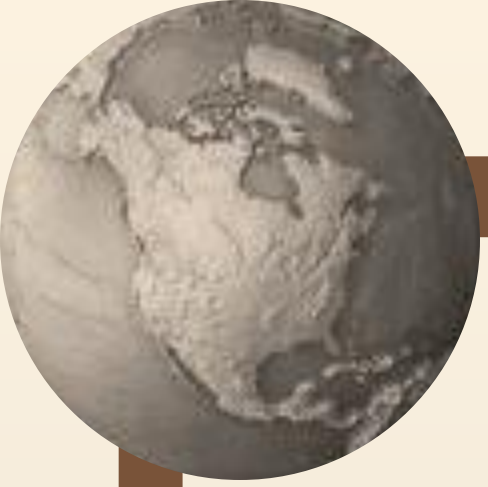
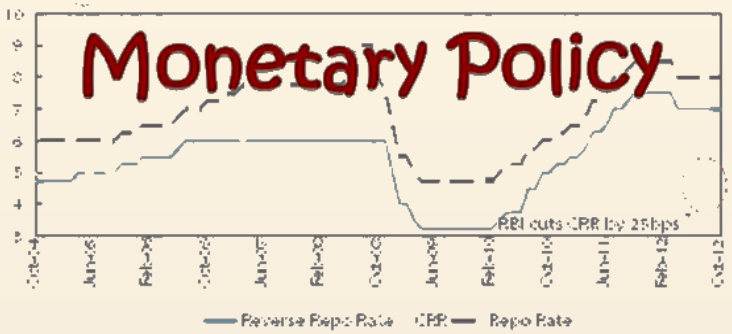


NATIONAL ECONOMIC POLICY PART II

Economic policy is like business ... It's all about compromise.

John Delaney

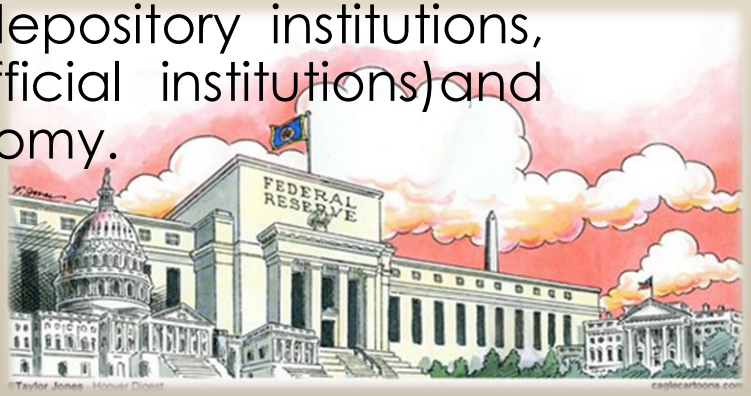
Monetary Policy



- monetary policy: a form of government regulation in which the nation's money supply and interest rates are controlled, the actions taken by government to vary the supply of money in an effort to stabilize the business cycle
  - When the supply of money *increases*, it is cheaper for private citizens and investors to borrow and spend more.
    - Decline in interest rates leads to more economic growth.
    - If money supply increases too quickly, result likely to be inflation.
  - If money supply *decreases*, borrowing is more costly, less to spend and invest so economy slows.
    - If supply decreases, chance of inflation decreases.
    - If economy contracts too quickly, the result is likely to be unemployment.

Monetary Policy: The Federal Reserve

- Federal Reserve System (the Fed): country's central bank, determines and implements monetary policy in the US
- Congress established three key objectives for monetary policy in the Federal Reserve Act: maximize employment, stabilize prices and moderate long-term interest rates.
- Fed also responsible for supervising and regulating banks, maintaining the stability of the financial system, providing financial services (to depository institutions, the government and foreign official institutions)and conducting research on the economy.



Monetary Policy: Structure of the Federal Reserve System

CONGRESS
oversees the Federal Reserve System and its entities.

FEDERAL OPEN MARKET COMMITTEE
consists of the members of the Board of Governors and Reserve Bank presidents. The Chair of the Board is the FOMC Chair.

