Lecture Notes for Chapter 9 of Macroeconomics: An Introduction

Monetary Policy

2/25/10

In this chapter we will discuss:

- In Chapters 6, 7, and 8 we learned how a central bank such as our Federal Reserve can, through monetary policy, affect the quantity of money, interest rates, economic activity, prices, wages and inflation.
- Now we will look at monetary policy in historical perspective to understand how it works, and has worked, in practice.

Today, the Fed is news…

- Media hang on every word of Chair Bernanke for clue to next policy move!
- Fed played central role in response to financial crisis and moves to end recession.
- Public concerned about both lingering recession and threat of inflation ahead.
- It was not always so!

US Monetary Policy - A History

- After WW II, role of Fed was to keep interest rates low to encourage the capital investment for long term economic growth.
- Inflation not seen as a problem.
- Occasionally "take away the punch bowl."
- Fear of another depression dominated.
- Government spending seen as the remedy.
- "Money doesn't matter" was popular idea.

Then inflation started in mid1960s

- Fed tightened in 1966 to slow inflation.
- ”Mini recession" followed.
- Money and Fed policy did matter after all!
- But prevailing view of inflation was that it was caused by pricing power of large corporation and big unions.
- If only those greedy people would stop raising prices and wages!!!!

The wild 1970’s

- Bell bottom jeans, long sideburns, pot, and
- Inflation spiraling every higher.
- Interest rates following inflation higher.
- Economic growth stagnating.
- High unemployment.
- STAGFLATION!

Was Fed policy to blame?

- Intense debate over role of Fed ensued.
- Was money growth causing inflation?
- Could inflation be stopped by wage and price controls? Pres. Ford's WIN program.
- Repeated failure to stop inflation undermined and confidence in the Fed.
- By 1979 few economists doubted failure of Fed played major role in stagflation.

The Volcker Era

- Pres. Carter appointed Paul Volcker as Fed Chair in 1979.
- Former Pres of Fed Reserve Bank of NY, Volcker had credibility on Wall St.
- Announced Fed would slow money growth no matter how high interest rates went.
- Double-dip recession of 1980-82 ensued.
- But inflation abated and growth resumed.

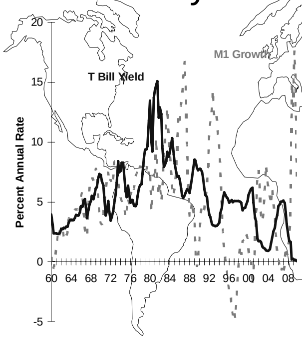
Greenspan and the 'Great Moderation'

- Alan Greenspan, formerly a Wall St consultant, succeeded Volcker in 1987.
- He inherited a healthy economy,
  low inflation,
  low interest rates,
  low unemployment.
- For almost 20 years we enjoyed era of stability, known as the Great Moderation.

A ‘National Treasure’

- First act was to avert crisis in 1987 crash.
- Greenspan became revered as a wizard.
- He quickly moved interest rates up or down in response to any apparent threat of recession or inflation.
- It seemed he could do no wrong.
- Bernanke stepped into very large shoes when he took over in 2006!

Monetary history in a picture.



- Short run: M% & T Bill move opposite directions
- But over 1960-1979, both trended upward.
- Paradox of monetary policy!
- Fed failed to keep interest rates low by creating M too fast!
- Wide fluctuations in M1 growth and T bill show Greenspan’s activist style!

Two big debates:

- Should the Fed use money growth or on interest rates as its primary policy ‘target’?
- Should the Fed keep money growth at a steady non-inflationary rate, or try to ‘fine-tune’ the economy, like Greenspan?

Money Growth target has problems.

- Money demand k(i) changes due to
  - ATM machines, “sweep accounts.”
  - dollar holdings abroad.
  - short term “noise” in k for many reasons.
- What is right M% when k is changing?

Interest Rate Target has problems too!

- What is the ‘right’ level of interest rates?
- People do not like to see higher interest rates (most are borrowers), so it is hard for Fed to raise rates when it should.
- That is what happened in the 1970’s, the Fed did not raise rates fast enough to stop inflation build-up. It always chickened out.

Second debate: ‘Rules vs. Discretion’

- Should Fed follow a simple rule,
- or actively manage policy to combat recession and inflation?

Why not a policy rule?

- Advantage: everyone would see what the policy is and can make plans accordingly.
- Builds credibility for Fed policy.
- If public realizes Fed will fight inflation, there will be no inflation!
- But which rule?
- In crisis, would you follow rule or use your discretion in light of current facts?

Why not discretion?

- Shouldn't you do what is best, always?
- But who is 'you'? Whose discretion?
- Greenspan used discretion and seemed to know just what to do, but crisis followed.
- Is a system that relies on judgment of one person a good system?
- If so, dictatorship would be great! (It isn't!)

The 'Monetarist' Rule

- Milton Friedman advocated steady money growth consistent with low inflation.
- Motivated by dismal record of Fed in mismanaging economy in 1970s.
- Monetarists said the Fed can't "fine tune."
- But steady M% insures price stability.
- Critics argued Fed should respond to recession!

