Monetary Policy and the Federal Reserve System

- The Fed's Goals
- The Fed's Tools
- Current Monetary Policy
- The Danger of Deflation?

The Fed's Objectives

- "Stable Prices"
- "Maximum Employment"
- Moderate Long-Term Interest rates

The Fed's Main Tool

- The federal funds rate
  - An interbank overnight interest rate
- How does the Fed control it?
  - Open Market Operations: Buying and selling U.S. government securities to raise and lower the interest rate.

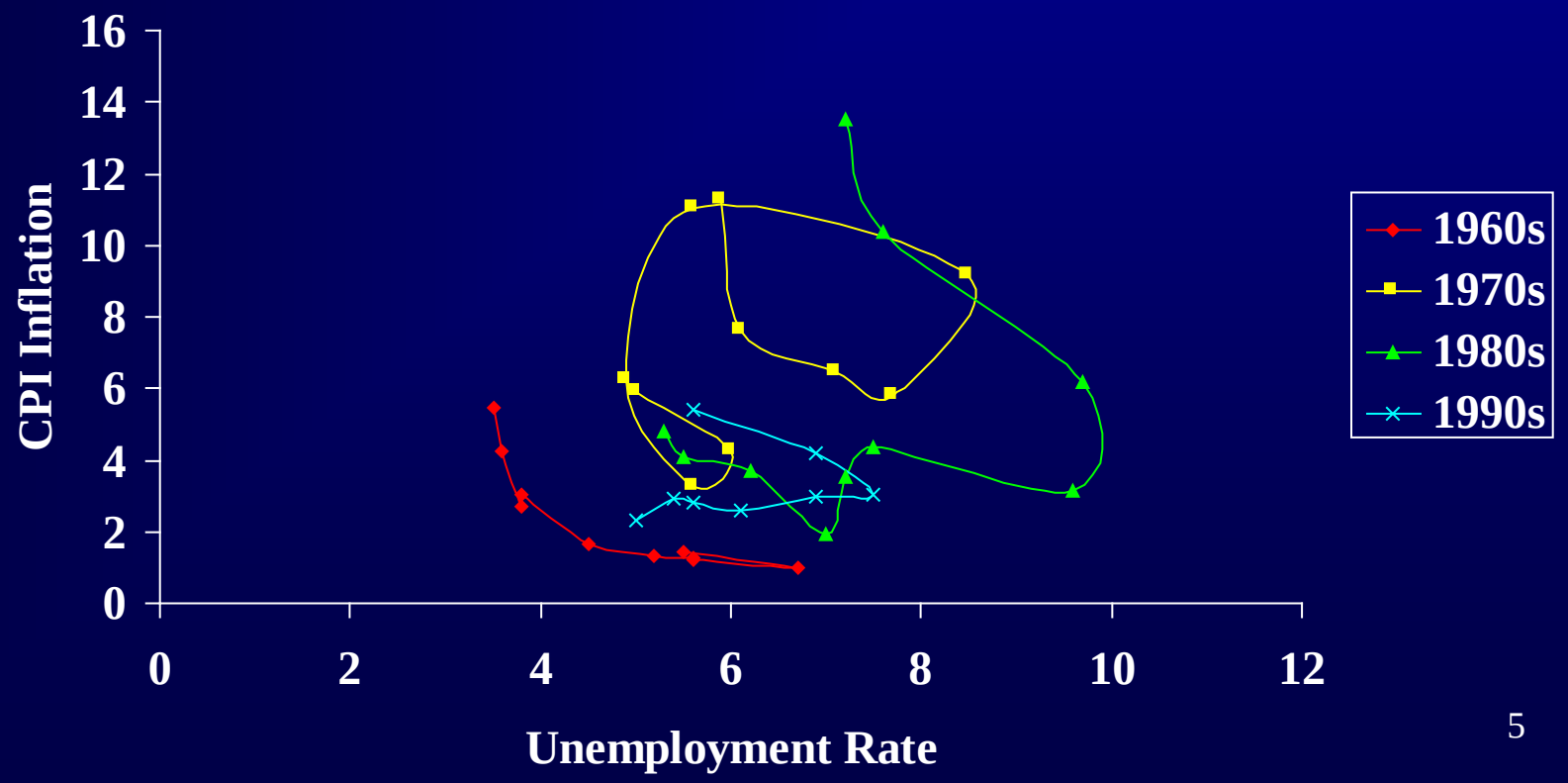
