Can the Federal Reserve System Set Interest Rates?

The FOMC meets, and makes a decision about monetary policy.

Fed Cuts Interest Rates!

Increase the Money Supply!

Y curve shifts up and to the right
M curve shifts up and to the left.
P up; r falls.

The Newspaper Headline

Y curve shifts up and to the right
Fed Cuts Interest Rates!
Can the Federal Reserve System Set Interest Rates

**Orders to New York**
- FOMC sets a target for \( r \), say \( r_1 \).
- New York Trading Desk then increases the money supply enough to reach \( r_1 \).

**What does this mean?**
- FOMC sets a target for a nominal rate. Holding expected inflation constant, we can translate that into a target for the real rate.

**Does this Mean they Set \( r \)?**
- Not Exactly

**Permanent Effects**
- The Quantity Theory works.
- In time, we move to \( 2P_0 \) and no change in \( r \).

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**Note:** the FOMC sets a target for a nominal rate. Holding expected inflation constant, we can translate that into a target for the real rate.

**In our terms:**
- The Federal Reserve System is changing the money supply, but they target an interest rate – a nominal interest rate.
Can the Federal Reserve System Set Interest Rates Continually Increasing M

- Suppose the Federal Reserve System keeps increasing the Money Supply to keep $r$ at $r_1$.

Lincoln’s Law

$$ r_N = r_R + \eta^e $$

Continuing to increase the money supply is inflationary and that will boost expected inflation!

In for a dime, in for a dollar…

$$ r_N = r_R + \eta^e $$

If $\eta^e$ is going up, and the FOMC wants to keep $r_N$ constant, they must reduce $r_R$.

Continually Increasing M

- If inflationary expectations rise by $\Delta \eta^e$, the target real interest rate is reduced by $\Delta \eta^e$.
- More money is required

Lincoln’s Law

$$ r_N = r_R + \eta^e $$

Round 2!
Lincoln’s Law

\[ r_N = r_R + \eta^e \]

When the government tries to cut interest rates, it may end up raising them.

The Late 1970’s

• High
  – Interest rates
  – Inflation rate
  – Rate of growth of money supply

The Late 1970’s

• Volker had no credibility
  • For a while,
    \[ \eta^e > \eta \]
The Impact

• Volker had no credibility
• For a while, $\eta > \eta^e$

$\eta - \eta^e$ U

Conclusion

• In the Short run, increases (decreases) in the money supply can cut (increase) interest rates.
• Any effect is temporary.
• And don’t forget about changing inflationary expectations.

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Back to the demand and supply of loans!

End

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