Fed's monetary policymaking body

BOARD OF GOVERNORS
is an independent agency of the federal government.

appointed by president, confirmed by Senate

7 governors with 14-year terms

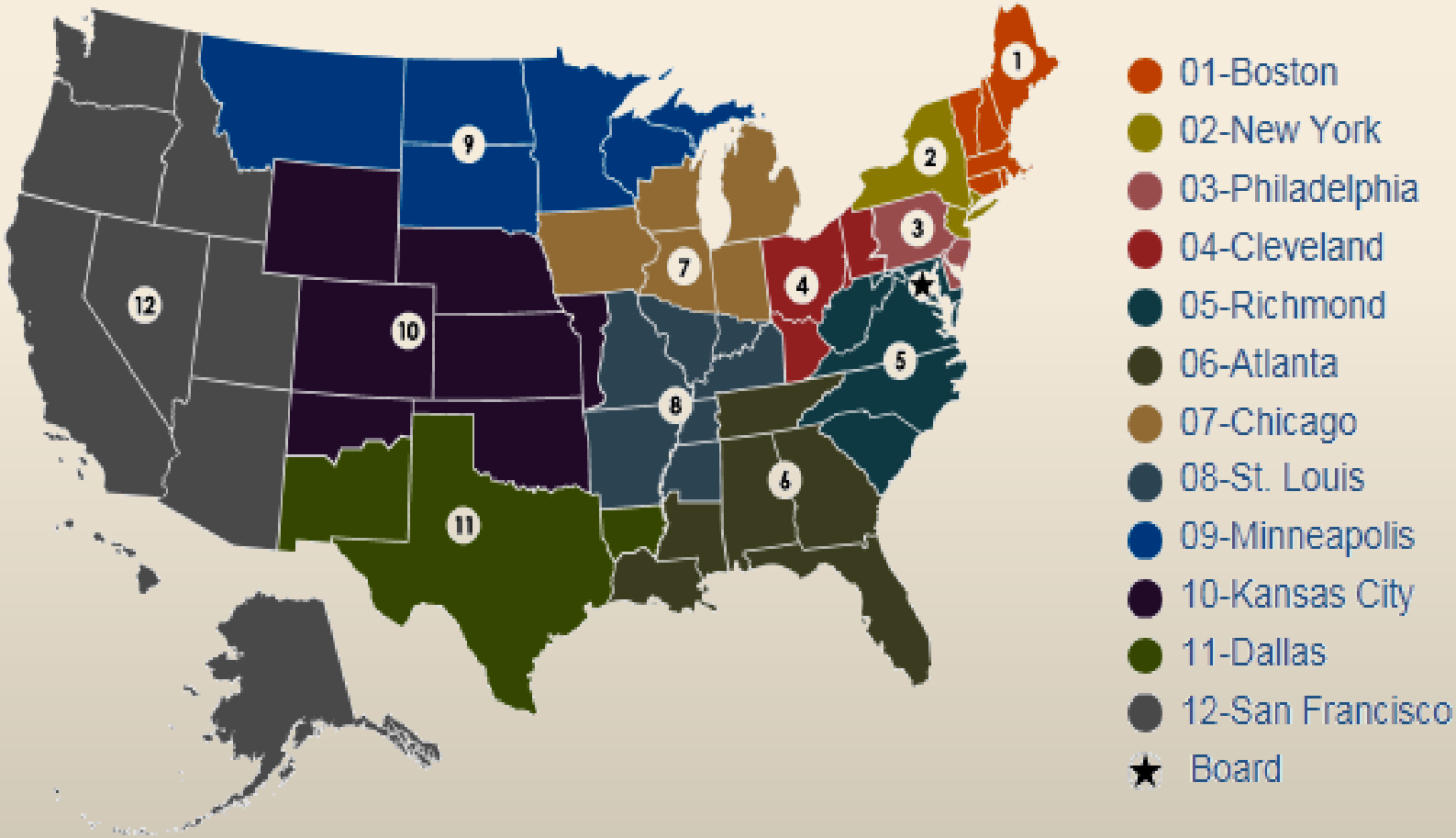
chair serves 4-year term

FEDERAL RESERVE BANKS
are the operating arms of the Federal Reserve System and are supervised by the Board of Governors.