The Fed's Main Tool

- What are the consequences?
  - Lower interest rates/more money leads to more spending and investment.
  - Higher interest rates/less money leads to less spending and investment.

- Where does the Fed get the money to buy bonds?
  - The government has the power to create base money. The Fed creates its own money.

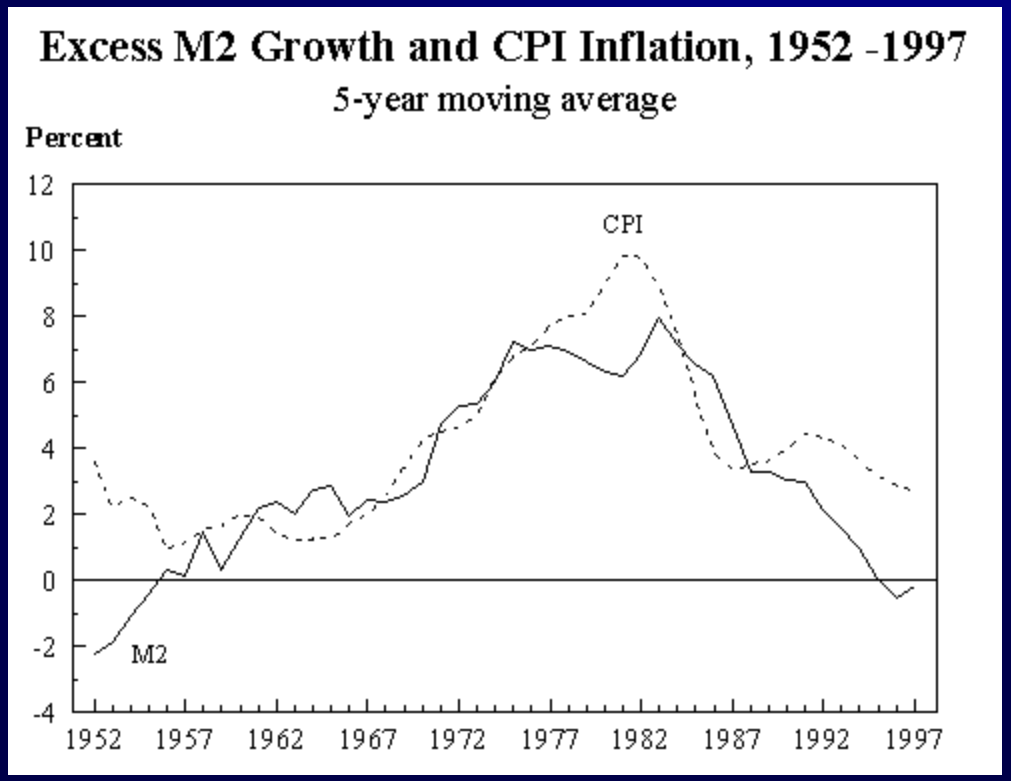
What does the Fed control?

- In the short run, the Fed can mostly control real economic activity
  - This is called "monetary neutrality."



