



ECONOMICS MADE EASY 09

A Journalism Workshop

Macroeconomics and Monetary Policy
Alexander L. Wolman
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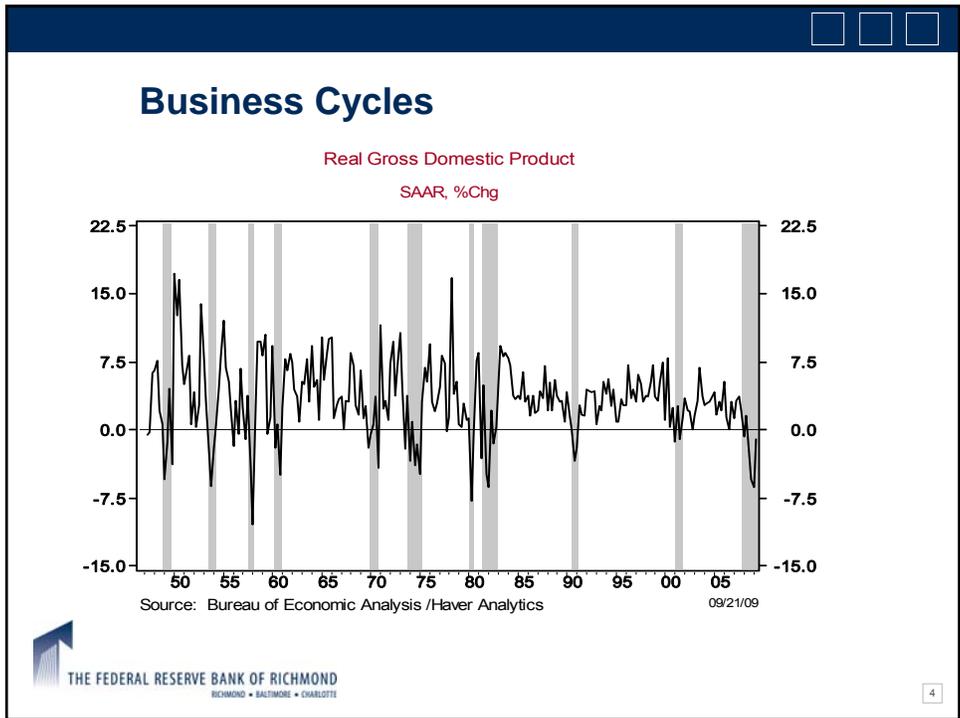
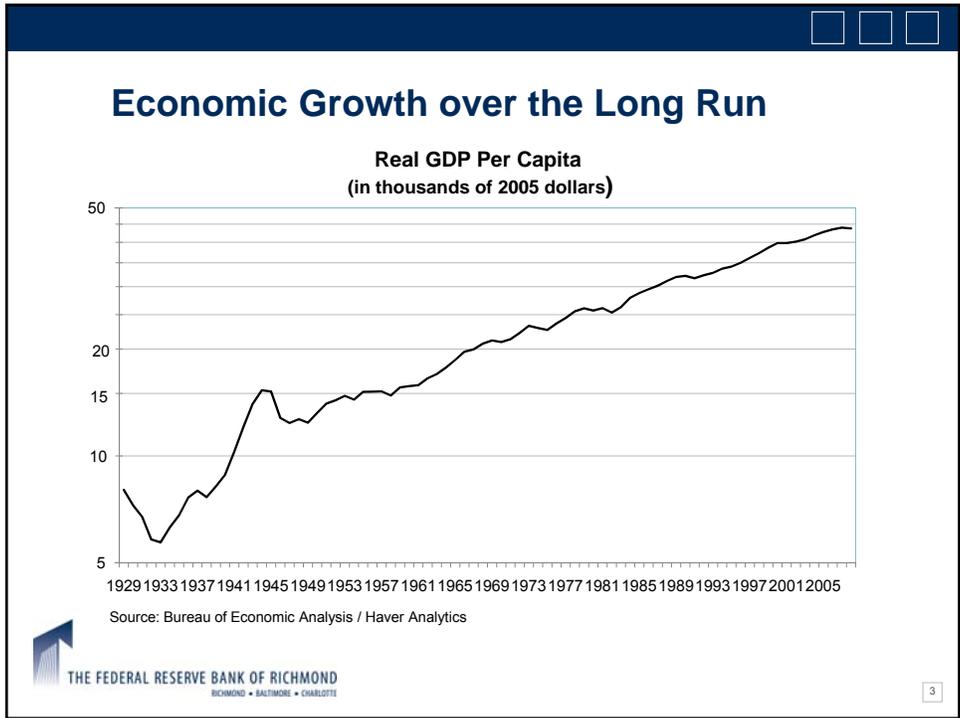
Macroeconomics and Monetary Policy

