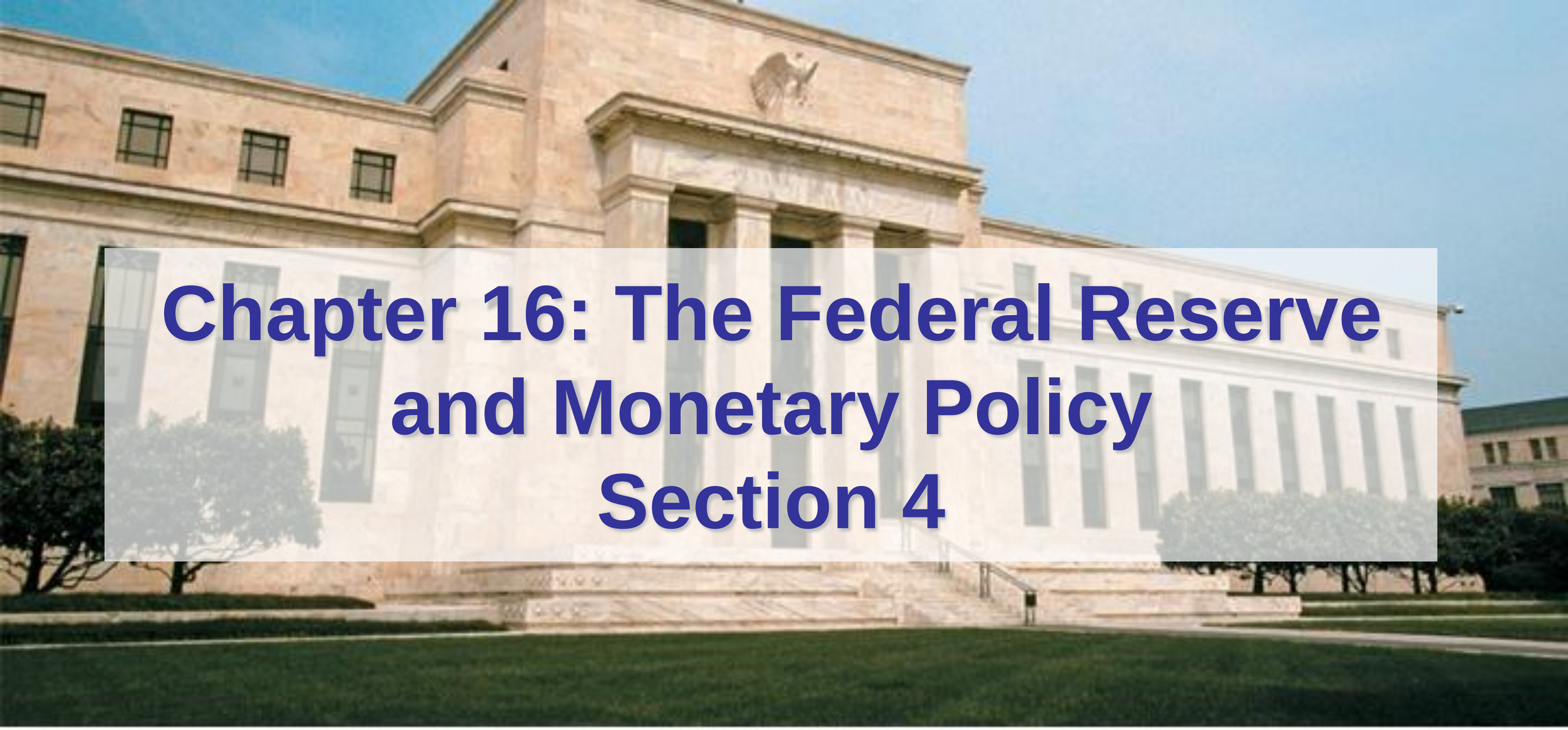

Chapter 16: The Federal Reserve and Monetary Policy
Section 4

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ECONOMICS

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Objectives

1. **Explain** how monetary policy works.
2. **Describe** the problem of timing in implementing monetary policy.
3. **Explain** why the Fed's monetary policy can involve predicting business cycles.
4. **Contrast** two general approaches to monetary policy.

