Chapter 11

Strategies and Rules for Monetary Policy

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After reading this chapter, you will understand the following:

1. Why lags, forecasting errors, and time inconsistency make it difficult to fine-tune the economy
2. The distinctions among policy instruments, operating targets, intermediate targets, and goals
3. How policy rules attempt to overcome the limits of fine-tuning
4. The advantages and disadvantages of various policy rules and targets

Before reading this chapter, make sure you know the following concepts:

The aggregate supply and demand model
Monetary policy instruments
Fiscal policy
Money
Planned expenditure
The multiplier effect
Equation of exchange
Velocity
Transmission mechanism

Chapter Outline

Stability and prosperity are the twin goals of macroeconomic policy. Achieving stability means taming the business cycle by moderating short-term swings in real output, inflation, and unemployment. Achieving prosperity means promoting productivity and growth of real output over a longer time horizon. There is a close relationship between the two goals: If short-term stabilization policy fails, long-run prosperity will prove elusive.

To achieve stability and prosperity, monetary and fiscal policy must work together. This chapter focuses primarily on strategies and rules for monetary policy, although some of the ideas it presents apply to both areas of policy. Chapters 12 and 13 will undertake a more detailed look at fiscal policy. Chapter 14 will show how policy rules can be used to tame inflation and deflation.

11.1 The Limits of Fine-Tuning

The discussions of domestic and international monetary policy instruments in Chapters 8 and 9, together with the aggregate supply and demand model developed in Chapter 10, provide a framework for our discussion of stabilization policy. They suggest the possibility of **countercyclical monetary** and fiscal policy—a pattern of policy that would moderate the business cycle by applying monetary or fiscal stimulus whenever the economy was in danger of falling into recession and restraint when it was in danger of overheating. As this chapter will make clear, however, the models make countercyclical policy look far too easy—as if policymakers were like engineers in a recording studio who could just twist a few knobs with labels like "taxes" and "federal funds rate," and—presto! —aggregate demand, real output, and the price level would slip into harmony with one another.

Countercyclical policy
A pattern of monetary or fiscal policy that applies stimulus when the economy is at risk of falling into recession and restraint when it is in danger of overheating

As *Applying Economic Ideas 11–1* explains, some economists came to think that countercyclical policy could be perfected. They envisioned a strategy of monetary and fiscal **fine-tuning** that would avoid even small, short-run departures from full employment and price stability. Over the years, however, it has become apparent that between the clean, orderly, world of the models and the real world where policymakers operate, there exist some messy problems that make it frustratingly difficult to fine-tune the economy into a state of harmonious stability.

Fine-tuning
An economic policy strategy that attempts to avoid even small, short-run departures from full employment and price stability

Applying Economic Ideas 11–1

"It Is Now Within Our Capabilities . . . "

The 1960s were an exciting decade for the economics profession. Some people had feared that the United States would sink into renewed depression after World War II; instead, the economy returned to prosperity. Although the 1950s were, on the whole, a good decade for the economy, many people thought the country could do even better.

In the 1960s, Harvard-educated President John F. Kennedy brought some of the country's best and brightest economists to Washington, including some of his former professors. His successor, Lyndon Johnson, kept them there. By 1966, the president's Council of Economic Advisers consisted of three of the most distinguished professionals ever to sit on that body: Gardner Ackley, Otto Eckstein, and Arthur Okun.

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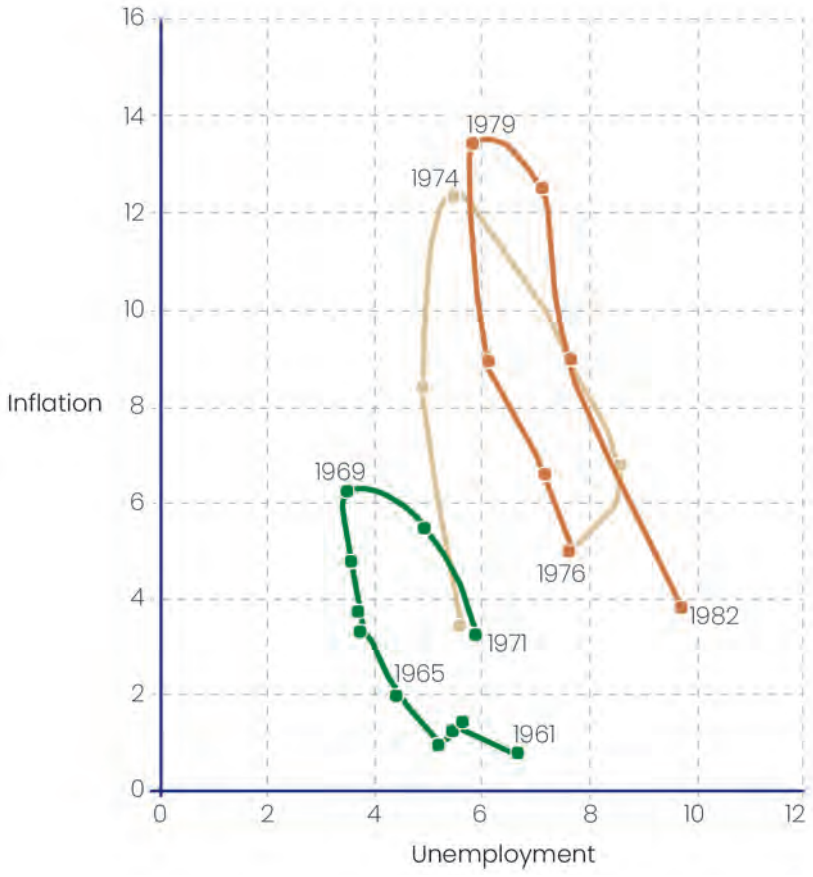
Armed with refined versions of theories that John Maynard Keynes had developed in the 1930s and with newly available computers, these policymakers became convinced that it was time to attempt more than just safeguarding the economy from deep depression and runaway inflation. In their 1966 *Economic Report of the President*, they wrote,

> It is now within our capabilities to set more ambitious goals. . . . We strive to avoid recurrent recessions, to keep unemployment far below rates of the past decade, to maintain price stability at full employment, . . . and indeed to make full prosperity the normal state of the American economy. It is a tribute to our success . . . that we now have not only the economic understanding but also the will and determination to use economic policy as an effective tool for progress.



It was a high-water mark of professional self-confidence. Regrettably, the hope that policymakers would be able to fine-tune the economy to recession-free and inflation-free prosperity proved unfounded. As the figure shows, 1965—with its enviable achievements of 4.5 percent unemployment with just 1.9 percent inflation—was the last good year before a long period of serious instability. Between 1965 and 1982, the US economy went through three severe cycles of inflation and unemployment. In each cycle, the highest rates of inflation and unemployment exceeded the cycle before. 1960s-style fine-tuning failed dismally to live up to expectations.

Source of Quotation: *Annual Report of the Council of Economic Advisers*, 1966. Washington, DC: Government Printing Office, p. 186. Data for figure from Bureau of Labor Statistics.

11.1a The Problem of Lags

The first problem standing in the way of fine-tuning is that of *lags*, a term economists use to refer to unavoidable delays in the execution of monetary or fiscal policy. There are two kinds of these lags. **Inside lags** are delays between the time a problem develops and the time policymakers decide what to do about it. **Outside lags** are delays between the time policymakers reach a decision and the time the resulting policy action affects the economy. Both kinds of lags are a problem for both monetary and fiscal policy.

Inside Lags

Some inside lags arise because of the time required to collect and report economic data. A few kinds of data, like interest rates and exchange rates, are available almost instantly; other important data take longer to gather. Data on inflation, unemployment, consumer confidence, and several other variables come out monthly. The longest lags are for data on GDP and foreign transactions, which are available only quarterly. Furthermore, the first estimates for each quarter, published about four weeks after the close of the quarter, are subject to significant revisions. Final data are not available until nearly three months after the close of the quarter.

Another problem compounds the effect of lags. Random events like weather and measurement errors influence all macroeconomic variables in a way that causes unpredictable ups and downs in monthly or quarterly indicators. That means it is usually not enough to base policy decisions on the single, most recent observation. It may take several monthly or quarterly observations to establish a clear trend that policymakers can use to reach sound decisions.