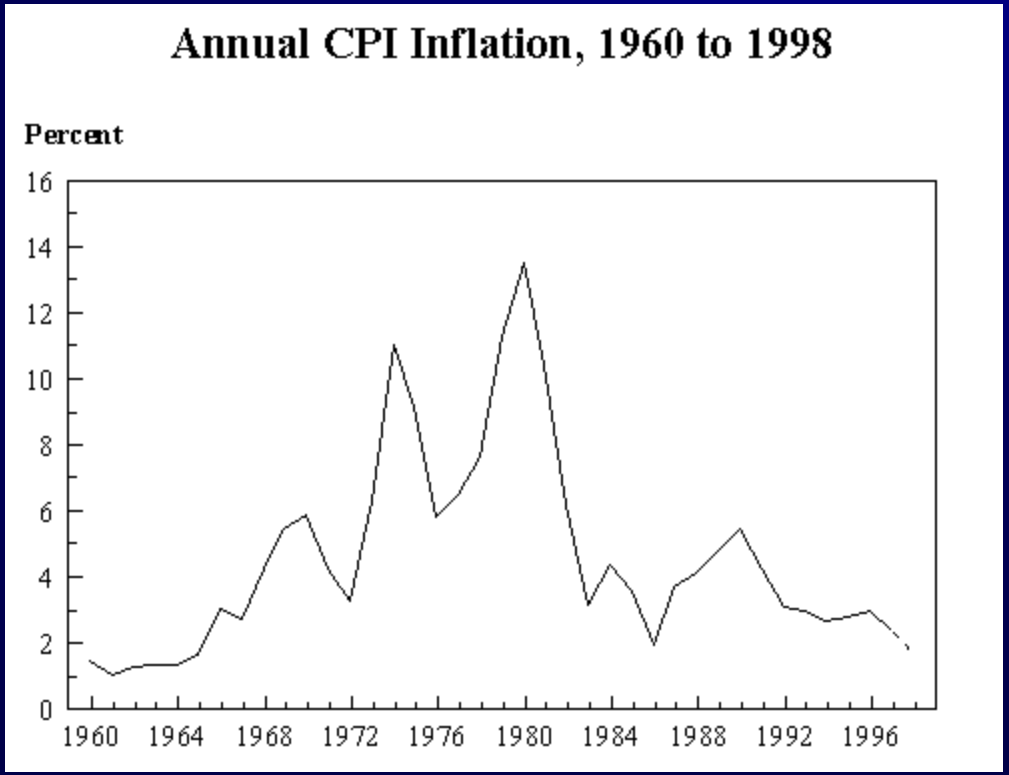
What does the Fed control?

- In the long run the Fed can only change the average rate of inflation.
  - "Inflation is always and everywhere a monetary phenomenon." — Milton Friedman



What is been the Fed's strategy?

- Opportunistic Disinflation.
  - Try to lower inflation if the economy is strong and the opportunity presents itself but don't raise interest rates if the real economy is weak.

