Monetary Policy

Maintaining Policy Credibility

- Policy makers are very concerned about establishing policy credibility because they believe that it is necessary to prevent inflationary expectations from becoming built into the economy.
- **Nominal interest rates** are the rates you actually see and pay.
- **Real interest rates** are nominal interest rates adjusted for expected inflation.
- Real interest rate = Nominal interest rate - Expected inflation.

Maintaining Policy Credibility

- The real interest rate cannot be observed since it depends on expected inflation, which cannot be directly observed.
- Making a distinction between nominal and real rates adds another uncertainty to the effect of monetary policy.
- If expansionary policy leads to expectations of increased inflation, nominal rates will increase and leave real rates unchanged.
Monetary Regimes

- Most economists believe that a monetary regime, not a monetary policy, is the best approach to policy.
  - A **monetary regime** is a predetermined statement of the policy that will be followed in various situations.
  - A monetary policy is a response to events chosen without a predetermined framework.
- Monetary regimes are now favored because rules can help generate market expectations.
- An explicit monetary regime has problems because special circumstances arise where it makes sense to deviate from the regime.

Chapter Summary

- Monetary policy is the policy of influencing the economy through changes in the banking system's reserves that affect the money supply.
- In the AS/AD model, expansionary monetary policy works as follows:
  \[ \text{M} \rightarrow \text{i} \rightarrow \text{I} \rightarrow \text{Y} \]
- Contractionary monetary policy works as follows:
  \[ \text{M} \rightarrow \text{i} \rightarrow \text{I} \rightarrow \text{Y} \]
- In the structural stagnation model, expansionary monetary policy lowers interest rates and raises asset prices.

Chapter Summary

- The Federal Open Market Committee (FOMC) makes the actual decisions about monetary policy.
- The Fed is a central bank; it conducts monetary policy for the U.S. and regulates financial institutions.
- The Fed changes the money supply through open market operations.
- The Federal funds rate is the rate at which one bank lends reserves to another bank.
- The Fed's direct control is on short-term interest rates.
Chapter Summary

- A change in reserves changes the money supply by the change in reserves times the money multiplier.
- The Taylor rule is a feedback rule that states: Set the Fed funds rate at 2 plus current inflation plus one-half the difference between actual and desired inflation plus one-half the percent difference between actual and potential output.
- Nominal interest rates are the interest rates we see and pay. Real interest rates are nominal interest rates adjusted for expected inflation: Real interest rate = Nominal interest rate - Expected inflation.