

The Power of Macroeconomics

Lecture Four: The Federal Reserve & Monetary Policy



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The Purpose Of This Lesson

1. Describe how our money and banking system works.
2. Show how monetary policy may be used to fight recessions and inflation.

Two Questions

Monetary or Fiscal Policy?

We will explain how Monetarism emerged in the 1970s to challenge Keynesianism.

Monetarism or Keynesianism?

A Definition



Fiscal Policy Plays First Fiddle

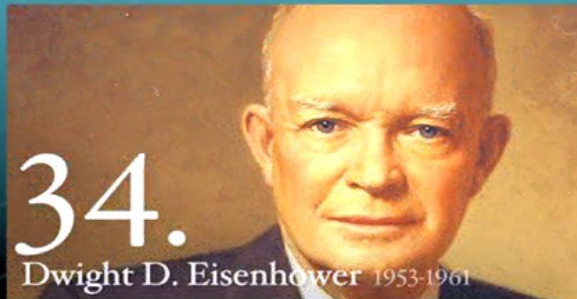
- Monetary policy largely played second fiddle to fiscal policy because of fiscal policy's successes.
- Fiscal policy helped lift us out of the Great Depression in the 1930s.
- Fiscal policy also worked well to end a more mild recession in 1949-1950.

Fiscal Policy & “Fine Tuning”

- The Kennedy tax cut of 1964 seemed to provide incontrovertible proof that Keynesian economics could be used to “fine tune” the economy and keep it at, or close to, full employment with minimum inflation.

Monetary Policy Played An Important Supporting Role

- During four decades of Keynesian triumphs, monetary policy played an important supporting role.
- Example: President Eisenhower relied on a tight monetary policy to keep inflation in check.



Monetary Policy Loses the 1960 Presidential Election for Nixon



- President Eisenhower's conservative monetary policy led to a stagnant economy.
- Eisenhower's Vice President Richard Nixon likely lost the 1960 presidential race to John F. Kennedy because of these events.
- The Democrat Kennedy vowed to "get the country moving again," and won the very close race.

The Economy Starts Moving Too Fast



By the late 1960s, demand-pull inflation began to rear its ugly head.



Inflation Rears Its Head

- By 1969, inflation had crept to over 5%.
- By the early 1970s, it had jumped to almost double digits.
- As stagflation began to emerge, Monetarism began to challenge the Keynesian orthodoxy.