The long lags in collection of macroeconomic data, especially data on real GDP and its components, mean that policymakers may not be aware of a turning point in the business cycle until long after it has occurred. Consider the example of the mild recession from March to November 2001, which marked the end of the dot-com boom. In May 2001, the latest government data still showed the economy to be expanding, although at a slowing rate. Only after the recession was over did revised data clearly show that the economy had begun to shrink at the end of 2000. Even the Great Recession had an ambiguous beginning. It is now known to have begun in the last quarter of 2007, but the first full quarter of falling GDP was the first quarter of 2008. However, GDP rose slightly in the second quarter of 2008. Just as some people began to think there might be a quick recovery, GDP turned down again and shrank for four more quarters.

In addition to delays in data collection, the time needed to make decisions adds to the inside lag. The Fed makes decisions on interest rates and other instruments at regular meetings of the Federal Open Market Committee, which occur just eight times a year. Before those meetings can take place, the Fed's professional staff spends weeks of work preparing background materials. The Fed has the power to make emergency changes in policy between regular meetings, but it does so only rarely. Decision-making lags for fiscal policy can be even longer since many key fiscal policy decisions require action by Congress. The next two chapters will return to the problem of lags in fiscal policy.

Inside lag
Delay between the time a problem develops and the time policymakers decide what to do about it

Outside Lags

Even after policymakers reach a decision, their actions do not affect the economy immediately. Consider the use of expansionary monetary policy in the form of lower interest rates, which are supposed to stimulate aggregate demand by reducing the cost of business investment and home mortgages. Firms and households do not react instantly to

Outside lag
Delay between the time policymakers reach a decision and the time the resulting policy action affects the economy

interest rate changes. It takes time for them to make investment decisions. Even after they make decisions, they must draw up designs, place orders, and obtain permits before projects can get underway.

The aggregate supply and demand model allows for some of the most important outside lags. Suppose a policy change shifts the aggregate demand curve to the right, as shown in Figure 10–6 of the previous chapter. At first the economy begins to move up and to the right along the short-run aggregate supply curve, with both prices and output rising. After a lag, the short-run aggregate supply curve begins to shift upward. Prices rise even more, but real output begins to move back toward its natural level. The economy does not reach a new long-run equilibrium until it returns to a point where the aggregate demand curve and the short- and long-run aggregate supply curves all intersect at a common point equal to the natural level of real output.

The model makes the sequence of events clear enough, but policymakers need to know more than that. Just how long, according to the calendar, are the abstract intervals of "short run" and "long run" that mark stages in the adjustment process? Econometric studies shed some light on the issue. Studies based on data from both the United States and Europe suggest that the "short run," during which real output increases following a reduction in interest rates (or falls following an increase in rates), lasts for at least one year and sometimes as much as two years. The full effect of an interest rate change on the price level, allowing time for real output to return to its natural level, appears to take three years or longer. By the time the full effects of one policy change work their way through the economy, it is likely that new events will disturb aggregate demand and supply. In reality, the economy is constantly in motion and long-run equilibrium is a moving target we never hit, even though it looks so easy in textbook graphs.

11.1b Forecasting Errors

Lags in data collection and policy effectiveness are serious problems, but they would cause less trouble if we had accurate forecasts. For comparison, suppose you were the captain of a giant oil tanker. As captain, you would also face a problem of lags. If you turned the wheel of your ship or signaled for a change in engine speed, it might take several miles for the ship to steady on its new course. Even so, you would be better off as captain than as an economic policymaker because you would have accurate charts of the waters you were navigating and radar to show obstacles ahead. Based on the charts and radar, you could give orders well in advance, so that the ship changed course long before it went on the rocks. In contrast, the economic policymaker has no good way to see into the future. The economic ship might end up on the rocks before anyone knows what has happened.

Instead of charts and radar, policymakers must rely on economic forecasts. In every country, competing teams of economists—some private and some in government agencies like the Fed and the Office of Management and Budget—publish estimates of key variables for the year ahead. Unfortunately, those forecasts are not as reliable as we would like. According to a study by the International Monetary Fund, one-year forecasts of the rate of real GDP growth for industrialized countries are, on average, wrong by more than a full percentage point (disregarding the sign of the error).[1] For two years ahead, the error is nearly two percentage points. For developing countries, accuracy is worse than this by still another full percentage point.

What is more, forecasts are least accurate at turning points in the business cycle, just when we need them most. Looking at an international sample of seventy-two recessions in the 1990s, the IMF study found only two cases in which forecasters accurately predicted the recession two years in advance. Even more than halfway through the year in which a recession began, only about half of forecasters were predicting that a recession would occur.

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Economic forecasts tend to be least accurate at turning points in the business cycle, when we need them most.

Several factors combine to reduce the accuracy of forecasts. First, forecasters themselves must cope with the problem of lags in data collection: They must try to see into the future when they are not yet sure what has happened in the recent past. Second, the real-world economy is much more complex than any model—not just more complex than the simplified models of textbooks like this one, but more complex than even the most sophisticated multivariate models of the best professional forecasters. Third, because the structure of the economy is always changing, models that rely on data from past periods may not be reliable for forecasting the future.

Finally, forecasts are subject to bias. Government forecasts may have a bias toward optimism because politicians do not like to hear or deliver bad news. Private-sector forecasters may see a marketing advantage in developing a reputation as being persistently optimistic or persistently gloomy. The private clients of forecasters may reinforce those tendencies when, knowing that forecasts are not accurate, they play it safe by buying forecasts from several sources with differing methodologies and reputations.

11.1c Time Inconsistency

Lags and forecasting errors together make the conduct of economic policy very difficult, but they are not the whole story. We must add one more factor to see the full difficulty of fine-tuning the economy. Economists call that factor **time inconsistency**, by which they mean a tendency of policymakers to take actions that have desirable results in the short run but undesirable long-run results.

Time inconsistency is especially troublesome when policymaking interacts with the cycle of democratic elections. The aggregate supply and demand model shows that expansionary policies like tax cuts initially have desirable results. They shift the aggregate demand curve, and the economy moves up and to the right along its short-run aggregate supply curve. Real output increases, incomes increase, unemployment falls, and there is only mild inflation. This process takes place over a short-run time frame of one to two years.

Later, as expectations adjust and the short-run aggregate supply curve begins to shift upward, less desirable consequences occur. Real output falls back toward its natural level, and unemployment rises back toward its natural rate. The rate of inflation increases. That process occurs over a time frame of one or two additional years, perhaps longer.

Taking all of the lags into account, we can see that if expansionary policy comes into effect a year or so before an election, the beneficial effects will be at their strongest just as the election approaches. The harmful effects will come along in due time, but not until the election has passed.

For contractionary policy, the sequence of events works in reverse. Suppose policymakers use an increase in interest rates or taxes to combat the overheating of the economy. The immediate effect will be a leftward shift of the aggregate demand curve and a move down and to the left along the short-run aggregate supply curve. During this painful phase, which lasts a year or two years, unemployment rises, real output and incomes fall, and the rate of inflation slows only a little. Later, after expectations adjust, the short-run aggregate supply curve will begin to shift downward. Real output will again rise toward its natural level, and unemployment will fall back toward its natural rate. There will be additional progress toward slowing, or even reversing, previous inflation.

Time inconsistency
Tendency of policymakers to take actions that have desirable results in the short run, but undesirable long-run results

In short, from a political point of view, the period just before an election is not a good time to make a move toward stopping inflation. There will be a temptation to let the economy overheat for a few months longer and begin to apply contractionary medicine only after the election has passed.

11.1d Unintended Consequences

When lags, forecasting errors, and time inconsistency are combined, well-intentioned efforts to fine-tune the economy are in danger of producing two types of unintended consequences.

