Apr 19

Does Monetary policy matter?
- update to Friedman and Schwartz
- shows that macro class matters

The narrative approach:
- uses information that is historical
- minutes of FOMC meetings
- non-pure statistical information to deal with reverse causality

The St Louis Regression:

$\Delta \ln Y_t = \hat{a} + \hat{\beta} X_t + \varepsilon_t$

- Y_t: GDP
- X_t: level of FFR

$\hat{\beta} \approx 0$!

expected from countercyclical policy!

Friedman and Schwartz: A Monetary History of the United States
- reverse causality / identification / endogeneity
- Historical Narrative approach

$Y \downarrow \Rightarrow$ fewer loans $\rightarrow M \downarrow$

$Y \uparrow \rightarrow$ loans $\uparrow \rightarrow M \uparrow$

F & S use "unusual" monetary movements

Crucial experiments:

- 1920: Federal reserve jacks up interest rates, doesn't know what its doing, no lag accounted for

- 1931: Gold outflows, Federal reserve raises interest rate to maintain the gold standard

- 1936-37: double reserve requirements, M↓ substantially as banks scramble to call loans

Decline in M causes decline in Y

strengths:
- address endogeneity problems
- money matters

weaknesses:
- identification strategy is largely a judgment call
- Two examples of missed episodes:
  - 1933
  - 1950
- Definition too vague
- time period
- OVB: Fiscal policy changes
  - Fiscal policy contraction → Y↓ ?

Power of definition of a monetary shock:
- negative shock
- actively wants to reduce inflation from excessive rates