Managing Monetary Policy

Monetary Policy 101

Issues
- How do you know Equilibrium
- The Costs of Error
- The Perils of Targeting Interest Rates
- Credibility
- Monetary Policy Rules

How Do You Know Equilibrium?

Before you decide where you want to go, you better know where you are
It doesn’t matter where you are now, it matters where you expect to be next year.

Just how sure are you of this picture?

Federal Reserve System looks for signs that \( Y \neq Y_f \). Basically it uses its own set of leading and coincident indicators. How accurate are forecasts? Not great.

What happens if you err?

- If you have an omniscient Chairman, then sleep tight, for \( Y = Y_c \). Always.
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What happens if you err?

• If you have an omniscient Chairman, then sleep tight, for Y=Y_f. Always.
• To be more precise, we can assure that there are no deviations between η and η_e
• No business cycles due to imperfect information.

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What happens if you err?

• If you have a mere mortal as Chairman, then
  – Sometimes the gap between η and η_e will be narrowed.
  – Sometimes the gap will be increased.

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The Fed’s Picture of Next Year

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The Reality

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Oops

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Oops

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Your intervention does not deal with a problem; it creates one.
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Should the Chairman of the Federal Reserve System play more golf?

Oops

If you routinely intervene, your actions may actually increase uncertainty about actual and expected inflation.

Two Track Records

<table>
<thead>
<tr>
<th>Interventions</th>
<th>Made the situation better (narrowed the gap between $Y$ and $Y_f$)</th>
<th>Made the situation worse (increased the gap between $Y$ and $Y_f$)</th>
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</thead>
<tbody>
<tr>
<td>Active Policy</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Passive Policy</td>
<td>7</td>
<td>7</td>
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The Final Exam, Monetary Policy 201

Handling the Money Supply may be a way of dampening business cycles.
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Handling the Money

Overdoing can cause a way of business cycles. It may be a way of dampening business cycles. Overdoing can cause inflation. You are only as good as your forecasts and understanding of the economy.

Federal Reserve System can actually increase uncertainty and make cycles worse.

Monetary Policy 301

• You are the humble chairman of the Federal Reserve System.
• You know what you know and what you don’t know.
• In particular...

• A 90% chance that the economy is ok and the right policy is for no intervention.
• A 10% chance that the economy is headed for a rough time period.

• If you add money and are wrong (90% chance)
• You create some inflation

• If you don’t add money are wrong (10% chance)
• You can see major problems

Monetary Policy 301
Conclusion

*Just because you can do something in theory doesn’t mean you will do so in practice.*

Conclusion

*And sometimes you may want to take insurance and do what you probably think is the wrong thing.*

End