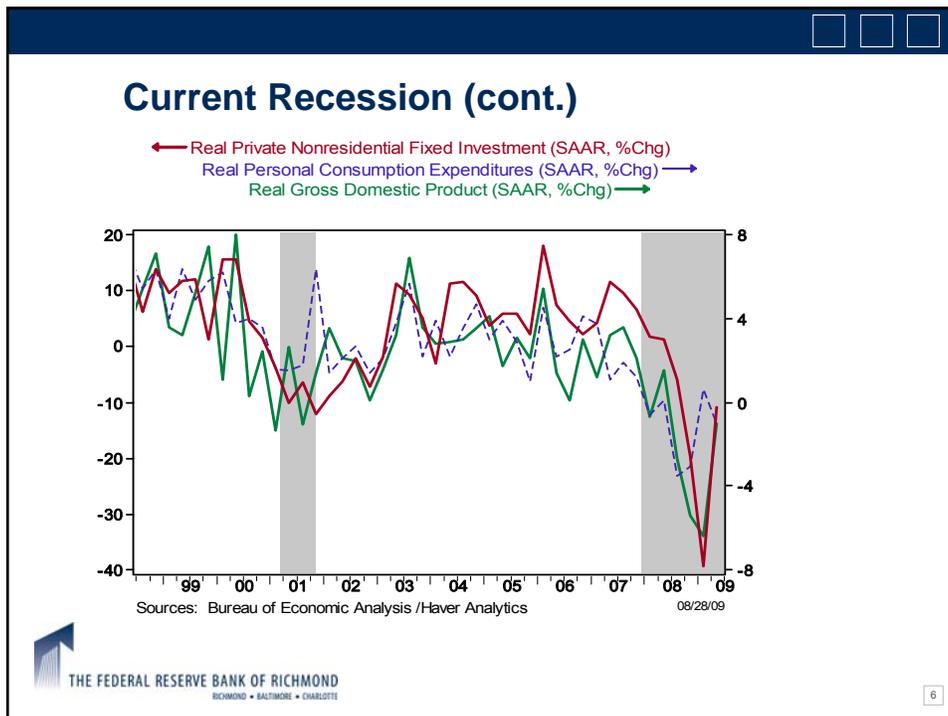
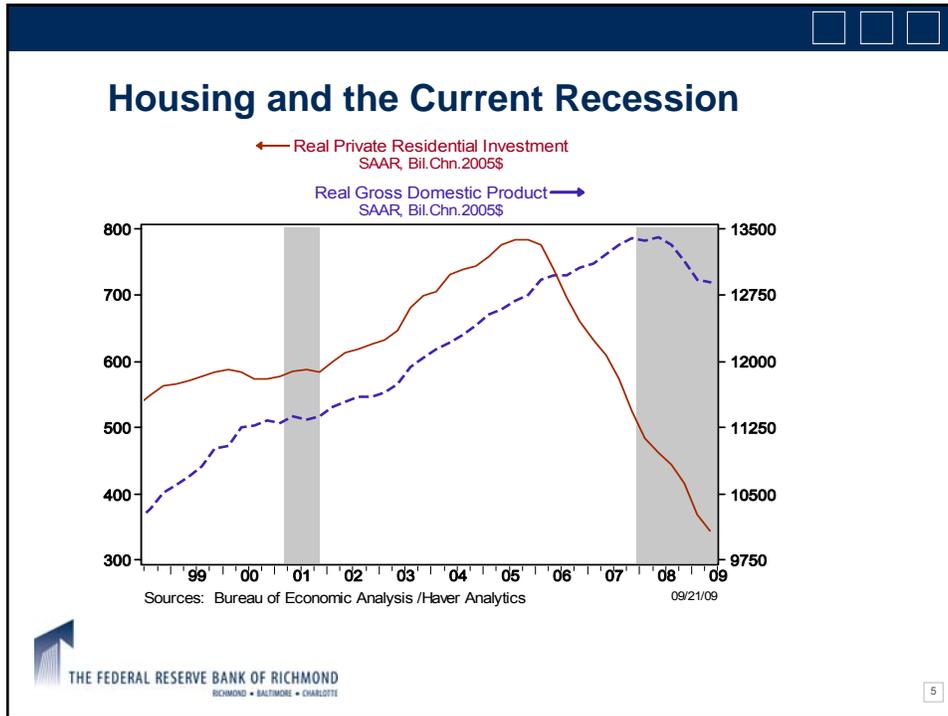
- Macroeconomics: concerned with explaining behavior over time of the overall economy, defined by a standard set of *aggregate* variables
 - GDP and its components
 - Employment, unemployment
 - Prices, as measured by such indexes as the CPI
 - Interest rates
- Monetary policy
 - Federal Reserve actions aimed at affecting inflation and, to a lesser extent, the real economy