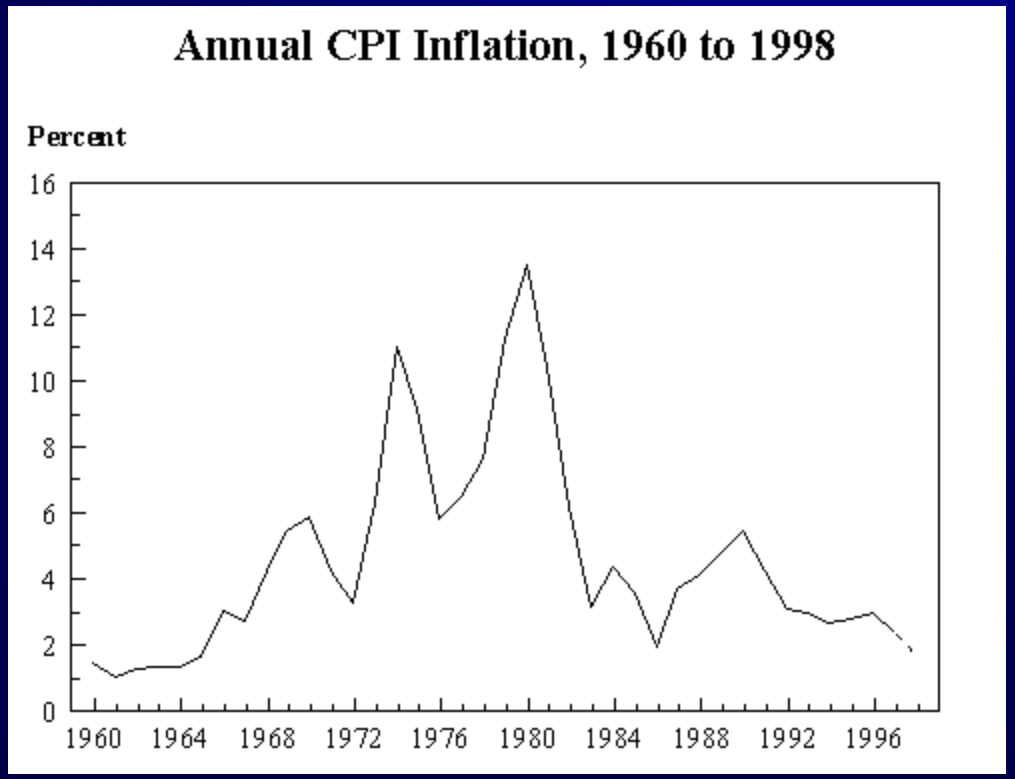


What is the stance of monetary policy?

- Inflation
- Nominal interest rates
- Real interest rates
- Monetary Aggregates
- Real Activity: Output growth and unemployment

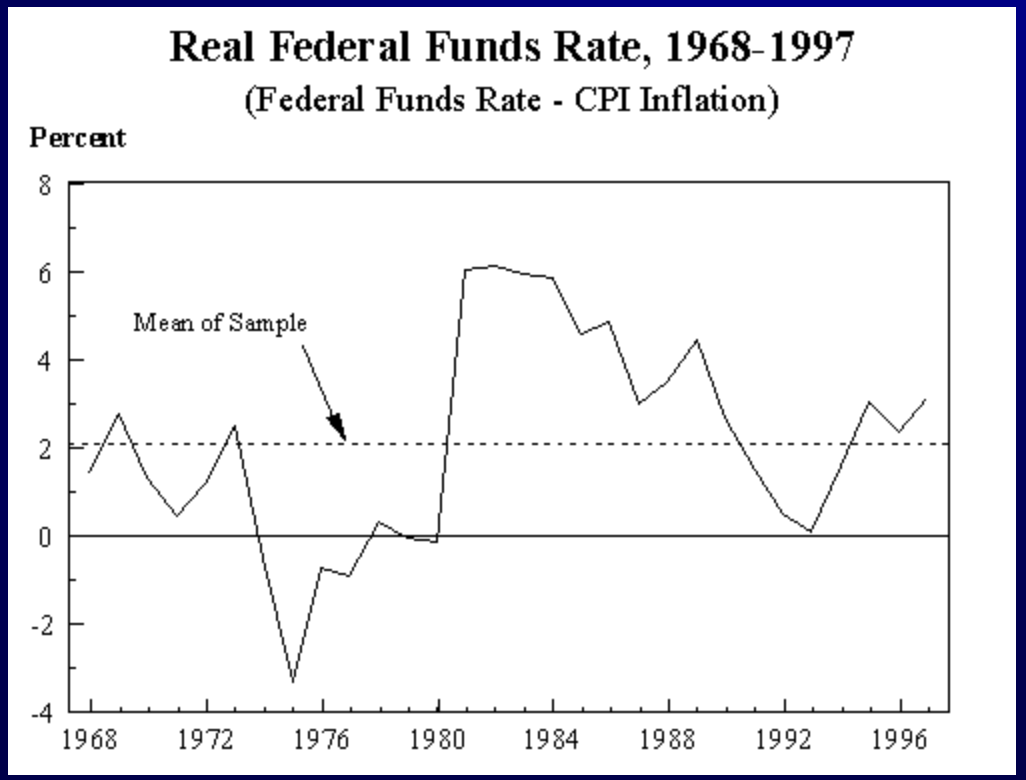
What is the stance of monetary policy?

