Monetary Policy 1

*Monetary Policy

Chapter 13 Part One What is it?

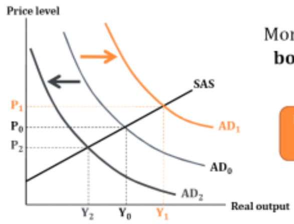
Chapter Goals

- Explain how monetary policy works in the AS/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

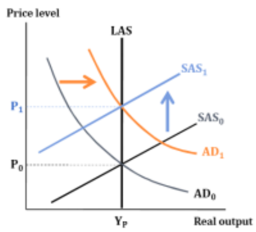


Monetary policy affects **both** real output and the price level

Expansionary monetary policy shifts the AD curve to the right

Contractionary monetary policy shifts the AD curve to the left

How Monetary Policy Works in the Models



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

Rising input costs will eventually shift the SAS curve up so that real output remains unchanged

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

How Monetary Policy Works in the Models *

- **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

$M\downarrow \rightarrow i\uparrow \rightarrow I\downarrow \rightarrow Y\downarrow$