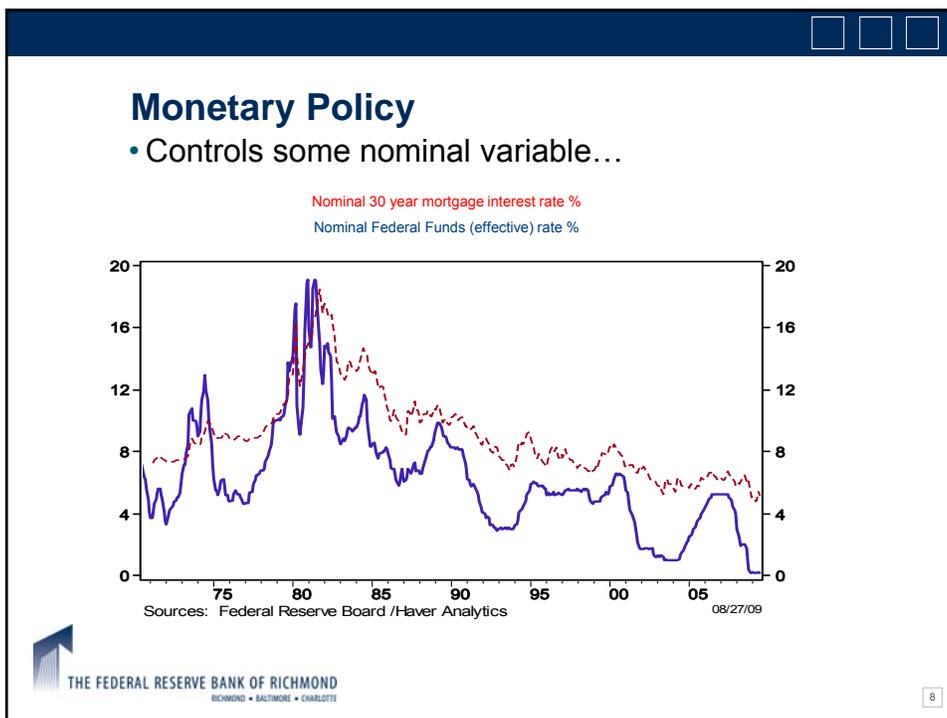
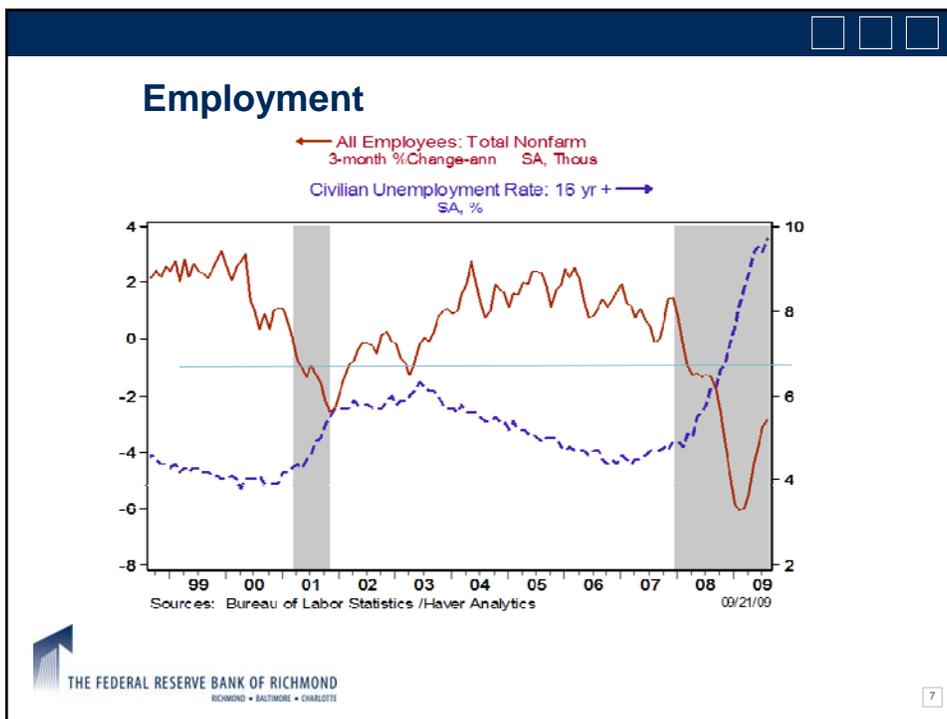


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Monetary Policy

- Controls some nominal variable...in order to stabilize inflation and expected inflation, (and in order *not* to destabilize the real economy).