- Recent Changes in Inflation?



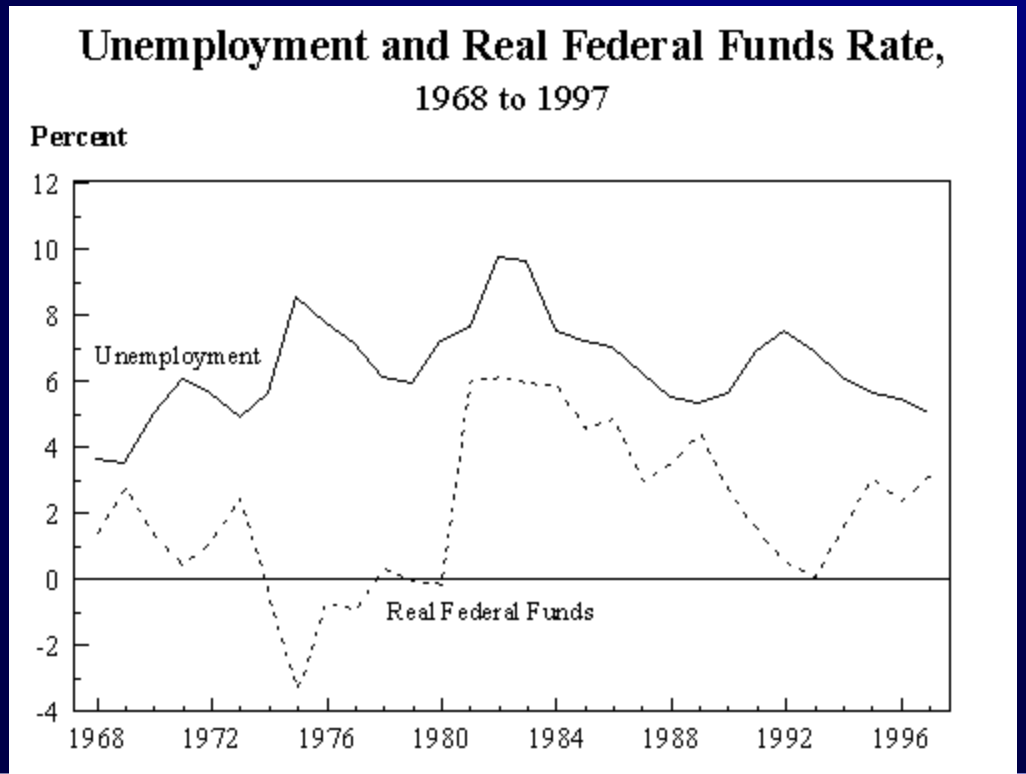
What is the stance of monetary policy?

- Real interest rates



What factors does the Fed consider in making policy?