First, there is a danger that lags and forecasting errors alone will lead policymakers to apply expansionary or contractionary policy too late in the business cycle. Expansionary policies, intended to combat a recession, may not have their full effect until after the recession, when the next upturn of the business cycle has already begun. When they do, they will push the economy past the point of long-run equilibrium and promote inflationary overheating. Similarly, contractionary policies, intended to prevent overexpansion during a boom, may come into effect only after the economy has already begun to slow. They will make the next recession worse than it would have been if policymakers had done nothing. Together, then, lags and forecasting errors create a danger of a **procyclical pattern of policy**—one that applies restraint when the economy is already at risk of recession and that applies stimulus when it is already beginning to overheat. Procyclical policies reinforce the business cycle, making booms bigger and recessions deeper.

Second, when we add the problem of time inconsistency to those of lags and forecasting errors, policy may develop a systematic bias toward expansion and inflation. Fiscal and monetary policy would be strongly procyclical during expansions and insufficiently countercyclical during recessions, cutting contractions short before they have fully squeezed out inflation. The motives for such an asymmetrical pattern of policy are largely political. Policymakers want to prolong expansionary policies like tax cuts, spending increases, or interest rate reductions, even at the risk of inflation, in order to keep unemployment low ahead of the next election. For the same reason, they want to delay the application of contractionary policies like tax increases, spending cuts, or interest rate increases. There's always another election just around the corner, after all.

Is this purely a theoretical danger, or could it actually happen? Look back for a moment to the diagram in *Applying Economic Ideas 11–1*. It shows inflation rates at the cyclical peaks of 1969, 1974, and 1979 that are each higher than the peak rate of the preceding cycle. Similarly, the unemployment rates at the cyclical troughs of 1971, 1976, and 1982 are each higher than those at the preceding trough. Clearly, the experience of the 1960s and 1970s failed to justify hopes that economists had finally acquired both the tools and the political will to implement successful fine-tuning.

11.2 Policy Rules

Since the 1970s, there has been a widespread shift in the way economists think about stabilization policy.[2] They no longer view fine-tuning with favor. That does not mean economists think monetary and fiscal policy are ineffective. It does not mean that the government should always take a hands-off approach to the business cycle. It does not deny that emergency measures may be helpful in extreme situations. What it does mean is that in a world of lags and forecasting errors, frequent discretionary tinkering with monetary and fiscal policy is more likely to be destabilizing than stabilizing. When we take politics and time inconsistency into account, there is a real risk that monetary and fiscal policy will become procyclical.

Procyclical policy
A poorly timed pattern of monetary or fiscal policy that applies restraint when the economy is already at risk of recession and stimulus when it is already beginning to overheat

In place of fine-tuning, a majority of economists now favor moderately countercyclical stabilization strategies based on preset **policy rules**. Not only should policymakers follow the rules, but they should also announce in advance the way they will respond to unfolding developments in the economy. There is a growing consensus that such rules minimize not only the risk that lags and forecasting errors will lead to overshooting at peaks and troughs of the business cycle but also the unintended consequences of politically motivated time inconsistency. If successful, policy rules will provide a stable framework for planning by private firms and households and promote long-run prosperity. This section focuses primarily on rules for monetary policy. We will look at rules for fiscal policy in Chapter 13.

11.2a Instruments and Targets

As background for our discussion of policy rules, it is useful to distinguish among instruments, targets, and goals of economic policy.

- A **policy instrument** is a variable that is directly under the control of policymakers. For example, open market purchases and the discount rate are policy instruments of the Federal Reserve.
- An **operating target** is a variable that responds immediately, or almost immediately, to the use of a policy instrument. For example, the federal funds rate for interbank lending (an operating target) responds almost immediately to an open market purchase (a policy instrument).
- An **intermediate target** is a variable that responds to the use of a policy instrument or a change in operating target with a significant lag. For example, inflation and real GDP (intermediate targets) respond to changes in interest rates (an operating target), but not immediately.
- A **policy goal** is a long-run objective of economic policy that is important for economic welfare. Stated in their broadest forms, the goals of macroeconomic policy are prosperity and stability.

Policy rules
A set of rules for monetary and fiscal policy that specifies in advance the actions that policymakers will take in response to economic developments

Policy instrument
A variable directly under the control of policymakers

Operating target
A variable that responds immediately to the use of a policy instrument

Intermediate target
A variable that responds to the use of a policy instrument or a change in operating target with a significant lag

Policy goal
A long-run objective of economic policy that is important for economic welfare

We can illustrate the hierarchy of instruments, targets, and goals by returning to our example of the oil tanker. The ship's wheel and engine speed control are the captain's main policy instruments. The ship's speed and course are operating targets that respond immediately, or almost immediately, to use of those instruments. The captain's intermediate target, on a given voyage, is to get the ship to a certain harbor by a certain date. Long-run goals, over a series of voyages, are to establish a reputation for reliability and earn a profit for the company that owns the ship. *Applying Economic Ideas 11–2* provides another helpful metaphor.

Debates over strategies for stabilization policy do not usually focus on the choice of policy instruments or the long-term policy goals of prosperity and stability. More often, they focus on which operating targets to emphasize and the choice of intermediate targets that link changes in operating targets to long-term goals. The remainder of the chapter will look at several alternative policy rules, each having its supporters and critics.

Applying Economic Ideas 11–2

Pool as a Metaphor for Macroeconomic Policy

If you've ever shot pool, you know how frustrating a game it can be, even though conceptually it may be very simple to understand. There are variations on the game, but the gist is that you've got to use the cue stick to strike the white cue ball, sending it to knock the colored balls into the pockets on the perimeter of the table.

You can think of the *policy instrument* as the cue stick: It's the tool that is directly under the control of the policymaker. The *operating target* of macroeconomic policy is the cue ball, in that it responds immediately to the actions that the policymakers take with the policy instrument. The colored balls represent the policymakers' *intermediate targets*, because they respond to what happens to the cue ball with a lag and often in ways that are hard to predict with precision. What represents the *policy goal* in this metaphor? Sinking the balls in the correct sequence in order to win the game!

(Shutterstock)

The frustration you may feel playing pool generally comes from three main sources: First, you cannot reach in and move balls—any of them. You must play them where they lie, and often they lie in inconvenient places. Second, you cannot strike the colored balls directly to send them into the pockets; instead, you can only strike the cue ball and use it to move the other balls around. Third, and perhaps most important for the amateurs among us, even if you know exactly how fast and in what direction you want the cue ball to move or spin, it may not do what you want it to. The cue ball's movements are very sensitive to the exact point at which you strike it and the precise amount of force that you use.

Macroeconomic policymakers can relate. First, like the pool player, the policymaker can't do anything to directly change the social, political, cultural, or economic landscape in which they have to perform their policy actions. Second, though they might wish otherwise, policymakers don't have direct control over key macroeconomic variables like inflation or unemployment. They only have control over their policy instruments, like the federal government's budget or the Fed's open market operations. Third, due to the size and complexity of the US economy, it's impossible for policymakers to predict the exact results they will get. Sometimes monetary stimulus is more effective and sometimes less. Sometimes the economy is more sensitive to interest rates and sometimes less sensitive.

There's one more way in which macroeconomic policy is like playing pool: If you don't get it quite right the first time, you generally get another chance to step up to the table and try again.

11.2b Monetarism: The Grandparent of Policy Rules

Monetarism
A school of economic thought that emphasized the importance of the quantity of money and advocated the use of stable rules for monetary policy

Even when enthusiasm for macroeconomic fine-tuning was at its peak in the 1960s, there were dissenters. One of the best known was University of Chicago professor Milton Friedman (*see Who Said It? Who Did it? 11–1*). Friedman was the intellectual leader, although by no means the only prominent member, of a school of thought that economists came to call **monetarism**.

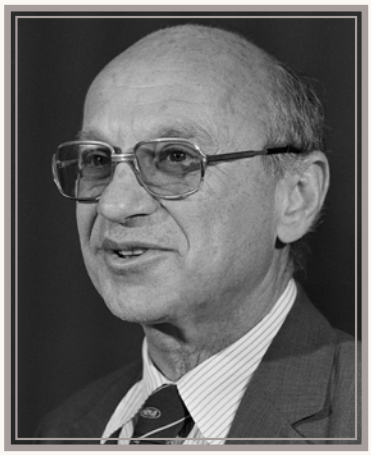
Who Said It? Who Did It? 11–1

Milton Friedman, Anna Schwartz, and Monetarism

Milton Friedman was born in New York in 1912, the son of immigrant garment workers. He attended Rutgers University, where he came under the influence of Arthur Burns, then a young assistant professor and later chairman of the Federal Reserve Board. From Burns, Friedman learned the importance of empirical work in economics. Statistical testing of all theory and policy prescriptions became a key feature of Friedman's later work. From Rutgers, Friedman went to the University of Chicago for an MA and then east again to Columbia University, where he received his PhD in 1946. He returned to Chicago to teach. There, he and his colleagues of the "Chicago school" of economics posed a major challenge to economists of the "Eastern establishment."