Sources: Bureau of Economic Analysis /Haver Analytics

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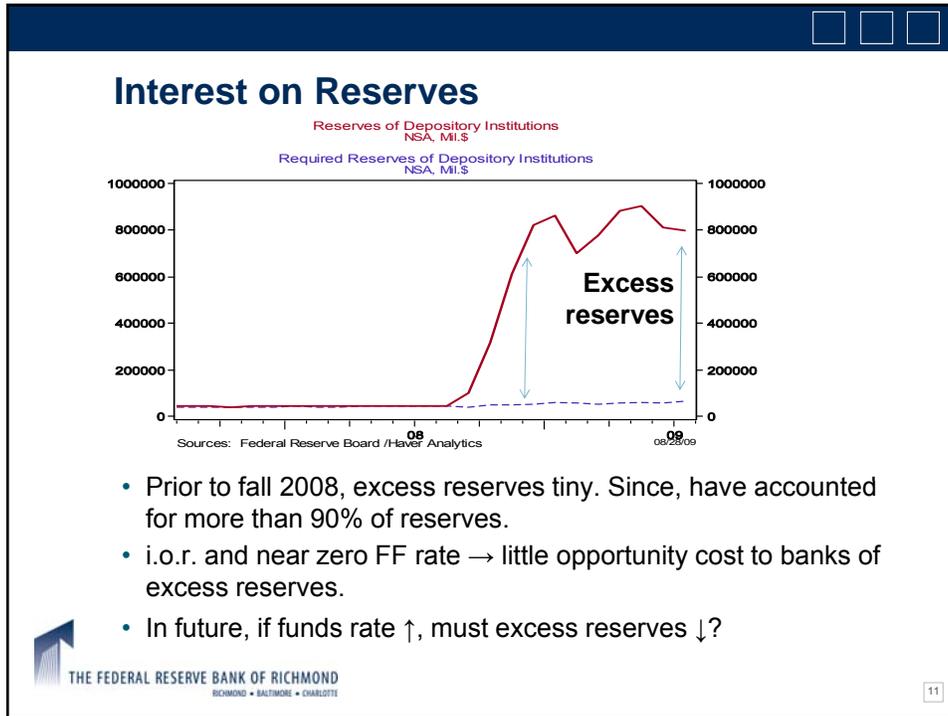
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A Recent Change in Fed Behavior

- Until fall '08, the Fed's policy of targeting FF rate was accomplished by buying/selling Treasury securities in the secondary market, which would increase or decrease the quantity of bank reserves.
- Last fall however, the Fed began paying interest on bank reserves at approx. the Federal Funds target.
- Interest on reserves (i.o.r.) affects banks' incentives to hold reserves beyond what they need for reserve requirements. Without i.o.r., costly to hold reserves, so banks try to hold small quantity. With i.o.r., "costless" to hold reserves, no reason to economize.

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Fiscal Stimulus 1

- What are the effects on GDP, employment, of an increase in gov't. spending or a tax cut?
- Natural approach to this question: measure the relationship between, for example, gov't. spending and GDP! Simple, right? . . .
 - No. From Ann's talk: correlation does not imply causation, so need to be sophisticated.
 - Even if can accurately measure past relationships, are today's conditions sufficiently close?

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Fiscal Stimulus 2

- Conclusions from empirical work not sharp.
- Theory allows us to conduct controlled experiments (usually can't do them in the field, though increasingly being conducted in development economics).
- From theory, we learn that for gov't. spending increase, all the details matter!
- Should we throw up our hands? No. We should try explain what matters, and why.

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Fiscal Stimulus 3

Example of How Details Matter

- Suppose G increases.
 - In most economic models there is a negative wealth effect which leads people to consume less and work more: Why? Because future taxes will rise to pay for the G , and that increase in future taxes makes people poorer today.
 - What can limit that wealth effect?
 - If today's consumers believe the taxes will be levied on future generations, and today's taxpayers do not "care" about future generations.
 - If the government spending is highly productive, so that it will "pay for itself" by generating an increase in future tax revenue.
 - ...

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The Role of Economic Theory

- The example on last 3 slides suggests the value of formal theory. Given specific assumptions, we can answer questions about, e.g., fiscal stimulus.
- But economists are often criticized for their theoretical models, in two ways:
 1. The models are absurdly simple, gloss over all kinds of important features of the world!
 2. Analyzing the models requires using complicated mathematical tools, making the whole approach divorced from the practical world.
- My response?



We Covered Four Topics

1. Housing and current recession: drop in construction (residential investment) predated drop in GDP.
2. Monetary policy: interest on reserves means may no longer be correct to interpret high level of reserves as inherently inflationary.
3. Fiscal stimulus: difficult to predict and evaluate effects, but . . .
4. Economic theory is an indispensable tool for attempting to predict and evaluate effects of fiscal or monetary policy changes.



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