- Inflation
  - Only reported with a lag
- Unemployment and Output Growth

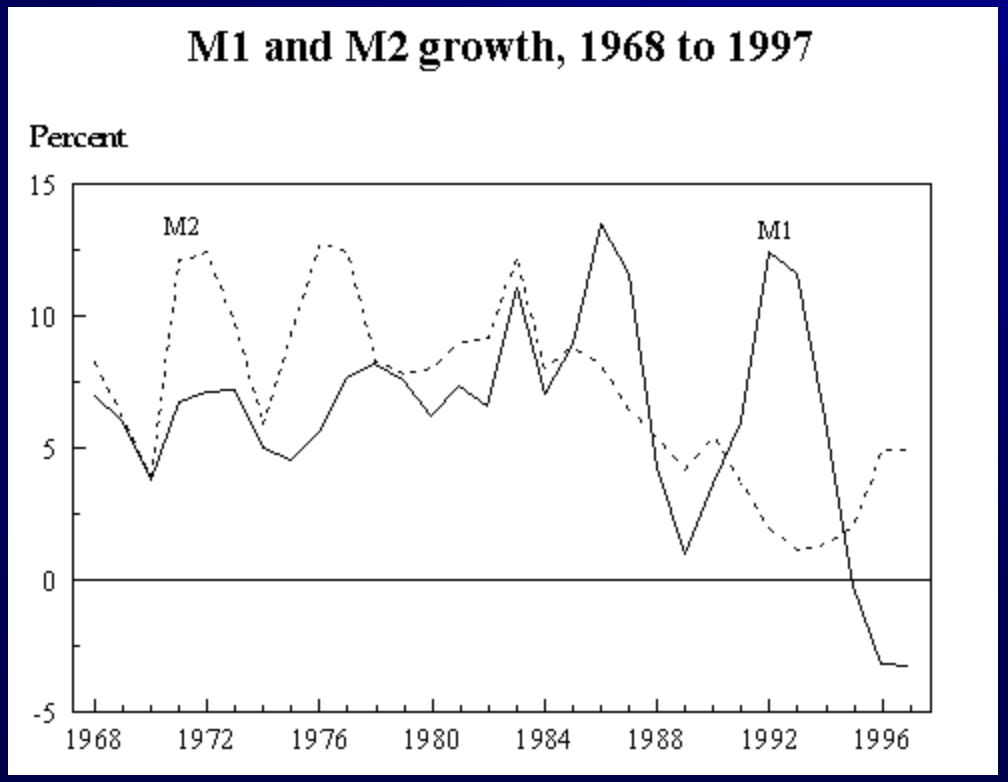


What factors does the Fed consider in making policy?

- Foreign Influences
  - Exchange rates can <u>temporarily</u> affect inflation through import prices.

What factors does the Fed consider in making policy?

- Monetary Aggregates
  - Can be useful but require careful interpretation.



Is Deflation a danger?

- What is deflation?
- Why are people afraid of it?
- Should they be afraid of it?
- Isn’t Japan suffering from deflation?
- Can Japan fight deflation?

What is deflation?

- Asset price deflation
- General price level deflation
  - A fall in the <u>general</u> price level, not deflation in a few prices

Why are people afraid of deflation?

- Two experiences in the United States
  - 1873-1895 and 1929-1933
  - Both resulted from a lack of monetary policy
  - Deflation was not feared in 1873-1895
  - Deflation did great damage during the period 1929-1933.

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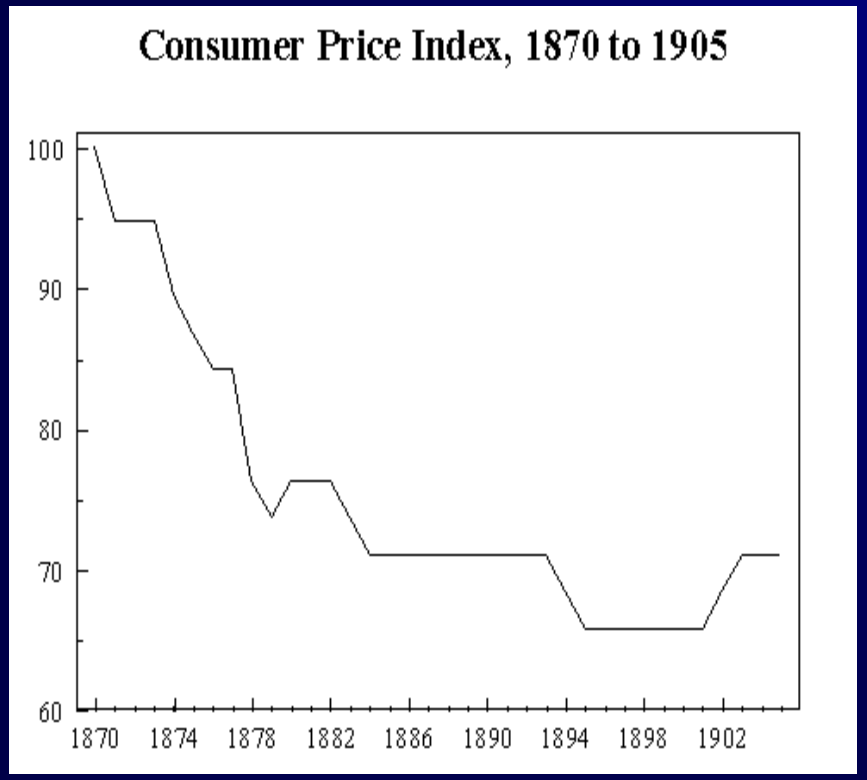