Key Terms

- **monetarism**: the belief that the money supply is the most important factor in macroeconomic performance
- **easy money policy:** a monetary policy that increases the money supply
- **tight money policy**: a monetary policy that decreases the money supply
- **inside lag**: the time it takes to implement monetary policy
- **outside lag**: the time it takes for monetary policy to have an effect

Introduction

ECONOMICS

- How does monetary policy affect economic stability?
  - The timing of monetary policy can help support the Fed's efforts to create economic stability.
  - Monetary policy, properly administered, affects the money supply and, in turn, can help create a stable economy.

Monetarism

- Some economists believe that the money supply is the most important factor in macroeconomic performance. This belief is known as monetarism.
- Monetary policy alters the supply of money, which, in turn, affects interest rates.
  - Interest rates affect the level of investment and spending in the economy.

Money Supply and Interest Rates

- The cost of money is the interest rate.
- The market for money is like any other market.
  - If the supply is higher, the price—the interest rates—is lower.
  - If the supply is lower, the price—the interest rates—is higher.
  - So, when the money supply is high, interest rates are low and when the money supply is low, interest rates are high.

Interest Rates and Spending

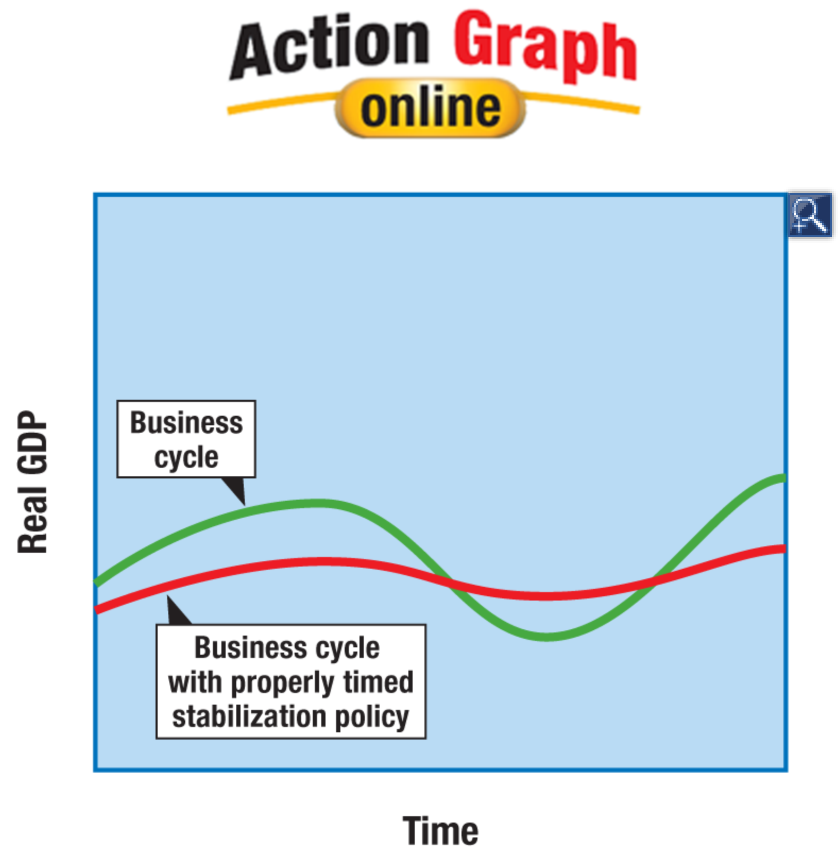
- Lower interest rates encourage greater investment spending by business firms because a firm's cost of borrowing decreases as the interest rate decreases.
  - Higher interest rates discourage business spending.
- If the economy is experiencing a contraction, the Fed will follow an easy money policy in order to increase the money supply.
- If the economy is experiencing a rapid expansion that may cause inflation, the Fed will introduce a tight money policy to reduce the money supply.

Interest Rates and Spending, cont.

- An increased money supply will lower interest rates and a decreased money supply will push interest rates upward.
- In this way, the Fed has a great impact on the economy.
  - The money supply determines the interest rate and the interest rate determines the level of aggregate demand.

