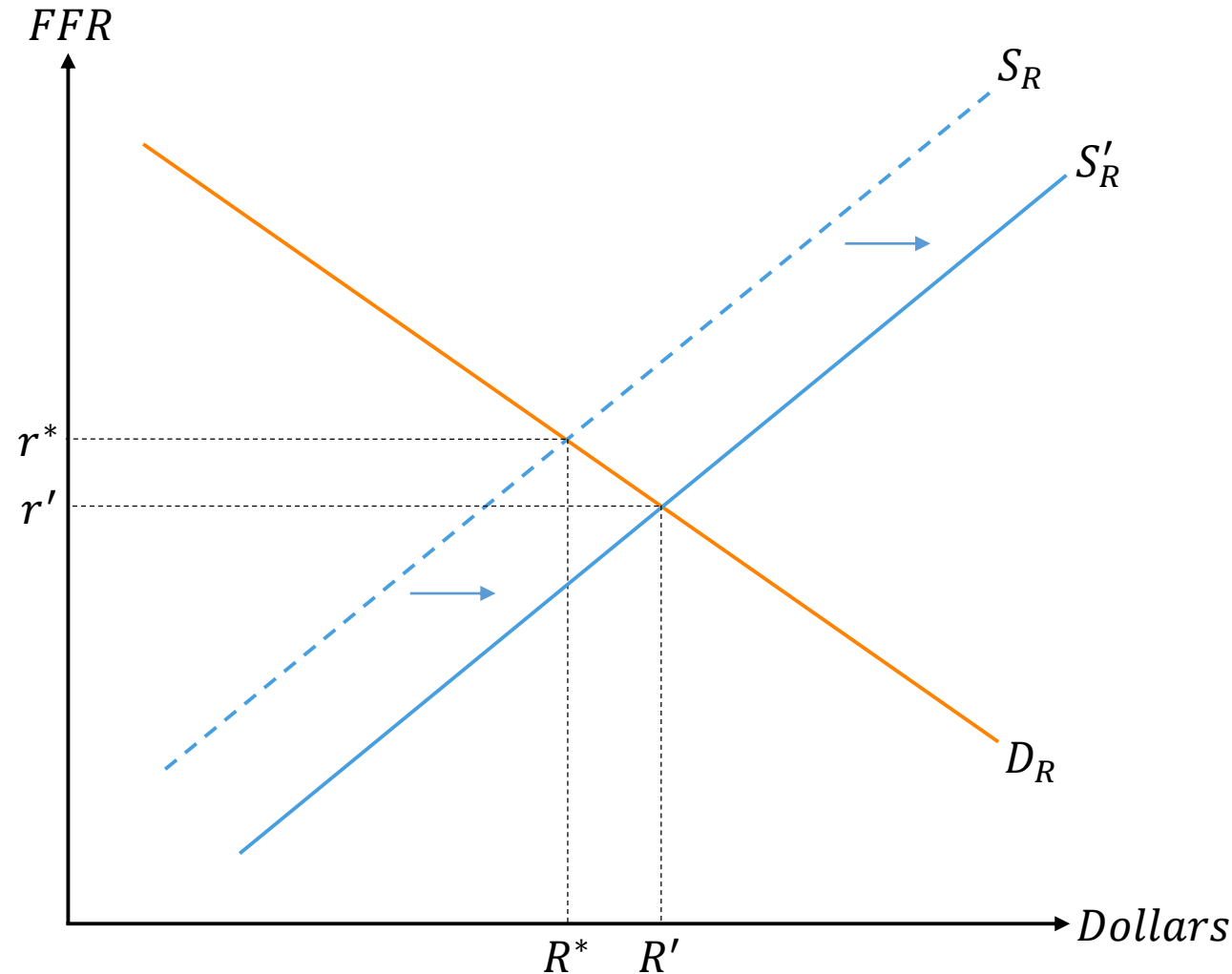
The Models We Use (and Don't Use)

The textbook still conceives of monetary policy as moving the **supply of money** and influencing the **interest rate** through the interplay of supply and demand in the “money market.”



The Models We Use (and Don't Use)

This approach is fine, I guess, but it seems to miss the fact that the **interest rate the Fed targets** (and has targeted for a while) is **the Federal Funds rate**. That rate is determined by a **market for reserves** inside the banking system.



The Words We Use (and Don't Use)

Pre 2021, when Open Market Operations was the primary tool of Monetary Policy, we would talk about “**buying bonds**” or “**selling bonds**” as the way monetary policy influenced “**the interest rate**” (the FFR). We would also talk about “**money growth**” or changes in “**the money supply.**”

We don't generally talk about it in terms of the money supply anymore; instead, our focus and our model is the FFR and the market for reserves in the banking system.

The Words We Use (and Don't Use)

After 2021, since Interest on Reserve Balances is the primary tool of Monetary Policy, we simply talk about “**raising interest rates**” or “**lowering interest rates.**”

We say it like this since IORB is the opportunity cost of supplying reserves on the market, thereby influencing “**the interest rate**” (the FFR).

Does Monetary Policy Work?

There are **various perspectives**.

“**Classical**” economists (and some old-school **Monetarists**) said “No,” since money was purely neutral. Changes in the money supply translate straight-forwardly into higher prices.

$$M \times \bar{V} = P \times \bar{Y}$$

This is the view **just about everyone** in modern contexts holds for **the long run**. For classical economists, the long run wasn't nearly so long—or maybe that was just the period they noticed.

Does Monetary Policy Work?

Keynesians hold that monetary policy **can** be effective in the short run, moving along *SRAS* but worry that in deep recessions, near-zero nominal interest rates ($i = r + \pi$) make **monetary policy ineffective**. This is the **liquidity trap**.

In response to the prospect of a liquidity trap, many orthodox Keynesians believe **fiscal policy is the better tool**.

Does Monetary Policy Work?

“Modern” **Monetarists** are skeptical of **fiscal policy** because crowding out drives the expenditure multiplier closer to 1 or even below 1 (but still positive).

Instead, they propose **monetary policy** for short-run alleviation of **recession** (expansionary) or **inflation** (contractionary), though they hold that in the long run, **money is more or less neutral** and monetary policy will primarily affect the price level.

Policy: Active vs Passive

Active – This means that the Fed ought to do what it can to “**balance the economy**” and work toward its mandates of full employment, price stability, economic growth, and moderate long-term interest rates.

Passive – the Fed is better served keeping the banking system operable and provide stable, background structure for economic activity. The Fed should **not** be committed to “balancing the economy” but to assuring the **stability the banking system** and **doing no harm**.

Policy: Discretion vs Rules

Discretion – expansionary and contractionary monetary policy are part of a general program of **discretionary policy**. This means that the Fed can **react** to changes in the economy.

Rules – the Fed should be bound up by rules. There are several proposed rules for monetary policy, but all of these have in common the idea that the Fed should **not** be committed to “balancing the economy” but to assuring the **stability of price expectations** and **doing no harm**.

What Does the Fed Actually Do?

The Fed seems to follow a general rule—aiming for about 2% annual inflation—subject to **normal** economic circumstances. In **extraordinary** circumstances (a recession, for instance), the Fed jumps into **discretionary** mode and attempts to alleviate the current situation.

The Fed's ability to sit in **both of these camps** requires walking a tightrope and implies **control of monetary policy** well **beyond** what is **likely possible**.