

Monetary Policy in “Normal” Times

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Monetary Policy is the Control of Money in an Economy

- Typically, central banks – like the Federal Reserve - have an exclusive right, or monopoly, on control over the supply of money
 - These institutions often buy government debt and pay “money,” thus reducing the amount of debt held and commensurately increasing the amount of money in the economy
 - Central banks can gauge changes in money by looking at changes in the quantity or interest rate (the price of money)
 - The Federal Reserve has used an interest rate gauge in recent years





Monetary Policy Objectives in Normal Times

- Policy attempts to supply the correct amount of money so that the economy can function optimally
- Since money makes buying and selling more efficient or “easier”, the “correct” amount of money generally means that growth in money roughly matches trend growth in economic output
 - If money growth dramatically exceeds trend economic growth, inflation can accelerate, leading to economic underperformance (some people look at labor market conditions)
 - If money growth falls short of trend economic growth, the cost of money can be high, also leading to economic underperformance





Monetary Policy Objectives in Normal Times (cont.)

- Looking at this through interest rate movements:
 - Interest rates are correct when consumers make sustainable purchase and savings decisions and businesses make sustainable production and investment decisions
 - If interest rates are too low, consumers view consuming “today” as attractive and choose to save little. Persistent behavior of this sort leads the economy to “overheat” as overall demand outstrips the economy’s ability to produce
 - If interest rates are too high, consumers opt to save more rather than consume, weakening overall demand. Business may curtail investment, leading overall demand and labor markets to weaken





What to Watch in Normal Times

- To conduct monetary policy properly then is to set interest rates (the Federal Funds Rate) at a level that balances demand in the economy with the economy's capability to produce
- Interest rates (the federal Funds Rate) are set in the Federal Funds Market. The Fed effectively controls the interest rate by controlling the amount of Treasury Securities it buys and - this is key - the amount of money it pays out (or injects)





What to Watch in Normal Times

- What guides the Fed?
 - The Fed watches trend growth of the economy to get an idea of the need for interest rate adjustments
 - If economic growth is well above or well below trend, the interest rate stance may be inappropriate
- The Fed also watches the rate of inflation
 - If inflation is rising, it's a sign that interest rates could be too low (or accommodative)
 - Falling inflation rates (especially if the rate of inflation is already low) suggest interest rates may be relatively high (or restrictive)





Looking ahead in Normal Times

- Of course, the Fed shapes the Public's expectations of what it will do with policy in the future as well through public statements
 - These actions affect longer term interest rates, also affecting perceptions of future economic conditions, including inflation





The Taylor Rule

- Named for John Taylor, the Taylor Rule is widely viewed as a simple description of the factors that drive the Fed's monetary policy decisions

- A common form of the Taylor rule is:

$$\dot{i}_t = \pi_t + r_t^* + a_\pi (\pi_t - \pi_t^*) + a_y (y_t - \bar{y}_t)$$

- This looks complicated, but it isn't
- \dot{i}_t is the “correct” nominal Federal Funds Interest Rate
- It depend on:
 - π_t the rate of inflation
 - r_t^* and he long term real interest rate
- Together, these determine the correct **nominal** interest rate if the economy is on a sustainable path





The Taylor Rule (cont.)

- But adjustments to the nominal Federal Funds Rate may be required in economic conditions are not judged sustainable
 - The Taylor Rule incorporates two economic conditions:
 - $(\pi_t - \pi_t^*)$ How much inflation (π_t) deviates from desired inflation (π_t^*)
 - And
 - $(y_t - \bar{y}_t)$ How much growth in GDP (y_t) deviates from potential or trend growth in GDP (\bar{y}_t)
 - For example:
 - When inflation exceeds desired inflation, the Fed tends to raise the Federal Funds Rate
 - When GDP growth is above potential or trend growth, the Fed tends to raise the Federal Funds Rate
 - If the measures are opposite, the Fed tends to lower the Federal Funds Rate