MF & Jimmy at the Seven-Eleven

The Taylor Rule

- Why not reduce Greenspan to a formula??
- The Taylor Rule was proposed by John Taylor of Stanford U. in 1993.
- It describes how successful central banks behave:
- Raise rates in response to inflation, and lower them in response to negative gap between actual and potential real GDP.

Here is Taylor's recipe:

- The Fed controls the Fed Funds rate.
- That averages about 2% plus inflation (Fisher hypothesis)
- Express output gap in %, multiply by .5, that means cut interest rate in recession!
- Now set a target inflation rate, say 2%, and multiply difference between actual and target by .5. Simmer for 2 hours.

Now add up all the components:

- The Taylor rule tells the Fed to set the Federal Funds rate at:

  Fed Funds = 2% + P% + .5*(Output Gap) +.5*(P% - 2%)
- What does is say now, in 2010: P% is about 2%, Gap is about -7%, so
- Fed Funds = 2%+2%-3.5%+0% = .5%! About where it is now!

Credibility.. key to effective monetary policy!

- Do people believe Fed will stick to non-inflationary policy?
- If so, it is easy to control inflation.
- If not, Fed has harder job.
- Greenspan’s success due in large part to belief that he would keep inflation low.
- Would a Taylor-type rule help credibility?

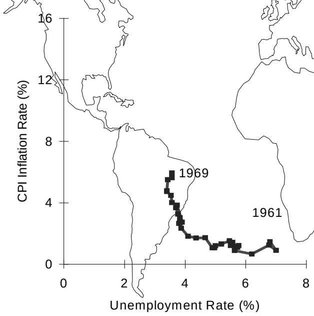
Fed credibility now under attack!

- From Congress who would like to assert control over monetary policy.
- Bernanke weakened by bitter reappointment debate in early 2010.
- Doubt about success in ending recession.
- Fear that attempt to stimulate economy with very low interest rates and money growth will be overdone, leading to inflation!

What monetary policy cannot do

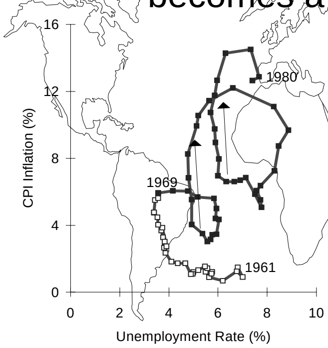
- It cannot raise level of economic growth for more than a short time.
- It cannot lower unemployment below 'natural rate' for more than a short time.
- It can give us low inflation!

The "Phillips Curve" and How It Disappeared



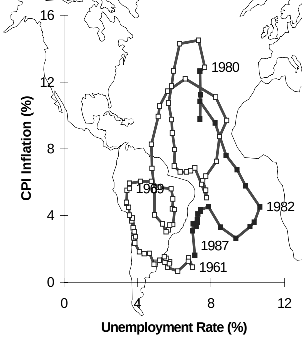
- Phillips noticed U & wages negatively correlated in the UK.
- Some saw "cruel choice" between unemployment and inflation.
- Inflation sold as tonic for economic growth

Then the Phillips "curve" becomes a spiral.



- As the Fed tried first to fight unemployment and then inflation,
- it created a rising spiral of inflation and unemployment in the 1970s

The Fed tames inflation.



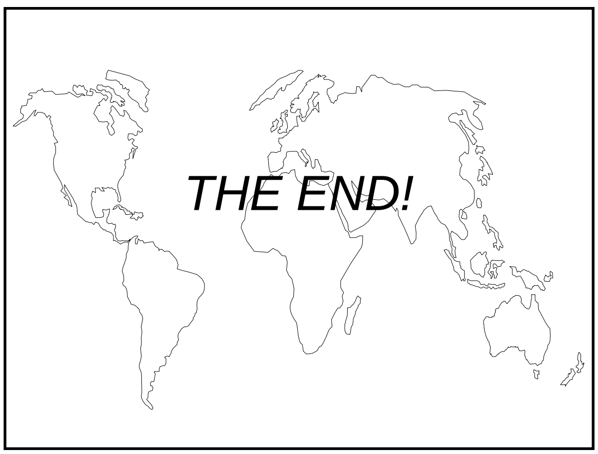
- U high early 1980s
- then inflation collapsed.
- by 1987 unemployment and inflation had returned almost exactly to where they had started in 1961!
- it was an expensive round trip!

Lessons:

- Deviations of U from it natural rate are transitory
- Hope of lower unemployment and faster growth through inflation were a mirage.
- Fed policy can only lower unemployment temporarily, not permanently.
- The cost of trying is higher inflation and, later, the recession that is needed to stop it.

Today, most economists accept the idea of a natural rate of unemployment which may not be ideal, but represents a tendency toward equilibrium.


But can't we somehow reduce unemployment?
◆ By expanding economic opportunity
◆ By investing in
– education,
– job training,
– technology,
◆ A free and open economy.


THE END!