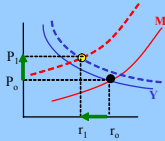


Can The Federal Reserve System set interest rates?



Newspapers and Interest Rates

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

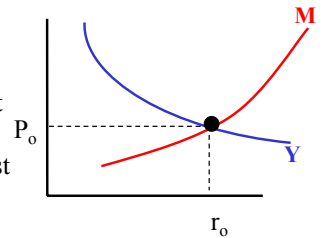
Setting Interest Rates

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

Fed Cuts Interest Rates!

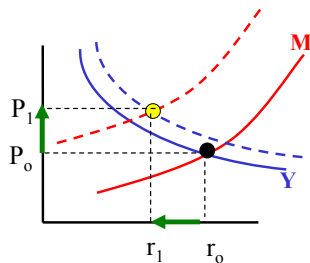
Interest Rate Management

- The Economy is humming along nicely, but not nicely enough that someone doesn't want lower interest rates.
- Can it be done?



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

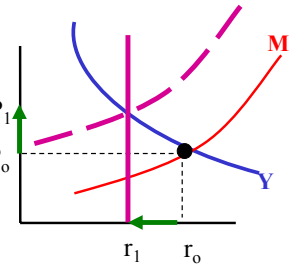
- Y curve shifts up and to the right

Fed Cuts Interest Rates!

Not so fast!

Orders to New York

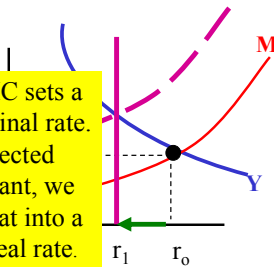
- FOMC sets a target for r , say r_1 .
- New York Trading Desk then increases the money supply enough to reach r_1



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

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.

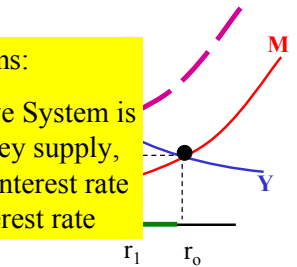


What does this mean?

- FOMC sets a target

In our terms:

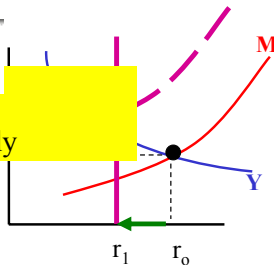
The Federal Reserve System is changing the money supply, but they target an interest rate – a nominal interest rate



Does this Mean they Set r ?

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

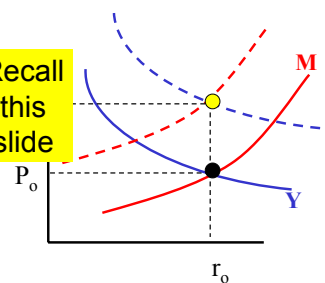
Not Exactly



Permanent Effects

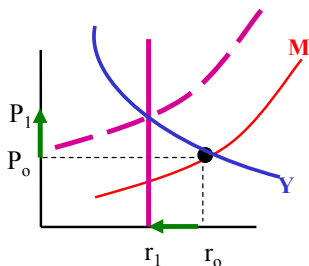
- The Quantity Theory works.
- In time, we move to $2P_0$ and no change in r .

Recall this slide



Continually Increasing M

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



Lincoln's Law

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

Lincoln's Law

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

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

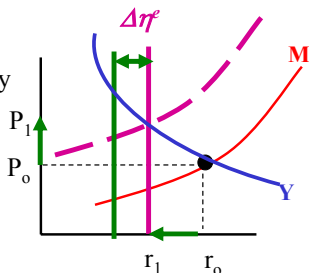
In for a dime, in for a dollar...

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

If η^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

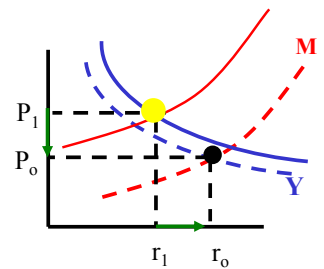
The Late 1970's

- High
 - Interest rates
 - Inflation rate
 - Rate of growth of money supply
- Paul Volker's solution
 - Cut rate of growth of money supply



Cut the Money Supply!

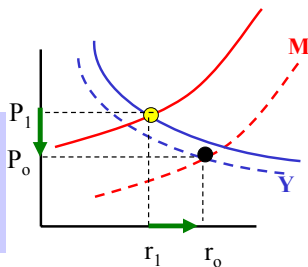
- This is a 100% recycled graph.



Cut the Money Supply!

- This is a 100% recycled graph.

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



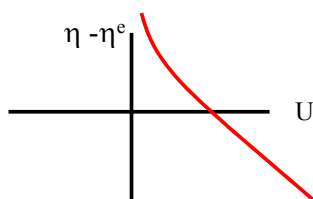
The Problem

- Volker had no credibility
- For a while,

$$\eta^e > \eta$$

The Impact

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



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.

Conclusion

- In the Short run, increases (decreases) in the money supply can cut (increase) interest rates.
- Any effect is temporary
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Back to the
demand and
supply of loans!

End

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