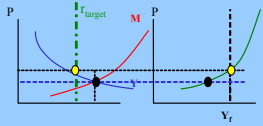
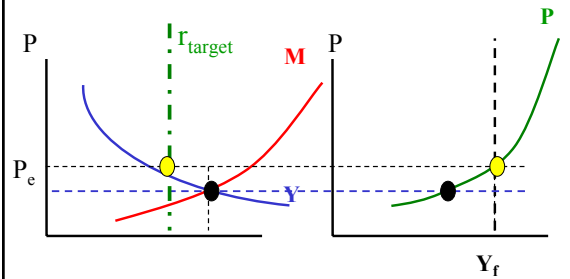


Targeting Interest Rates



Targeting Interest Rates



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

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

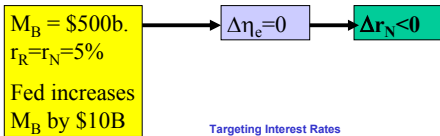
$$r_N = r_R + \eta^e$$

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

$M_B = \$500b.$
 $r_R = r_N = 5\%$
 Fed increases M_B by \$10B

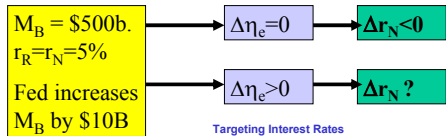
$$r_N = r_R + \eta^e$$

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



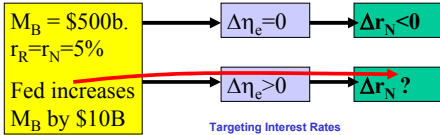
$$r_N = r_R + \eta^e$$

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



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

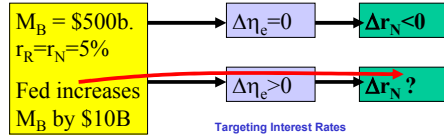
- In 1970's, Fed grew money supply to cut interest rates. The quantity theory asserted itself, and inflationary expectations followed right along.



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

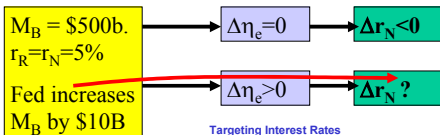
- Changes in the money supply are only intended to change interest rates, but are offset by changes in inflationary expectations.

WIN



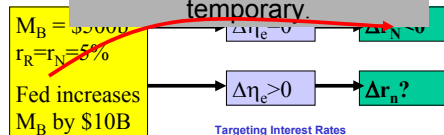
$$r_N = r_R + \eta^e$$

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



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

- 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.



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

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

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

- 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

©2004 Charles W. Upton.
All rights reserved