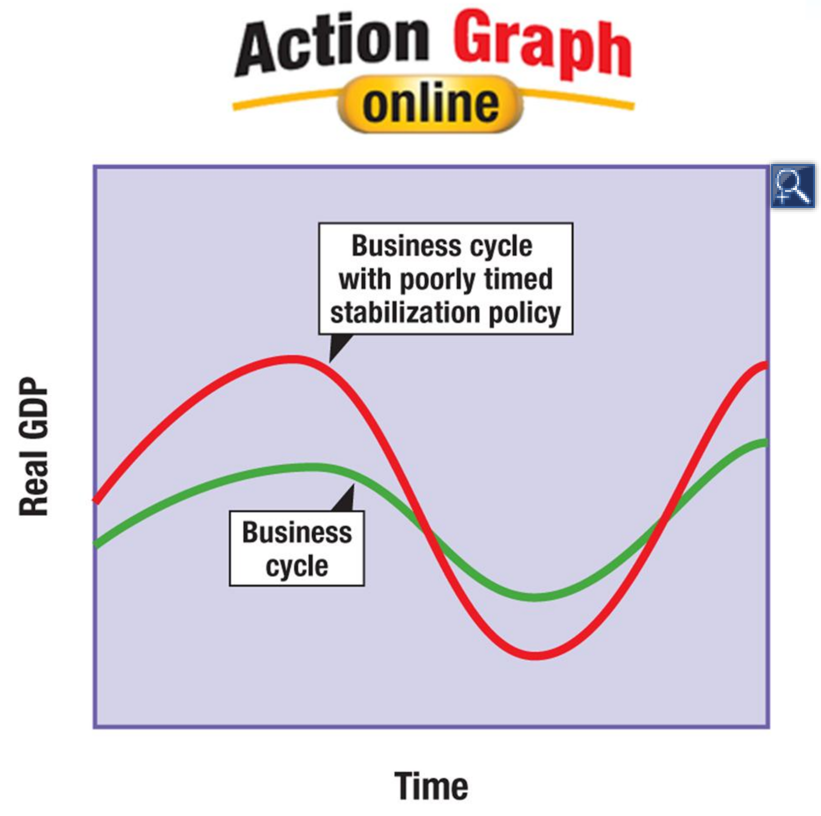
Good Timing

- Monetary policy must be carefully timed.
- Policies with good timing achieve economic stability.
  - Properly timed stabilization policy, which makes peaks a little bit lower and troughs not quite so deep, helps smooth out the business cycle.



Bad Timing

- If stabilization policy is not timed properly, it can make the business cycle worse.
- Government economists do not realize that a contraction is occurring until the economy is deeply in it.
- It takes time to enact expansionary policies and by the time these policies take place, the economy may be coming out of the recession on its own or businesses may be reluctant to borrow at any new rate.



Inside Lags

- Problems in the timing of macroeconomic policy are called lags.
- The inside lag is the time it takes to implement monetary policy and occurs for two reasons:
  - It takes time to identify a problem
  - Once a problem has been recognized, it can take additional time to enact policies

- The second problem is more severe for fiscal policy than monetary policy because monetary policy is streamlined and does not have to go through Congress and the President.

Outside Lags

- The outside lag is the time it takes for monetary policy to have an effect.
  - Outside lags can be very long for monetary policy since they primarily affect business investment plans.
  - Because firms may require months or even years to make large investment plans, a change in interest rates may not have its full effect on investment spending for several years.
  - Because of the political difficulties of implementing fiscal policy, we rely to a greater extent on the Fed to use monetary policy to soften the business cycle.

Predicting Business Cycles

- How should policy makers decide when to intervene in the economy?
  - If an expansionary policy is enacted at the wrong time, it may lead to high inflation. This is the chief danger of using an easy money policy to get the economy out of a recession.
  - The decision of whether to use monetary policy must be partly based, then, on our expectations of the business cycle.
  - The length of a recessionary or inflationary period determines how the Fed will respond.

Predicting Business Cycles, cont.

- How quickly does the economy self-correct?
  - Economists' estimates for the U.S. economy range from two to six years.
  - Since the economy may take quite a long time to recover on its own from an inflationary peak or a recessionary trough, there is time for policymakers to guide the economy back to stable levels of inputs and outputs.

Approaches to Monetary Policy

- Checkpoint: How do the two approaches to monetary policy differ from each other?
  - Interventionist policy, which encourages action, is likely to make the business cycle worse if the economy self-adjusts quickly.
  - A laissez-faire policy, on the other hand, will recommend against enacting new policies.
  - The rate of adjustment may also vary over time, making decisions even more difficult.

Review

- Now that you have learned how monetary policy effects economic stability, go back and answer the Chapter Essential Question.
  - How effective is monetary policy as an economic tool?