

Economics Chapter 15 – Monetary Policy

1. **Monetary Policy** – changes in the money supply, or in the rate of change of the money supply, to achieve particular macroeconomic goals
2. **Demand for Money** – represents the inverse relationship between the quantity demanded of money balances and the price of holding money balances
3. **Transmission Mechanism** – the routes of channels that ripple effects created in the money market travel to affect the goods and services market
4. When interest rates fall, investment rises. However, some Keynesians believe that interest rates are not the only point of concern, and other factors also influence investment
5. **Liquidity Trap** – the horizontal portion of the demand curve for money. Since the interest rate is not changing while the quantity of money is increasing, real Keynesians conclude that sometimes, monetary policy is NOT able to raise Real GDP or lower unemployment
6. While Keynesians believe in the indirect relationship between the money market and the goods and services market, Monetarists believe that a change in the money market will directly affect the goods and services market
7. **Expansionary Monetary Policy** – The Fed increases the money supply
8. **Contractionary Monetary Policy** – the Fed decreases the money supply
9. **Activists** – people who argue that monetary and fiscal policies should be deliberately used to smooth out the business cycle
10. **Fine Tuning** – the use of monetary and fiscal policies to counteract even small undesirable movements in economic activity
11. **Non-activists** – people who argue against the deliberate use of discretionary fiscal and monetary policies. They believe in a permanent, stable, rule oriented monetary and fiscal framework
12. **Monetary Rule** – describes monetary policy that is based on a predetermined steady growth rate in the money supply
13. **Gold Standard** – the monetary arrangement whereby a nation backs its paper money totally or partially with gold

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1. **Phillips Curve** – the curve that shows the negative relationship between inflation and unemployment. However, this gain is short term only. Eventually, GDP will return to potential GDP, and unemployment will go back to what it was before the change to higher inflation was made, but inflation would be higher
2. Central banks are useful because they're independent from the government, and prevents the government from adjusting interest rates for short term political reasons
3. **Political business cycle** – a business cycle caused by politicians use of economic policy to over stimulate the economy just before an election
4. **Time inconsistency** – the situation in which policymakers have the incentive to announce one economic policy but then change that policy after citizens have acted on the initial, stated policy – governments say they want low inflation but then increase spending which in the long run increases inflation
5. **Disadvantages of a central bank** – no one to check its power, but leaders can be fired if they don't do their job
6. The central bank constantly struggles to keep GDP at potential GDP to keep inflation at its target
7. **The Goldilocks Economy** – real GDP is exactly at potential GDP
8. When GDP is too high, Fed raises inflation to bring it back. When too low, lower inflation to stimulate economy
9. In 2000, the Fed thought the AD Curve had shifted because people were more wealthy due to the boom in the stock market
10. Aggregate demand changes relatively slowly, and potential GDP is hard to predict, which is why the Fed's job is hard
11. **The New Monetary Policy Rule** – combines adjusting interest rates for both inflation and responses to GDP shifts. This is a more accurate description of central bank policy
12. **Money Demand** – a relationship between the interest rate and the quantity of money that people are willing to hold at any given interest rate. Remember that money = currency + checking deposits + money in business cash registers + money businesses have in checking accounts. The money demand curve slopes downwards and has the interest rate on the vertical axis, and the quantity of money on the horizontal. The vertical line that intersects the curve at the current interest rate is the money supply, and "shifts" according to the interest rate
13. When the interest rate is low, there's less reason to invest, so people hold more money. Conversely, when the interest rate is high, more people invest, hence they have less money in their checking accounts
14. **Opportunity cost of holding money** – the interest that you would have gotten had you invested the money
15. **Short Term Interest Rates** – investment rates such as the treasury bill rate move w/ the federal funds rate
16. Money supply always equals money demanded. To get interest rates to fall, the fed sells bonds, which increases the money supply, which coincides w/ the increase in demand due to the lower interest rates
17. Changing the interest rates and changing the money supply is the same thing. We don't focus on the money supply because money demand tends to shift often, and if we held it constant, interest rates would shift constantly, which could cause recessions.

18. **Constant money growth rule** – hold the growth of money constant – recommended by Milton Friedman
19. Higher money growth leads to higher inflation, since more money is chasing the same number of goods/services
20. **Discount Rates** – the interest rate that the Fed charges commercial banks when they borrow from the Fed
21. Banks borrow from the Fed as a last resort, so people don't have to worry about losing their deposits
22. If discount rates were much lower than the funds rate, banks would save interest by borrowing at the discount rate instead of the overnight federal funds rate, so discount rate is always close to the FF rate
23. If the Fed decreases the reserve ratio, demand to borrow to meet reserves will fall and the FF rate falls
24. The reserve ratio is usually only used to change bank profits, usually to keep them from closing. Less reserves means banks can make more interest earning loans
25. Fixing the exchange rate limits a country from changing its interest rates. However, it helps trade since the exchange rates are now constant and predictable. It also shields countries from bad monetary policy. Generally, exchange rates are fixed w/ countries w/ good monetary policy, which is equivalent of adopting the monetary policy of that country