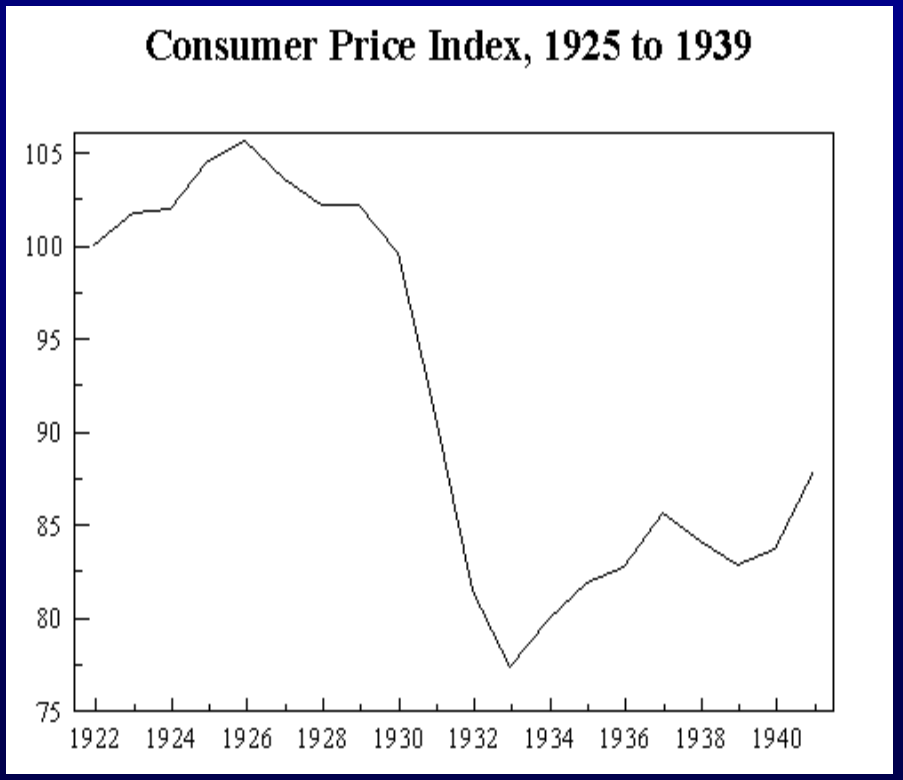

Why are people afraid of deflation?

- Deflation is thought to depress demand by creating anticipations of further price decreases.
- Unexpected deflation might hurt debtors by increasing the real value of debt.
- Deflation puts a floor on real interest rates.
- Deflation may prevent wages from adjusting downwards when they need to do so.

Should we fear deflation?

- No. Deflation is easy to fight by increasing the money supply.
  - Deflation is much easier to fight than inflation.
- Doesn't Japan have a problem with deflation?
  - Yes, but that isn't their main problem.
- How can Japan fight inflation when their interest rates are near zero?
  - You can still increase the money supply by buying assets, even if interest rates are very low.

The End