Monetary Policy II

Outline Notes

THE GOALS OF MONETARY POLICY

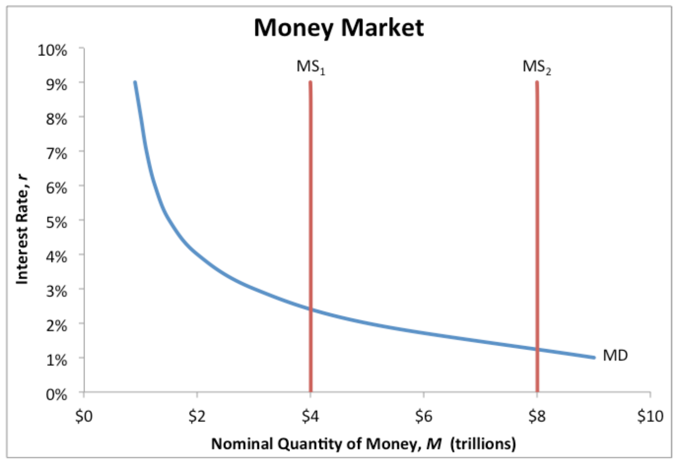
The Fed uses monetary policy to achieve two competing objectives, known as the **dual mandate**: maximum employment and price stability.

1) Maximum Employment

A)

B)

C)

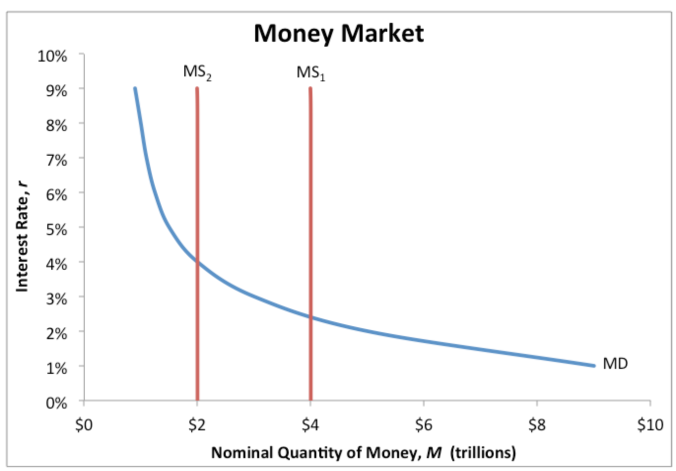


2) Price Stability

A)

B)

C)



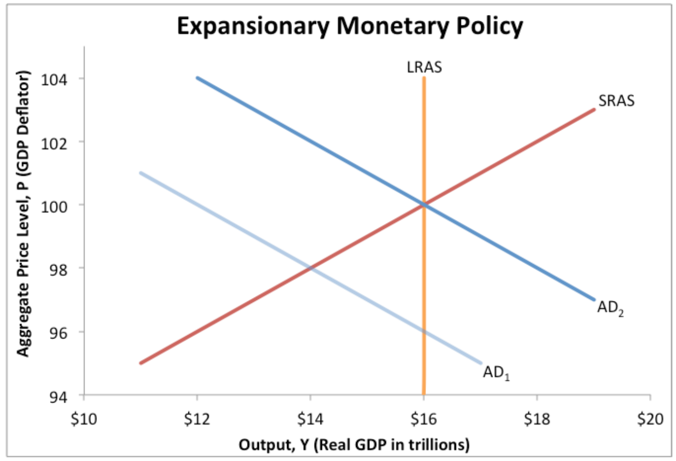
EXPANSIONARY MONETARY POLICY

To prevent the unemployment rate from getting too high, the Fed can adopt an expansionary monetary policy, inducing aggregate demand to increase.

1) Description

A)

B)



2) How It Works

A)

B)

C)

D)

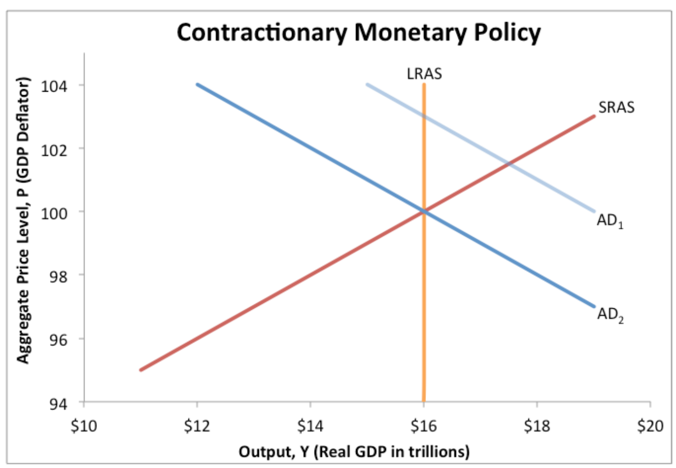
CONTRACTIONARY MONETARY POLICY

To prevent the inflation rate from getting too high, the Fed can adopt a contractionary monetary policy, inducing aggregate demand to decrease.