If one could single out a recurrent theme in Friedman's work, it would be his belief that the market economy works—and that it works best when left alone. "The Great Depression," Friedman once wrote, "far from being a sign of the inherent instability of the private enterprise system, is a testament to how much harm can be done by mistakes on the part of a few men when they wield vast power over the monetary system of the country." The view that poor monetary policy was primarily responsible for the severity of the Great Depression was one that Friedman advanced with his frequent collaborator Anna Schwartz in their landmark book *A Monetary History of the United States, 1867–1960*. Published in 1963, it was the first of three books on monetary policy that the pair wrote together.

Anna Schwartz was born Anna Jacobson in New York in 1915. She graduated from Barnard College at 18 and received a master's degree in economics from Columbia University at 19. Soon after, she began working at the National Bureau of Economic Research (NBER), where she worked into her 90s. While working there, a colleague suggested she team up with Friedman to study monetary



(Courtesy of UPI, circa 1976, US-PD via Wikimedia)

Milton Friedman

("Anna Schwartz," by David Shankbone, circa 2007, available under a CC by SA 3.0 license via Wikimedia)

Anna Schwartz

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policy. The suggestion was a good one, and soon "Friedman and Schwartz" became the most influential figures in monetary macroeconomics in the twentieth century.

Their work together was very successful, and Milton Friedman and Anna Schwartz were very supportive of each other's work. Schwartz claimed that Friedman was "a great person to work with," and even after his death, at the age of 91, she penned a lengthy response to an op-ed by Paul Krugman that she felt misrepresented Friedman's ideas and unfairly attempted to tarnish his reputation. For his part, Friedman once quipped that Schwartz did all the work, and he got all the credit. He was right: Even though his 1976 Nobel Prize was in part for work that he did with Schwartz, she did not share the award and was not even cited in the official commendation. Most economists today view this as a grave oversight.

Friedman strongly favored a hands-off policy by government in almost every area. In his view, the problem was not that government is evil by nature, but that so many policies end up having the opposite of their intended effects. He thought that social reformers who claimed to do nothing but serve the public interest would invariably be led to serve some private interest, even if doing so was not part of their intention. Schwartz largely agreed, and near the end of her life she was outspoken in her opposition to moves the Fed and the Treasury made in response to the financial crisis in 2008. She said for example that the Fed had "no business" bailing out Bear Stearns, a move she called a "rogue operation." The "Friedman and Schwartz" view is that monetary authorities should take a less active role.

Sources: Milton Friedman, *Capitalism and Freedom*, Chicago: University of Chicago Press, 1962; and Steven Matthews and Vivien Lou Chen, "Anna Schwartz, economist and collaborator with Friedman, dies," *The Washington Post*, June 22, 2012, https://bvtlab.com/987qE.

His most famous work, *A Monetary History of the United States*, which he co-authored with Anna Schwartz (see *Who Said It? Who Did It? 11–1*), reinterprets the causes of the Great Depression. Friedman and Schwartz took issue with the approach that John Maynard Keynes had taken in the 1930s (see *Who Said It? Who Did It? 5–1*). Rather than tracing the causes of the depression to an inherent instability of market economies, they saw mistakes in monetary policy as the principal factor that turned an ordinary cyclical recession into a national disaster. In *Monetary History* and elsewhere, Friedman and Schwartz consistently argued that the correct conduct of monetary policy was the key to economic stability. That emphasis on monetary policy gave the monetarist school its name.

A second element of their thinking was the argument that neither monetary nor fiscal policy is capable of fine-tuning the economy. Instead, the Federal Reserve should conduct its policy according to a simple rule that would avoid the problems of lags, forecasting errors, and time inconsistency. Specifically, Friedman recommended that the Fed use open market operations to hold growth of the money stock at a target equal to the economy's long-run rate of growth of real GDP. In his view, such a cyclically neutral policy would avoid the procyclical tendencies that inevitably undermine any more active stabilization strategies.

Support for a monetary growth target is a direct outgrowth of the equation of exchange. As explained in Chapter 8, the equation of exchange tells us that the quantity of money times the price level is, by definition, equal to the velocity of circulation of money times the price level. It follows that if M grows steadily at the same rate as Q and V is subject only to minor or predictable variations (as Friedman thought), the price level P would remain approximately constant in the long run. Although random events might cause short-term variations in prices, real output, and employment, Friedman thought that a monetary growth target would inoculate the economy against the risk of runaway inflation or deep, lasting depression.

The Fed never made a commitment to Friedman's rule. Structural reforms in the banking industry during the 1980s increased the variability of velocity and weakened the link between the growth rate of the money stock and the rate of inflation. However, the idea that policy rules were a better basis for stabilization strategy than fine-tuning prevailed. It was just a matter of finding the right rule.

11.2c Inflation Targeting

By the end of the twentieth century, economists and central bankers who argued in favor of policy rules had largely turned away from a money growth target to **inflation targeting**. They use that term to describe any stabilization strategy that focuses on establishing a target range for the rate of inflation.

The basic idea behind inflation targeting, like Friedman's money growth target, can be explained in terms of the equation of exchange, $MV = PQ$. A money growth target achieves long-term price stability only if both velocity (V) and the growth rate of real output (Q) are stable. If either or both are subject to significant, unpredictable changes, even a steady rate of money growth can lead to undesired inflation or deflation. Inflation targeting, rather, is supposed to guard against these sources of instability by focusing on the rate of change of the price level itself.

Interest Rates as an Operating Target

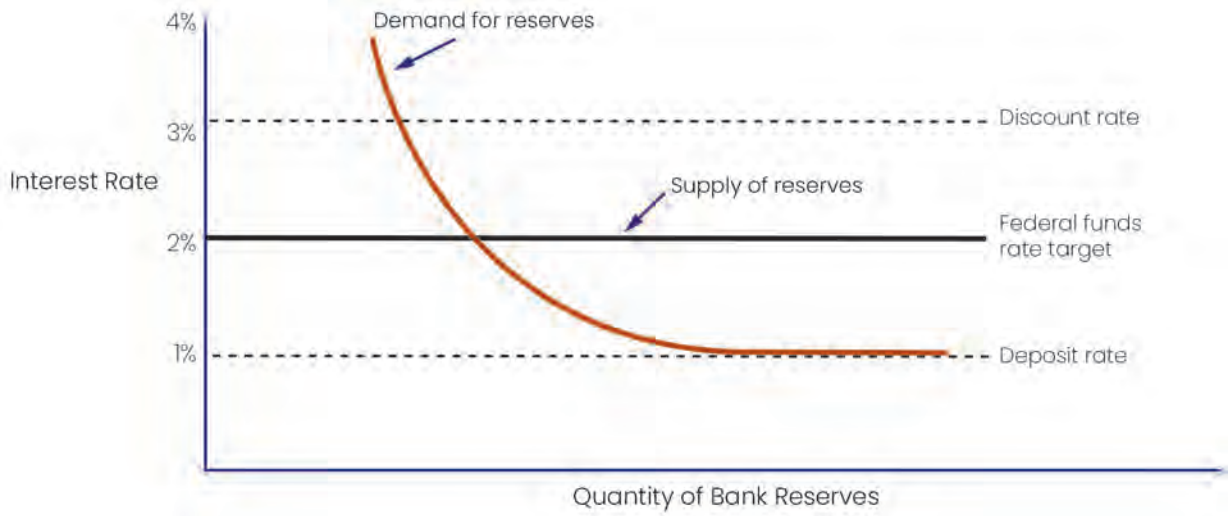
Although the concept of inflation targeting is simple, implementing it is not so easy. One major problem is that policymakers cannot use the rate of inflation itself as a short-run operating target. Inflation simply does not respond fast enough to the use of policy instruments. Instead, as our discussion of the aggregate supply and demand model has shown, inflation responds to policy actions only after a lag of months or even years. Policymakers can use the rate of inflation, averaged over a one- or two-year time horizon, as an intermediate target; but in order to implement an inflation targeting strategy, they must also have a suitable operating target over which they can exercise closer control.

