Chapter Goals

- Explain how monetary policy works in the IS/AD model in both the traditional and structural stagnation models.
- Discuss how monetary policy works in practice.
- Discuss the tools of conventional monetary policy.
- Discuss the complex nature of monetary policy and the importance of central bank credibility.

Monetary Policy

- **Monetary policy** is a policy of influencing the economy through changes in the banking system’s reserves that influence the money supply, credit availability, and interest rates in the economy.
- **Fiscal policy** is controlled by the government directly.
- **Monetary policy** is controlled by the U.S. central bank, the Federal Reserve Bank (the Fed).
- **Monetary policy** works through its influence on credit conditions and the interest rate in the economy.
How Monetary Policy Works in the Models

Monetary policy affects both real output and the price level.

If the economy is at or above potential, expansionary monetary policy will cause input costs to rise.

The only long-run effect of expansionary monetary policy when the economy is above potential is to increase the price level.

Expansionary monetary policy is a policy that increases the money supply and decreases the interest rate and it tends to increase both investment and output.
**How Monetary Policy Works in the Models**

- **Contractionary monetary policy** is a policy that decreases the money supply and increases the interest rate, and it tends to decrease both investment and output.