

Chapter 24 : The Role of Expectations in Monetary Policy

Policy Evaluation

1. Reduced Form Evidence :

- $M \Rightarrow ?$ (Black box) $\Rightarrow Y$
- Good: No restrictions on causality between M and Y, looks only at their correlation.
- Drawback: Correlation does not imply causation (Reverse causation)

2. Structural Model Evidence :

- $M \Rightarrow i \Rightarrow I \Rightarrow Y$
- Good: Provides clear direction of causality between money and output.
- Drawback: Might be misspecified, doesn't include all channels.

3. Lucas Critique: Expectations change as policies change.

Policy Conduct

1. Discretion

- Good: Flexible, No commitment to future actions
- Drawback: Time-inconsistency problem
 - (a) Trying to exploit the short-run tradeoff between inflation and employment
 - (b) Political business cycle

2. Rules

- Examples:
 - (a) Constant-money-growth-rate rule
 - (b) Taylor Rule
- Good: Avoiding the time-inconsistency problem
- Drawback:
 - Cannot foresee every contingency
 - Do not incorporate the use of judgement

3. Credibility:

- Keeps inflation low
- Inflation targeting
- Exchange-rate targeting
- Central Bank independence

Chapter 25 : Transmission Mechanism of Monetary Policy

• Transmission mechanisms/channels of Monetary Policy

– Traditional Interest-rate channels :

- * Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
- * Expansionary monetary policy $\Rightarrow P^e \uparrow \Rightarrow \pi^e \uparrow \Rightarrow r \downarrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$

– Asset price:

- * Net Export
 - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow E \downarrow \Rightarrow NX \uparrow \Rightarrow Y^{ad} \uparrow$
- * Tobin's q theory¹
 - 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 $\Rightarrow r \downarrow \Rightarrow P_s \uparrow \Rightarrow \text{wealth} \uparrow \Rightarrow \text{Consumption} \uparrow \Rightarrow Y^{ad} \uparrow$

– Credit view:

- * Bank lending
 - Expansionary monetary policy $\Rightarrow \text{Bank deposits} \uparrow \Rightarrow \text{Bank loans} \uparrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
- * Balance sheet,
 - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow P_s \uparrow \Rightarrow \text{Firms' net worth} \uparrow \Rightarrow \text{Adverse selection} \downarrow$
& Moral Hazard $\downarrow \Rightarrow \text{lending} \uparrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
- * Cash flow,
 - Expansionary monetary policy $\Rightarrow i \downarrow \Rightarrow \text{Firms' cash flow} \uparrow \Rightarrow \text{Adverse selection} \downarrow$ &
Moral Hazard $\downarrow \Rightarrow \text{lending} \uparrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
- * Unanticipated price level
 - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow \pi \uparrow \Rightarrow \text{unanticipated } P \uparrow \Rightarrow \text{Firms' real net worth} \uparrow$
 $\Rightarrow \text{Adverse selection} \downarrow$ & Moral Hazard $\downarrow \Rightarrow \text{lending} \uparrow \Rightarrow I \uparrow \Rightarrow Y^{ad} \uparrow$
- * Household liquidity effects
 - Expansionary monetary policy $\Rightarrow r \downarrow \Rightarrow P_s \uparrow \Rightarrow \text{Value of households' financial assets} \uparrow$
 $\Rightarrow \text{Likelihood of financial distress} \downarrow \Rightarrow \text{Consumer durable and housing expenditure} \uparrow$
 $\Rightarrow Y^{ad} \uparrow$

¹Tobin's q=Market value of firms/Replacement cost of capital

- Lessons from Monetary Policy

1. Real interest rate (**not nominal interest rate!**) is what determines whether monetary policy was actually expansionary (ease) 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. Even at very low (zero) interest rates, Monetary Policy can be effective by affecting channels other than the interest rate.
 - E.g. Open Market purchases of foreign exchange increase Monetary Base and money supply.
4. Ultimate goal of monetary policy is price stability. Effort to avoid unanticipated fluctuations in the price level which will affect Investments and Output.

Practice questions: Chapter 25

[Q1] Due to asymmetric information in credits markets, monetary policy may affect economics activity through the balance sheet channel, where an increase in money supply

- A) lowers the value of the dollar, increasing net exports and aggregate demand.
- B) raises the level of bank reserves, deposits, and the bank loans, thereby raising spending by those individuals who do not have access to credit markets
- C) raises firm's net worth, decreasing adverse selection and moral hazard problems, thus increasing bank's willingness to lend to finance investment spending.
- D) raises stock prices, lowering the cost of new capital relative to firms' market value, thus increasing investment spending.

[Q2] In a period of deflation, when there is a declining price level, _____ nominal interest rates do not necessarily indicate that the cost of borrowing is _____ or that monetary policy is easy.

- A) low; low
- B) high; low
- C) high; high
- D) low; high

[Q3] Franco Modigliani has found that an expansionary monetary policy can cause stock market prices to _____ and consumption to _____.

- A) decrease; increase
- B) increase; decrease
- C) decrease; decrease
- D) increase; increase

[Q4] According to Tobin's q theory, _____ policy can affect _____ spending through its effect on the prices of common stock.

- A) monetary; consumption
- B) fiscal; investment
- C) fiscal; consumption
- D) monetary; investment

[Q5] Analysis of the transmission mechanisms of monetary policy provides four basic lessons for a central bank's conduct of monetary policy. These lessons include:

A) Monetary policy can be highly effective in reviving a weak economy even if short-term interest rates are already near zero.

B) Other asset prices beside those on short-term debt instruments do not contain important information about the stance of monetary policy because they are not important elements in various monetary policy transmission mechanisms

C) Avoiding fluctuations in the level of unemployment is an important objective of monetary policy, thus providing a rationale for interest-rate stability as the primary long-run goal for monetary policy.

D) Rising interest rates indicate a tightening of monetary policy, whereas falling interest rates indicate an easing of monetary policy.

[Q6] The monetary transmission mechanism that links monetary policy to GDP through real interest rates and investment spending is called the

A) traditional interest-rate channel

B) cash flow channel

C) wealth effects

D) Tobin's q theory

[Q7] According to the household liquidity effect, an expansionary monetary policy causes a _____ in the value of households' financial assets, causing consumer durable expenditure to _____.

A) decline; fall

B) decline; rise

C) rise; fall

D) rise; rise

Answers: C A D D A A D