Most central banks that pursue inflation targeting in any form use short-term interest rates as their principal operating target. That is true both for central banks, like those of the UK and Australia, that have explicitly adopted inflation targeting and for others, like the Fed in the US and the European Central Bank, that pursue a mixed strategy that includes some elements of inflation targeting. This section illustrates this approach by showing how the Fed might implement a strict inflation targeting strategy if it chose to do so.[3]

As discussed in Chapter 8, the Fed, like most other modern central banks, maintains direct or indirect control over three short-term interest rates, as shown in Figure 11–1. The first two are administrative rates set directly by the central bank: the discount rate (that is, the rate charged on loans of reserves to commercial banks) and the rate paid on reserves that commercial banks keep on deposit with the central bank. The third interest rate is the federal funds rate—that is, the rate on interbank loans of reserves. The discount rate and deposit rate are administratively set, while the federal funds rate depends on supply and demand in the interbank loan market.

Inflation targeting
A strategy for stabilization policy that focuses on holding the rate of inflation within a target range

Figure 11–1 How Interest Rates Work as Operating Targets



The Fed's discount rate and deposit rate instruments are under its direct administrative control. The federal funds rate for interbank lending is a market rate set by supply and demand. Commercial bank demand for reserves has a negative slope because lower interest rates mean a lower opportunity cost of holding reserves. To implement an interest rate operating target, the Fed would set a target value for the federal funds rate (2 percent in this example) and set its administrative rates to form a corridor above and below the target. If the demand curve shifted to the right or left, the Fed would use open market purchases or sales to hold the federal funds rate at its target. In effect, then, the supply curve of reserves becomes a horizontal line at the federal funds rate target.

Figure 11–1 also shows commercial banks' demand curve for reserves. As explained in Chapter 8, commercial banks hold reserves of liquid assets to meet their customers' needs and minimize liquidity risk, but the amount of reserves they hold depends on the interest rate. Other things being equal, the lower the interest rate, the lower the opportunity cost of holding reserves—so the greater the quantity of reserves demanded. The demand curve becomes horizontal as it approaches the central bank's deposit rate, because if the interbank rate were to fall below the deposit rate, banks could make an effortless, risk-free profit by borrowing reserves from other banks and depositing them with the central bank.[4]

The figure shows a hypothetical situation in which the Fed selects 2 percent as its target for the federal funds rate. To implement that target, it first sets the discount rate and the deposit rate so that they form a corridor above and below the federal funds rate target. Although the Fed cannot directly control the federal funds rate, it can control it indirectly by using open market operations to adjust the quantity of reserves available to the banking system. If the demand for reserves were to increase, the Fed could use open market purchases to increase the supply of reserves and keep the federal funds rate from rising above the 2 percent target. If the demand for reserves were to decrease, the Fed could use open market sales to reduce the supply of reserves and keep the federal funds rate from falling. In effect, until the Fed changed its federal funds rate target, these open market operations that match changes in demand cause the supply curve of reserves to be a horizontal line at 2 percent, as shown in Figure 11–1.

How would the Fed or another inflation-targeting central bank know where to set the operating target for the interbank lending rate? Why should the federal funds rate target be 2 percent rather than, say, 1 percent or 5 percent?

To set the right operating target, the Fed would have to use a forecasting model to predict how a given interest rate target will affect the rest of the economy. A reduction in interest rates stimulates planned investment and purchases of durable consumer goods. As explained in Chapter 10, the increased planned expenditure shifts the aggregate demand curve to the right. In the short run, real output and the price level both increase. In the long run, the price level increases further and real output returns to its natural level. An effective forecasting model would be able to estimate the rate of inflation over the next year or two that would result from any given interest rate operating target. So, once the Fed has established a target range of inflation—for example, between 2 percent and 4 percent on average over the next two years—it would use its forecasting model to find an operating target for the federal funds rate that appeared likely to result in a rate of inflation near the center of the cone. It would then use open market operations, as shown in Figure 11–1, to maintain the interbank rate at that level.

Now comes the tricky part. As we know from our earlier discussion, forecasting models are far from perfect. Even if policymakers maintain their operating target for the interest rate, unforeseen events are likely to cause the actual path of inflation to swing up and down within the target range of inflation. In order to anticipate such developments, the Fed would need to revise its inflation forecasts on a regular basis. If a revised forecast indicated that the rate of inflation started to drop near the bottom of the target range, the central bank would have to act. It would lower its operating target for the interbank interest rate and use open market operations to nudge the rate toward the new, lower target. Doing so would stimulate the growth of aggregate demand. When the forecasting model indicated that predicted inflation was back in the acceptable range, the Fed would stop easing monetary policy and would hold interest rates steady until new developments occurred. In the opposite case, if the rate of inflation started to rise toward the top of the target range, the Fed would lower its interest rate operating target in order to stimulate aggregate demand.

Beginning in 2012, the Fed announced that it would consider "price stability" to mean a rate of inflation close to 2 percent. For many years, that target was interpreted as a 2 percent ceiling. Since 2020, it has changed its approach announcing that instead of setting an inflation ceiling, it would aim for inflation of close to 2 percent on average over a time horizon of a few years.

With or without a formal target, over most of the last several decades, the Fed effectively kept inflation in the US low and stable for many years. When inflation rates began to rise in 2021, the Fed announced that it would begin gradually raising the federal funds rate, starting in March 2022, with further increases planned for 2023 and 2024. The Fed also began to slow its open market purchases of Treasury securities in 2021, hoping to end the purchases by the second quarter of 2022.

11.2d Other Proposed Monetary Policy Rules

The monetary policy of the Federal Reserve has, in recent years, resembled inflation targeting in some—but not all—ways. The Fed does place a higher priority on price stability than on any other single intermediate policy target. With this goal in mind, it uses open market instruments to hold the federal funds rate at a chosen target very much as described above.

Even so, the Fed's policy is not true inflation targeting because it pursues other targets as well. The most important of those is the unemployment rate—which, by law, is a goal that the Fed is required to balance with its duty to maintain price stability. The twin targets of full employment and price stability are known as the "dual mandate." Up to now, the Fed has balanced the two parts of its dual mandate somewhat subjectively, but a number of economists have suggested that the subjective approach could be replaced by an explicit rule that took both parts of the mandate into account.

The Taylor Rule

The best known of these proposed rules is the **Taylor rule**, proposed by Stanford University economist John Taylor. Under a Taylor rule, the Fed would tighten policy by adjusting its interest rate operating target upward by a specified amount whenever the rate of inflation increased, and also raising interest rates whenever real output exceeded its natural level—that is, when a positive output gap developed.

(From "Understanding Monetary Policy with John B. Taylor/Lessons from the Hoover Policy Boot Camp) by PolicyEd via YouTube)

The Taylor rule was developed by Stanford University economist John Taylor.

Despite its resemblance to what the Fed actually does, explicit implementation of a Taylor rule would encounter some practical difficulties. One is the question of how much to adjust interest rates for a given change in inflation or the output gap. If the adjustment were too small, the policy would not be effective in damping the business cycle. If it were too large, policy might overshoot its goals at cyclical peaks and troughs, making things worse rather than better. Taylor's original formulation also encounters the difficulty that data on the output gap are available to policymakers only with a long lag. A variation of the Taylor rule would instead watch the unemployment rate. Unemployment varies inversely with changes in the output gap, but data are available with a much shorter lag.

NGDP Targeting

Another scheme that some economists prefer to the Taylor rule is **NGDP targeting**, which focuses on the rate of growth of nominal GDP—that is, on the right-hand side of the equation of exchange, $MV = PQ$.