1) Description

A)

B)



2) How It Works

A)

B)

C)

D)

EFFECTS ON AGGREGATE DEMAND

When the Fed uses monetary policy to affect aggregate demand, the size of the change is determined by the initial change in spending and the multiplier effect.

1) The Multiplier Effect

A)

B)

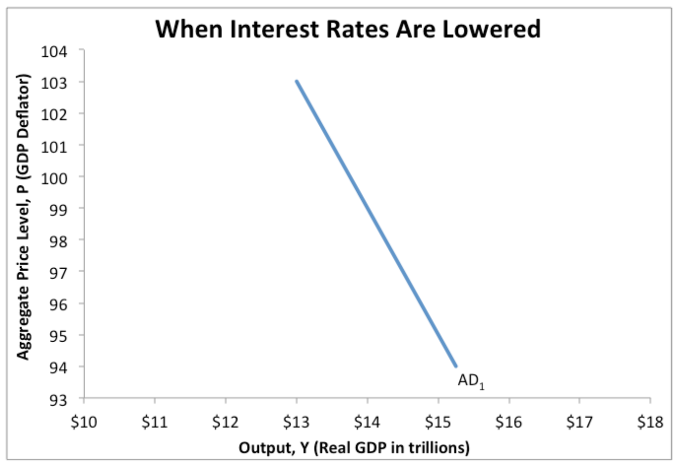
Variable	Description
Δ	Change in
Y	Output (as measured by real GDP)
MPC	Marginal Propensity to Consume
AAS	Autonomous Aggregate Spending
I	Investment Spending

$$\Delta Y = \frac{1}{1 - MPC} \times \Delta AAS$$

2) When Interest Rates Are Lowered

A)

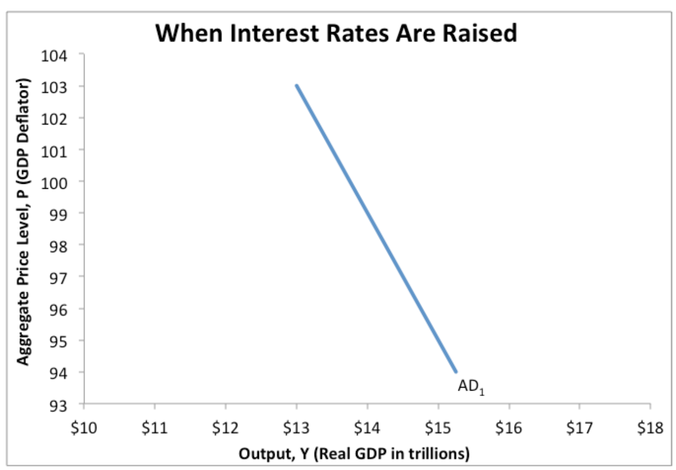
B)



3) When Interest Rates Are Raised

A)

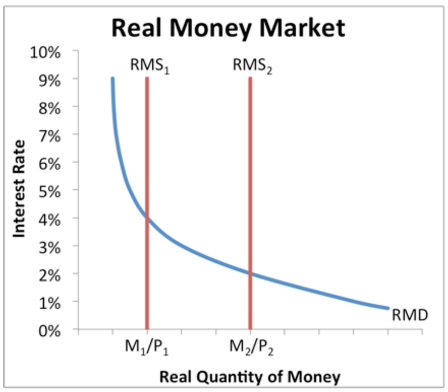
B)

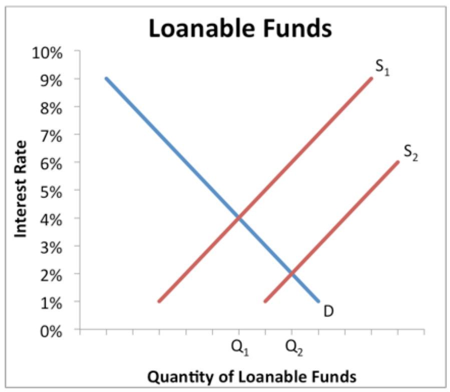


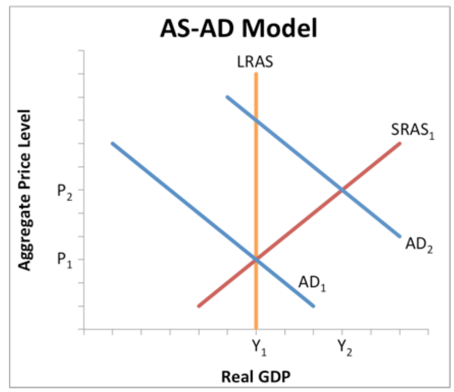
MONETARY POLICY IN THE SHORT RUN

Monetary policy can stabilize the economy in the short run because the money market (not the loanable funds market) determines the short-run interest rate.

Real Money Market	**Loanable Funds**	**AS-AD Model**
1)	5)	3)
2)	6)	4)







MONETARY POLICY IN THE LONG RUN

Monetary policy has no real effects in the long run because the loanable funds market (not the money market) determines the long-run interest rate.

Real Money Market	**Loanable Funds**	**AS-AD Model**
3)	5)	1)
4)	6)	2)