**Monetary Policy**

* Monetary Policy: Use of money supply to impact/influence the economy.
  + How does monetary policy directly affect the economy? Through its impact on
    - Real GDP growth
    - Unemployment rates
    - Prices
    - Imports
    - Exports
* The Federal Reserve Bank is charged with the responsibility of monitoring the monetary policy of the United States
  + Goal of Federal Reserve Bank is price stability – they also have to balance full employment and GDP growth
* Rational Expectation: Use of all available resources and information to make a decision.

|  |  |
| --- | --- |
| KEYNES | Classicalists/Rational Expectation Theorists |
| * Keynesians want to steer the market |  Classicalist/RET believe that the market should be set free. |
|  MS ↑, Real GDP ↑, unemployment ↓, Prices↑ |  MS ↑, Real GDP stays the same, Unemployment stays the same, Prices ↑ |
|  MS↓, Real GDP ↓, unemployment ↑, Prices ↓ |  MS↓, Real GDP stays the same, Unemployment stays the same, Prices ↓ |
|  By controlling the money supply, it is possible to control the market |  An increase or decrease in money supply does nothing to the market accept change the price. |

                        \*\*MS= Money Supply=M1 or M2 growth\*\*

* Tools used to impact the money supply:
  + Reserve Ratio
  + Open market operations
    - Buying of U.S Treasury Securities
    - Usually happens every Tuesday
  + Discount Rate: Interest rate the Federal Reserve Bank charges its member banks.
    - When this is lowered, signifies that there is a chance there will be an increase in the money supply.
    - Banks aim not to use the discount rate because they would rather borrow the money from another bank.
      * …Think of the example given in class. Is it more convenient to borrow money from your friends or your parent?
    - Federal Funds Rate: Interest rate that banks charge each other. Banks borrow from each other to meet reserve requirements
* To increase the money supply, the Federal Reserve Bank buys U.S treasury bonds from banks
  + By doing this, Fed gets the Treasury bonds. Banks get the money (money = reserves), which results in excess reserves. When excess reserves increase, bank lending is expected to increase

Graph notes:

**Keynes: How does money impact the economy?**

In the money market,

**First:** changes in money causes interest rates to change

The Federal Reserve Bank controls the money supply. If MS increases the Ms line shifts right to Ms’

***MS↑  R↓***

**Rates** Ms Ms’

r’

r\* Md

M’ M\* **Money**

\*\*\*\*\*Increasing the money supply (buying of US treasury securities), moves the supply curve to the right, which decreases the interest rates. \*\*\*\*

On the good side

**Second:** changes in interest rates cause investment and consumption to change. When

***MS↑, R↓,  I ↑, C↑***

**Rates**

 R\*



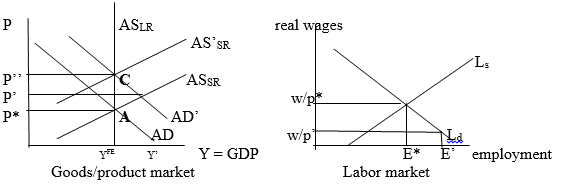
 R’

IC\* *→* IC’ **Investment(consumption)**

In the product market:

**Third:** changes in investment cause aggregate demand to change in GDP to change and prices to change. When

MS↑ , R↓, I↑ , C↑, AD shifts right. Under the Keynesian theory the AS line does not shift.



\*\*\*\* *Classical theorists continue: As*  MS↑ , R↓, I↑ , C↑, AD shifts right, but when prices increase, wages also increase. Therefore, the increase in wages causes the ASsr line to shift left to ASsr’.

After the wage and prices adjustments, MS↑, GDP stays the same, Unemployment stays the same, Prices ↑

Additional knowledge

\*\*Whenever consumption or Investment increases, AD will always increase also

**\*\*Supply curve captures cost. If cost increases, supply moves left**

* Anytime there’s an increase in prices, there’s an increase in wages
  + Wages increase to adjust for price increase
  + real wage= W/P
    - If Wages increases and Prices increase at the same time, there is no change. Since there is no change, you are technically not better off.

Difference between Keynes and Classical theorists:

* Keynes look at the short run