Because the level of nominal GDP is equal to the price level, P, times real output, Q, the rate of growth of nominal GDP is the sum of the real growth rate and the rate of inflation. The average rate of growth of US real GDP since 2000 has been about 2.0 percent. If we combine this with the Fed's 2.0 percent target rate of inflation, we get 4.0 percent as an appropriate target rate of growth for NGDP.

If velocity were constant, then maintaining NGDP growth at a steady 4.0 percent would simply require an equal steady rate of growth of the money stock. In that sense, many economists consider NGDP targeting to be the natural heir of Milton Friedman's monetarism. NGDP targeting is more flexible than simple monetary targeting, however. It takes into account the fact that velocity has proved much more variable in recent years than was foreseen in the 1960s. Under NGDP targeting, an unexpected increase in velocity could be offset by a slowdown in the rate of growth of the money stock, or vice versa.

Among the considerations that favor NGDP targeting is the possibility that inflation targeting, under some conditions, can have harmful unintended consequences. One problem occurs when an event arising outside the control of policymakers causes a burst of inflation. Holding to a strict inflation target would require the central bank to raise interest rates and pursue a strong contractionary policy that could cause a decrease in real output and send the unemployment rate up sharply. Its shift to symmetrical inflation targeting with multiyear averaging is a partial response to that problem, but not enough for fans of NGDP targeting. If the central bank were, instead, targeting NGDP growth,

Taylor rule
A rule that adjusts monetary policy according to changes in the rate of inflation and the output gap (or unemployment)

NGDP targeting
A policy under which the central bank adopts the rate of growth of nominal GDP as its principal intermediate target

the oil price shock could be absorbed partly by a higher price level and only partly by a reduction in real output. NGDP targeting, in this sense, is less rigid and more inclusive of multiple policy objectives than is inflation targeting.

The sudden uptick in inflation that occurred in 2021 and 2022 and the Fed's response seem in part to recognize the weaknesses of inflation targeting. At its March 2022 meeting, the FOMC announced its economic projections, assuming appropriate monetary policy. Those projections suggest that the Fed believed that inflation would stay above its 2 percent "target" until the end of 2024. With these projections, it seems like the Fed is signaling that they aren't willing to take the drastic measures that would be necessary (and would likely cause a recession) to quickly get back to the 2 percent target.

NGDP targeting would also give the central bank more flexibility when the economy enters a deep recession. In that case, the rate of inflation may fall to zero, or even below. Under those circumstances, if the central bank did no more than aim for an inflation target of 2.0 percent, it could be years before real GDP recovered to its potential level. Instead, a central bank that set a 4.0 percent target for NGDP growth would be willing to tolerate a more aggressive expansionary policy. Doing so might, in the short run, allow inflation to rise well above 2.0 percent; but once real GDP returned to its long-run potential growth of 2.0 percent, inflation would slow again. We will return to these and other NGDP targeting scenarios in Chapter 14, where we will discuss inflation and deflation in more detail.

Overall, there is no simple answer to which monetary policy strategy is best for any given country. The choice of an inflation target, an NGDP target, or some mixed target involves both economic and political considerations. Nonetheless, over the past couple of decades, economists have more and more come around to the view that transparent policy rule, based on preset targets of some kind, does a better job of promoting stability and prosperity than the kind of ad hoc fine-tuning that many countries, including the US, attempted in the past.

Summary

1. **Why do lags, forecasting errors, and time inconsistency make it difficult to fine-tune the economy?**

   Simple textbook models make it look as if it would be easy to *fine-tune* the economy to achieve a perfect countercyclical policy. In practice, three problems make fine-tuning difficult. *Lags* create delays between the time problems develop and the time policies take effect. *Forecasting* errors make it difficult for policymakers to overcome the problem of lags by acting before a turning point in the business cycle approaches. *Time inconsistency* is a tendency for policymakers to take actions that are beneficial in the short run but make problems worse in the long run.

2. **What are the distinctions among policy instruments, operating targets, intermediate targets, and policy goals?**

   Policy instruments are variables that are under direct control of policymakers. *Operating targets* are variables that respond immediately, or almost immediately, to changes in policy instruments. *Intermediate targets* are variables that respond to changes in operating targets with a significant lag. *Policy goals,* like prosperity and stability, contribute directly to people's long-run economic welfare.

3. **How do policymakers attempt to overcome the limits of fine-tuning?**

   If policymakers follow transparent, preset policy rules, there is less chance that lags and forecasting errors will lead to a procyclical policy that features overshooting at the top and bottom of the business cycle. Also, preset rules reduce the risk that time inconsistency will lead to politically motivated destabilizing actions.

4. **What are the advantages and disadvantages of various policy targets?**

   The school of monetarism, which emerged in the 1960s, advocated using the money stock as the Fed's chief policy target. Under inflation targeting, the central bank uses its policy instruments to hold the forecast rate of inflation within a target range over a one- to two-year time horizon. Under a Taylor rule, the central bank would watch developments both of inflation and of real output or unemployment. NGDP targeting makes nominal GDP (real output times the price level) the target for monetary policy. All such policy rules face a trade-off between simplicity and flexibility.

Key Terms

Countercyclical policy	268	Outside lag	270
Fine-tuning	268	Policy goal	274
Inflation targeting	278	Policy instrument	274
Inside lag	270	Policy rules	274
Intermediate target	274	Procyclical policy	273
Monetarism	276	Taylor rule	281
NGDP targeting	281	Time inconsistency	272
Operating target	274		

Problems and Topics for Discussion

1. Terms of Federal Reserve governors

The Federal Reserve System operates under a seven-member Board of Governors. The term of a governor is fourteen years, and governors usually cannot serve more than one term (except for an additional partial term to fill a vacancy). Terms are staggered, so that one governor's term expires every other year. Governors can only be removed from office "for cause"—that is, for abuse of their office, not just for policy disagreements. In what way do the long terms and secure tenure of Federal Reserve governors help to overcome the problem of time inconsistency in monetary policy? In practice, Fed governors rarely serve out their full fourteen-year term. Is that a problem? Discuss.

2. Monetary policy targets in Eudemonia

Suppose that natural real output in the country of Eudemonia grows at a steady rate of 3 percent per year. In the past, velocity has been approximately constant, and the Eudemonian Central Bank has maintained a target rate of growth of 4 percent per year for the money stock. What would be the resulting rate of inflation? Now suppose that the introduction of internet banking allows people to make transactions online without holding large amounts of currency or bank balances. As internet banking spreads, velocity begins to increase at a rate of 3 percent per year. What will happen to the rate of inflation if money growth is unchanged? How would the central bank react to the change in velocity if it pursued an NGDP target instead of a money stock target?

3. Core versus headline inflation

Among central banks that practice inflation targeting, there is a debate over whether to target "headline" inflation or "core" inflation. Headline inflation means the consumer price index for all items. Some central banks favor headline inflation as a target because promising to stabilize a widely publicized inflation measure has maximum psychological impact on public expectations. Core inflation means consumer price inflation with adjustments to remove the most variable prices, like those of food and energy. Some central banks favor core inflation because food and energy prices are set in world markets and are beyond the control of domestic monetary policy. Compare the rates of core and headline inflation for the most recent month and the past year (for the United States, these data can be found on the web at www.bls.gov/cpi).

4. Inflation targeting in Norway

The Fed does not pursue a true inflation targeting strategy, but many central banks around the world do. The central bank of Norway is a good example. Visit the bank's website, www.norges-bank.no/en, and type "inflation targeting" in the search box to find several papers about the bank's strategy. Among other things, look for charts that give the bank's forecasts for consumer price inflation (CPI). In what ways do they resemble our discussion in the chapter? In what ways do they differ? Is the Norwegian central bank currently succeeding in its policy for maintaining price stability in that country?

Case for Discussion

The FOMC Reveals Its Strategy

The main policymaking body of the Federal Reserve is the Federal Open Market Committee (FOMC), which meets eight times per year. After each meeting, the FOMC issues a brief statement explaining its views on the state of the economy and the monetary policy actions it sees as appropriate. Following is a slightly truncated version of the statement for January 26, 2022.

