# Econ 330: Money and Banking, Fall 2014, Handout 12

## Chapter 24: The Role of Expectations in Monetary Policy

### The Lucas Critique

- The way in which monetary policy affects the economy depends on the expectations of the public
- If you change from one policy to another, expections will change
- Therefore, you can't evaluate the effects of the new policy using data collected under the old policy

### Rules vs. discretion

- Discretion - policymakers can choose whatever policy they see fit, given circumstances
  - Pros: Can adapt policy to situation
  - Cons: Time-inconsistency problem - policymakers always tempted to boost growth in the short-term $\rightarrow$ Fed loses credibility in controlling inflation
- Rules
  - Constant money growth rate (advocated by Friedman and monetarists)
  - Taylor rule - takes into account output gap and inflation gap
- Constrained discretion - combination of rules and discretion
  - Nominal anchor e.g. policymakers commit to a 2% inflation rate

### Central bank credibility

- Positive aggregate demand shock - monetary policy credibility stabilizes inflation in the short run
- Negative demand shock - credibility stabilizes output in the short run
- Negative supply shocks - credibility stabilizes both inflation and output in the short run
- With greater credibility, the central bank's ability to fight inflation increases since markets believe it will accomplish its goals

## Chapter 25: Transmission Mechanism of Monetary Policy

- Transmission mechanism/channels of monetary policy
  - Traditional interest-rate channels
    - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
    - Expansionary monetary policy $\Rightarrow \pi^e \uparrow \Rightarrow r \downarrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
  - Asset price:
    - Net Export
      - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow E \downarrow \Rightarrow NX \uparrow \Rightarrow Y^{ad} \uparrow$
    - Tobin's q theory
      - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow P_s \uparrow \Rightarrow q \uparrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$

        - Wealth effects (Franco Modigliani's life cycle hypothesis of consumption)
            - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow P_s \uparrow \Rightarrow wealth \uparrow \Rightarrow Consumption \uparrow \Rightarrow Y^{ad} \uparrow$
    - <u>Credit view:</u>
        - Bank lending
            - Expansionary monetary policy $\Rightarrow$ Bank deposits $\uparrow \Rightarrow$ Bank loans $\uparrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
        - Balance sheet
            - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow P_s \uparrow \Rightarrow$ Firms' net worth $\uparrow \Rightarrow$ Adverse selection $\downarrow$ & Moral Hazard $\downarrow \Rightarrow$ lending $\uparrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
        - <u>Cash flow</u>
            - Expansionary monetary policy $\Rightarrow i \downarrow \Rightarrow$ Firms' cash flow $\uparrow \Rightarrow$ Adverse selection $\downarrow$ & Moral Hazard $\downarrow \Rightarrow$ lending $\uparrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
        - Unanticipated price level
            - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow \pi \uparrow \Rightarrow$ unanticipated P $\uparrow \Rightarrow$ Firms' real net worth $\uparrow \Rightarrow$ Adverse selection $\downarrow$ & Moral Hazard $\downarrow \Rightarrow$ lending $\uparrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
        - Household liquidity effects
            - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow P_s \uparrow \Rightarrow$ Value of households' financial assets $\uparrow \Rightarrow$ Likelihood of financial distress $\downarrow \Rightarrow$ Consumer durable and housing expenditure $\uparrow \Rightarrow Y_{ad} \uparrow$

- Lessons from Monetary Policy

    1. Real interest rate (not nominal interest rate) is what determines whether monetary policy was actually expansionary (easy) or contractionary (tight)
    2. Other asset's prices besides short-term debt instruments contain information about stance of monetary policy.
        - E.g. low interest rate (even zero) with low home and stock prices, with appreciated dollar actually means monetary policy is tight, not easy (Great Depression 1929-1933).
    3. Event at very low (zero) interest rates, Monetary Policy can be effective by affecting channles other than the interest rate.
        - E.g. Open market purcahses of foreign exchange increase Monetary Base and money supply.
    4. Ultimate goal of monetary policy is <u>price stability.</u> Effort to avoid unanticipated fluctuations in the price level which will affect Investments and Output.

# Practice Questions

[Q 1] The channels through which monetary policy affects economic activity are called the ———— of monetary policy.
A) transmission mechanisms
B) flow mechanisms
C) distribution mechanisms
D) allocational mechanisms
Answer: A

[Q 2] Which of the following is most likely to lead to inflationary monetary policy?
A) Declining oil prices
B) Resolution of conflict in the Middle East
C) The enactment of a free-trade agreement with Mexico
D) Rising unemployment
Answer: D

[Q 3] If aggregate output is below the natural rate level, advocates of discretionary policy would recommend that the government

A) do nothing.
B) try to eliminate the high unemployment by attempting to shift the aggregate supply curve to the right.
C) try to eliminate the high unemployment by attempting to shift the aggregate demand curve to the right.
D) try to eliminate the high unemployment by attempting to shift the aggregate demand curve to the left.
Answer: C

[Q 4] Advocates of nondiscretionary policy contend that a discretionary policy of shifting the aggregate ———— curve will be costly because it produces ———— volatility in both the price level and output.
A) supply; less
B) supply; more
C) demand; less
D) demand; more
Answer: D

[Q 5] If the central bank's commitment to fighting inflation is not credible, a positive aggregate demand shock will cause inflation expectations to ——-, leading to ——- inflation than if the central bank had credibility.
A) fall; less
B) fall; more
C) rise; less
D) rise; more
Answer: D

[Q 6] Lucas argues that when policies change, expectations will change thereby
A) changing the relationships in econometric models.
B) causing the government to abandon its discretionary stance.
C) forcing the Fed to keep its deliberations secret.
D) making it easier to predict the effects of policy changes.
Answer: A

[Q 7] If the central bank lowers the interest rate and this boosts stock prices, consumption is likely to ——, an example of a ————
A) fall; wealth effect
B) rise; wealth effect
C) fall; bank lending channel
D) rise; bank lending channel
Answer: B

[Q 8] If the central bank creates reserves, leading to increases in bank deposits, loans to businesses will ——. This is an example of the ————.
A) fall; wealth effect
B) rise; wealth effect
C) fall; bank lending channel
D) rise; bank lending channel
Answer: D