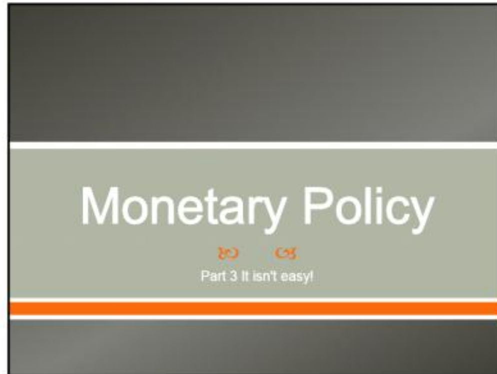
Monetary Policy Conclusion p3



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:

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

- Contractionary monetary policy works as follows:

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

- 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.