Press Release (January 26, 2022)

Indicators of economic activity and employment have continued to strengthen. The sectors most adversely affected by the pandemic have improved in recent months but are being affected by the recent sharp rise in COVID-19 cases. Job gains have been solid in recent months, and the unemployment rate has declined substantially. Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation. Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The path of the economy continues to depend on the course of the virus. Progress on vaccinations and an easing of supply constraints are expected to support continued gains in economic activity and employment as well as a reduction in inflation. Risks to the economic outlook remain, including from new variants of the virus.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to keep the target range for the federal funds rate at 0 to ¼ percent. With inflation well above 2 percent and a strong labor market, the Committee expects it will soon be appropriate to raise the target range for the federal funds rate. The Committee decided to continue to reduce the monthly pace of its net asset purchases, bringing them to an end in early March.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

(continues)

Questions

1. What mention does this press release make of the Fed's "dual mandate"? (See *11.2d Other Proposed Monetary Policy Rules* for a review.) What are the target variables about which the Fed expresses the greatest concern in this memo? On the basis of this statement, would you classify the Fed as pursuing an inflation targeting strategy? Why or why not?
2. What is the federal funds rate? Would you classify the federal funds rate as a policy instrument, an operating target, an intermediate target, or a policy goal? Explain.
3. Based on the information in this statement, does it appear that the Fed is attempting to fine-tune the economy—that is, to adjust its policy on a month-to-month basis in response to the latest economic data? What parts of the statement give you a clue as to the Fed's attitude toward fine-tuning?
4. Visit the Fed's website, www.federalreserve.gov. Click on the tab labeled "Monetary Policy" and look for the most recent FOMC statement. After some meetings, the FOMC also holds a press conference and posts the video to its website. Based on the latest FOMC statement, how has the state of the US economy changed since January 2022? Is the Fed still pursuing its policy of a very low (0 to 0.25 percent) target for the federal funds rate?

Endnotes

1 Grace Juhn and Prakesh Lougani, "Further Cross-Country Evidence on the Accuracy of the Private Sector's Output Forecasts," *IMF Staff Papers* Vol. 49, No. 1 (2002).

2 For an excellent account of the evolution of economists' views on policy rules, see Marvin Goodfriend, "How the World Achieved Consensus on Monetary Policy," *Journal of Economic Perspectives* (Fall 2007): 47–68.

3 The appendix to this chapter gives an alternative presentation of interest-rate targeting.

4 The diagram assumes that banks are the dominant participants in the interbank loan market. As explained in Chapter 8, in the special circumstances that followed the financial crisis of 2008, government-sponsored enterprises came to dominate the federal funds market. Because GSEs are not eligible to receive interest on deposits of reserves held at the Fed, they are willing to lend and borrow reserves at rates below the deposit rate. Presumably, this situation is a temporary departure from normal

Appendix to Chapter 11

Supply and Demand for Money

As we have seen, central banks control interest rates in two ways. First, the discount rate charged on borrowed reserves and the deposit rate for reserves that commercial banks hold on deposit at the central bank are set administratively. Second, central banks control interest rates indirectly by adjusting the monetary base and the quantity of money using open market operations or other instruments. Some central banks use interest rates as their principal operating target, while some use other targets. This chapter has explained the technicalities of an interest rate operating target using a diagram that shows the supply and demand for bank reserves (see Figure 11–1). This appendix takes an alternate approach that explains interest rates in terms of the supply and demand for money itself. The model presented here also provides insight into how monetary policy would be conducted by a central bank that used the money stock, rather than an interest rate, as its principal operating target, as recommended by economists of the monetarist school. Keep in mind, however, that the Fed has never adopted such a policy.

The Money Demand Curve

What do we mean when we speak of the "demand for money"? As used in daily conversation, the term *money* is a synonym for income or wealth; in that case, the answer would be that people seem to have an unlimited demand for money:

> *"I'm studying economics because I want to work on Wall Street and make a lot of money when I graduate," a friend might tell you.*
>
> *"How much money do you want?" you might ask.*
>
> *"The more the better!" your friend would say.*

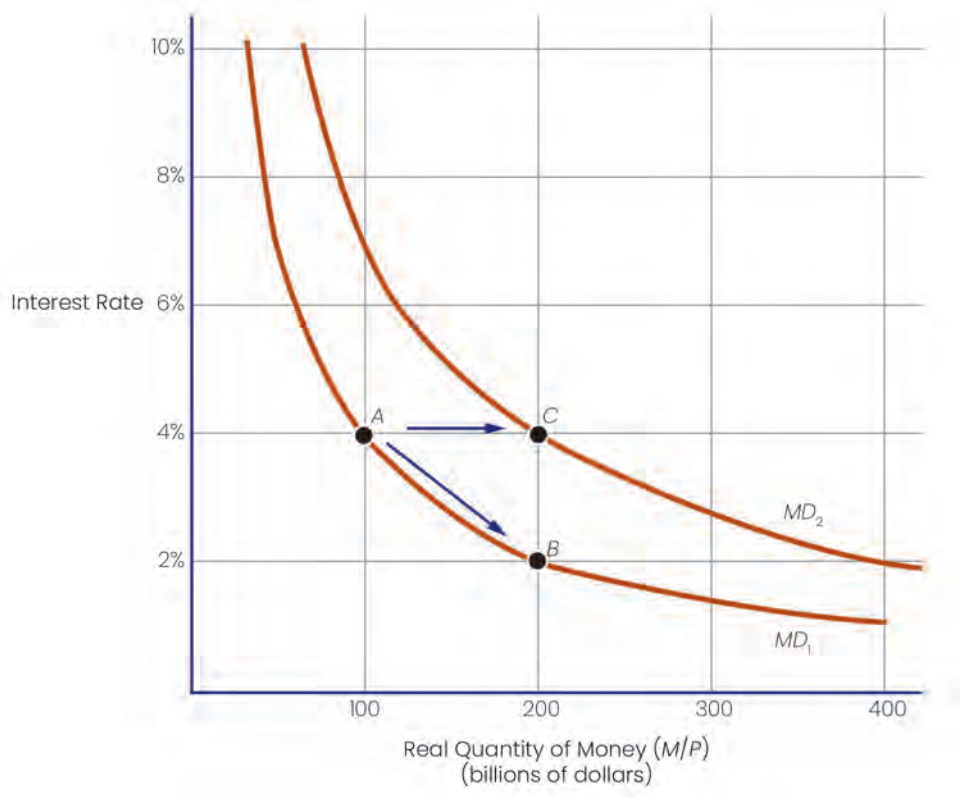
This use of the term *money* is imprecise. When economists discuss the demand for money, they have something different in mind. As we saw in Chapter 8, economists use the term *money* to mean a specific set of liquid assets—the currency, transaction deposits, and other elements that make up M2 or some other specific measure of the money stock. To an economist, the demand for money means how much of those particular assets a person wants to hold at any one time, other things being equal. The "other things" include one's total wealth (that is, the sum of all of one's assets, including less-liquid assets like houses, cars, and shares of stock) and one's income.

The quantity of money demanded, given one's level of income, depends on the opportunity cost of holding money. For an ordinary good like chicken or movie tickets, the measure of opportunity cost is the market price—the amount of money per unit needed to buy it. However, people do not "buy" money in the same sense that they buy other goods. Instead, they obtain money by exchanging other assets for it—for example, by selling securities in exchange for bank deposits. In that case, the "price"—or, more accurately, the opportunity cost—of obtaining money is the rate of interest that they could have earned by holding securities instead of currency or transaction deposits that pay no interest.

In this brief appendix, we will make two simplifications with regard to the opportunity cost of money. First, we will assume that money earns no interest at all. It is true that some forms of money, like savings deposits, do pay a small rate of interest, but we will leave these out of consideration. Second, there are many different kinds of securities that we could exchange for money, each of which would pay a different interest rate and, therefore, imply a different opportunity cost. To keep things simple, we will consider only one nonmonetary asset—namely, a short-term, interest-bearing asset that has zero default risk (for example, Treasury bills).

Figure 11–2 shows the demand for money in graphical form. The vertical axis shows the interest rate chosen to measure the opportunity cost of money. The horizontal axis shows the quantity of money. We will represent the quantity of money in real terms, so the horizontal axis is labeled M/P, meaning the quantity of money divided by the price level. This means that the horizontal axis shows the purchasing power of the money stock—how much real stuff can be purchased using the money that is available. It would be possible, instead, to place the nominal money stock, M, on the horizontal axis, but the real-money version of the diagram is the one economists most often use.

