\[ r_N = r_R + \eta e \]

Changes in the money supply intended to change interest rates can be offset by changes in inflationary expectations.

- Fed increases MB by $10B
- \( \Delta \eta > 0 \)

\[ \Delta r_N < 0 \]
\[ r_N = r_R + \eta e \]

Changes in the money supply intended to change interest rates can be offset by changes in inflationary expectations.

*In 1970's, Fed grew money supply to cut interest rates. The quantity theory asserted itself, and inflationary expectations followed right along.*

\[ M_B = $500b. \quad r_R = r_N = 5\% \]

Fed increases \( M_B \) by $10B

\[ \Delta \eta e = 0 \]

\[ \Delta r_N < 0 \]

*Like an addict, the Fed increased the money supply even more.*

\[ M_B = $500b. \quad r_R = r_N = 5\% \]

Fed increases \( M_B \) by $10B

\[ \Delta \eta e > 0 \]

\[ \Delta r_N > 0 \]

*Today the Fed sets targets for both the money supply and interest rates.*

*In 1980, Fed cut money supply but public refused to believe inflation would fall, instead believing, in a triumph of experience over hope, that Fed's policy change was temporary.*

\[ M_B = $500b. \quad r_R = r_N = 5\% \]

Fed increases \( M_B \) by $10B

\[ \Delta \eta e > 0 \]

\[ \Delta r_N > 0 \]

One solution is to announce exactly what you are doing.

- Indeed the Fed is more open today than in the past.
- Credibility
Credibility

- Key to successful policy
- Hard to say what gives credibility
- Some ideas
  - Make pay raises dependent on performance.
  - Openness.
  - Honor commitments.
  - Adopt a policy rule.

Monetary Policy Rules

- Announce Monetary Policy as a function of conditions.
- Thus people know what you are doing.

End