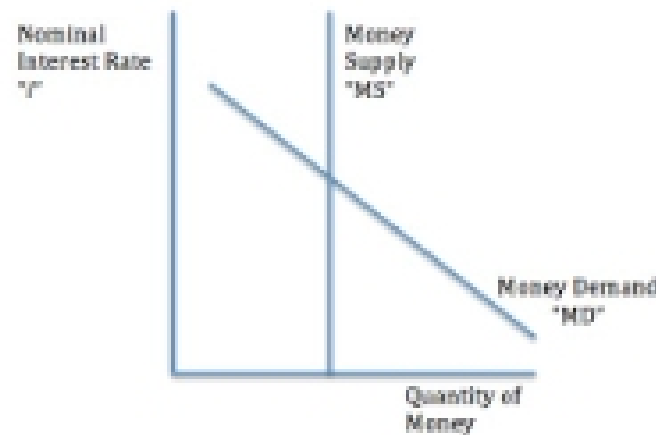


Chapter 14 - Modern Macroeconomics and Monetary Policy

- remember: the demand for money balances is not the same as the demand for wealth
- reasons to hold money: buy stuff now, in case of emergency, buy stuff later



The Money Market Graph

- demand for money - illustrates the relationship between interest rate and quantity of money people want to hold
 - downward sloping - the opportunity cost of holding money is the nominal interest rate
 - shifts right when nominal GDP rises; shift left when nominal GDP falls and as people use more electronic transactions
- supply of money - the Fed controls the supply of money through the reserve requirement, open market operations (federal funds rate), discount rate, and interest paid on excess reserves
 - vertical - changes in the interest rate do not impact the Fed's ability to control the money supply
- restrictive monetary policy - when the Fed sells bonds → supply of money decreases, supply of loanable funds decrease, AD shifts left

(because a higher interest rate makes current investment and consumption more expensive therefore decreasing it, a higher interest rate causes financial assets to appreciate the US dollar, net exports will fall, and asset prices will decrease)

- when monetary policy is timed correctly...it will help mitigate a recession, it will help control and prevent inflation, and it will lead to economic stability
- when monetary policy is timed incorrectly... it will make recession even worse, it will lead to massive inflation, and it will lead to economic instability
- **it takes 6-15 months to impact real output and 12-30 months to impact price level and inflation**
- monetary policy in the long run...
 - quantity theory of money - a theory that says a change in the money supply will cause a proportional change in the price level
 - $PY = MV$ (p =price level, Y =real GDP, M =money supply, V =velocity of money, PY =nominal GDP)
 - rate of inflation + growth rate of real output = growth rate of money supply + growth rate of velocity
 - velocity of money - average number of times a dollar is used to purchase final goods and services during a year
- in the short run, expansionary policy will increase output and restrictive monetary policy will reduce output
- in the long run, expansionary policy will only lead to inflation
- limitation of monetary policy: expansionary monetary policy cannot promote long term economic growth, economists have limited forecasting abilities, and price stability is key to economic prosperity
- Austrian view of the business cycle...
 - expansionary monetary policy pushes the interest rate to an artificial low
 - the low interest rates will induce entrepreneurs to undertake long-term investments which will generate an economic boom
 - however, the boom will be unstable because savings are too low to purchase new assets
 - the boom turns to a bust and a large share of the newly constructed assets end up unoccupied
 - THIS IS REFERRED TO AS MALINVESTMENT
- impact of stop-go monetary policy
 - monetary policy is variable over the past decade
 - it is likely to increase economic instability
 - it is hard for monetary policy makers to institute stop-go policy in a stabilizing manner