Ch 31 Monetary Policy

Principles of Macroeconomics

Econon 102

Outline

- Monetary Policy Objectives and Framework
- The Conduct of Monetary Policy
- Monetary Policy Transmission

Monetary Policy Objectives and Framework

- The objective of a monetary policy is to control the economic performance of a country
  - Based on different indicators:
    1. Inflation rate (stable prices) → controlling inflation to not be too high or even negative to ensure anticipated inflation and the economy is growing
    2. Employment rate → achieving full employment (not unemployment rate = 0%)
    3. Output gap → minimizing the difference between real GDP and potential GDP
       - Keep in mind that it takes time and effort to determine/forecast the real GDP and potential GDP

The Conduct of Monetary Policy

- To carry out a monetary policy, the instruments are:
  - Monetary base
    - Controlling the monetary base is a direct shock to the money supply
  - Interest rate
    - Fixing the interest rate would cause adjustments in the money market. It can shift the money supply, money demand, or both
    - However, in the US market, the way that interest rate is being fixed is forcing the money supply to shift. Researches have shown that money demand usually is not affected

Monetary Policy Transmission

- The Central Bank implement a monetary policy that gives a shock in the money market that carries over to goods and services market
    - When the Central Bank implements a monetary policy:
        1. Shock to the money market
        2. New equilibrium interest rate and quantity of money in the money market
        3. Shock to the market for loanable funds
        4. New equilibrium interest rate and quantity of funds available in the loanable funds market
        5. Changes in investment spending
        6. Changes in Aggregate Demand

Fighting Inflation

Fighting Recession