Figure 11–2 Demand for Money



The money demand curve shows the real quantity of money balances that people want to hold at any given interest rate. A change in the interest rate causes a movement along a given money demand curve (for example, from A to B). An increase in real income causes a shift in the money demand curve (for example, from MD_1 to MD_2).

Along the money demand curve MD_1, the real quantity of money demanded increases as the interest rate decreases. For example, at an interest rate of 4 percent, the quantity of money demanded is $100 billion (point *A*). If the interest rate falls to 2 percent, the quantity demanded increases to $200 billion (point *B*).

If real domestic income increases, people will want to buy more goods and services. Other things being equal, people will demand more money to carry out the greater volume of transactions. An increase in real domestic income thus shifts the money demand curve to the right. For example, suppose that MD_1 corresponds to a domestic income of $1 trillion. If domestic income increases to $2 trillion, the money demand curve will shift rightward to MD_2. If the interest rate were to remain at 4 percent as domestic income increased, the quantity of money demand would increase to $200 billion (point *C*).

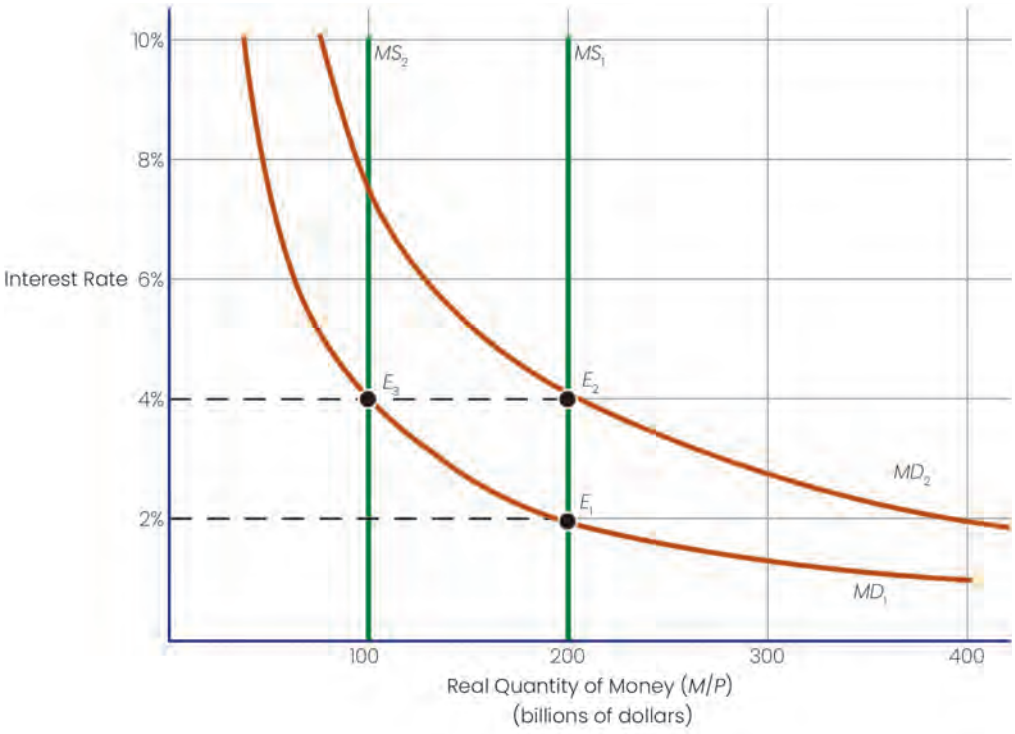
To summarize, we see that the demand for real money balances is inversely proportional to the interest rate and directly proportional to real domestic income, other things being equal. A change in the interest rate causes a movement along the money demand curve, and a change in real income causes a shift in the curve.

The Money Supply Curve

The central bank can control the quantity of bank reserves directly using open market operations. In principle, it could also control the supply of money, provided it also used open market operations appropriately to offset changes in the value of the money multiplier. Figure 11–3 shows how money supply interacts with money demand in an economy where the central bank maintains a specific target value for the money stock.

Starting from point E_1, any change in money demand, while money supply remains constant, would change the equilibrium interest rate. For example, suppose that real domestic income increases, shifting the money demand curve to MD_2. If the interest rate remained unchanged, people would want more money to carry out the greater volume of transactions associated with their higher income. Firms and households would try to get the money they want by borrowing it from their banks. However, if the central bank held the quantity of reserves unchanged, and if the money multiplier remained constant, the banking system would not have the reserves needed to supply the desired amount of money. As the demand for loans increased with limited reserves available, banks would raise their interest rates. Increasing interest rates, in turn, would cause firms and households to tighten up their cash management practices and find ways to make do with less money per dollar of income. As interest rates rose, the economy would move to a new equilibrium at E_2.

Figure 11–3 How Money Supply Interacts with Money Demand



Suppose, for example, that the central bank uses open market operations to adjust the real money supply to $200 billion. The result is the money supply curve MS_1. If the money demand curve is in the position MD_1, the equilibrium interest rate will be 2 percent, shown by the intersection of MS_1 and MD_1.

Interest rates would also increase if the central bank used open market sales of securities to reduce the real money supply while real income and the price level remained unchanged. For example, suppose the central bank reduces the real money supply from $200 billion to $100 billion. We would show that by a leftward shift in the money supply curve from MS_1 to MS_2. Banks would suddenly find themselves short on reserves. They would have to reduce their volume of lending by refusing to extend new loans when customers paid off existing loans. Competition among borrowers for the limited volume of loans available would drive up interest rates, and the economy would move from equilibrium at E_1 to a new equilibrium at E_3.

A third factor that can affect the equilibrium interest rate is a change in the price level. Again we start from equilibrium at E_1. Now assume that real income remains constant but the price level increases. The increase in the price level will not shift the demand curve because its position depends on real, not nominal, income. However, if the central bank does not use open market operations or other instruments to increase the nominal quantity of money, the real quantity of money, M/P, will decrease, because P is increasing while M is constant. If the price level doubled, the real money supply curve would shift from MS_1 to MS_2, and the equilibrium interest rate would rise to 4 percent, as shown by E_3.

We can summarize our findings by saying that any of the following three events will cause the interest rate to increase, other things being equal:

1. An increase in real domestic income while the price level and the real money supply are constant
2. A decrease in the real money supply while the price level and real domestic income are constant
3. An increase in the price level while real domestic income and the nominal money supply are constant

Money Supply Target Versus Interest Rate Target

The diagrams in this appendix provide additional perspective on the use of different targets and policy rules by the central bank. A monetarist policy rule of the kind favored by Milton Friedman would use open market operations to hold the nominal money stock constant in the short run and allow it to grow at a predetermined rate over the long run. Under such a policy rule, any short-run increase in nominal domestic income—whether in the form of inflation, an increase in real income, or a combination of the two—would cause interest rates to rise. As interest rates rose, credit market conditions would tighten, planned investment would decrease, and the growth of nominal income would go down. Similarly, any decrease in nominal income would cause interest rates to fall. Planned investment would be encouraged, counteracting the slowdown of nominal income. In short, under the monetarist rule, countercyclical changes in interest rates would tend to moderate excessive variations in the growth of nominal income.

A central bank that used an interest rate operating target would operate differently. After setting its interest rate target, it would use open market operations to adjust the position of the money supply curve as needed to hit the target. However, the central bank would have to be careful that the interest rate target was set at the right level. If it maintained too low an interest rate target for too long, it would risk an inflationary spiral. When inflation accelerated, it would have to increase the nominal money stock in order to prevent a rising price level from shifting the real money supply curve to the left and, thereby, increasing interest rates. The increase in the nominal money stock, in turn, would feed further inflation, unless it were offset by a decrease in velocity. To avoid this trap and prevent unwanted inflation, a central bank must supplement an interest rate operating target with inflation targeting, a Taylor rule, an NGDP rule, or some other intermediate target that tells it when and by how much to adjust the short-run interest rate operating target.