12 district banks, each with a president approved by Fed chair

each oversees the member banks in its district

Monetary Policy: the Federal Reserve Banks

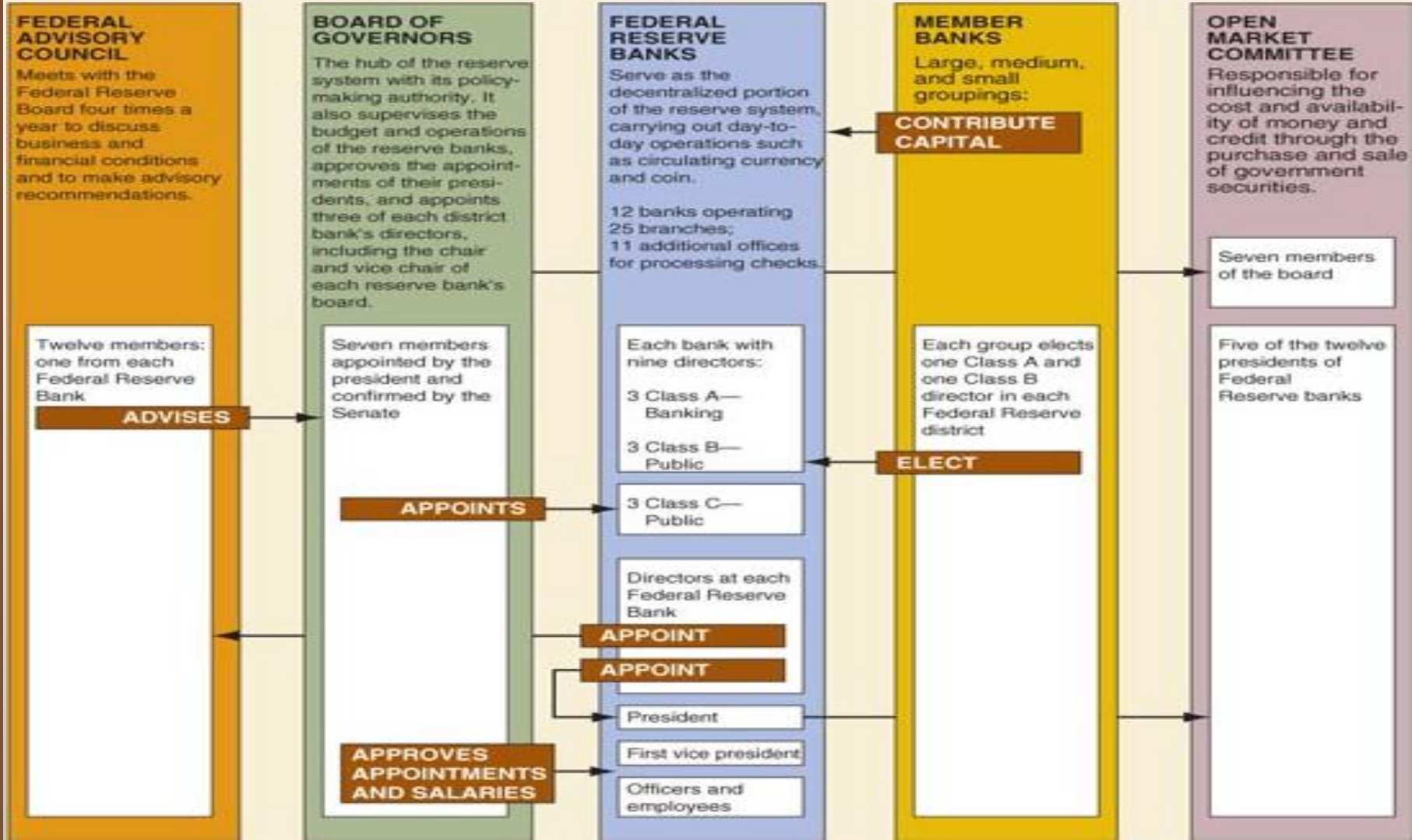


Monetary Policy: The Fed Chair

- The Fed is the second most powerful agency in DC.
- Chair of the Fed Board of Governors (Board) ranks among the most powerful persons in government.
  - Janet L. Yellen Fed Chair since 2014
  - direct access to economic information
  - power to approve appointments of Fed bank presidents
- Fed chair has close ties to the president.
  - President shares responsibility for fiscal policy with Congress.
  - Congress authorizes the Fed to make monetary policy.
  - But there are many formal and informal contacts between the White House and the Fed.

Fed Chair Janet Yellen

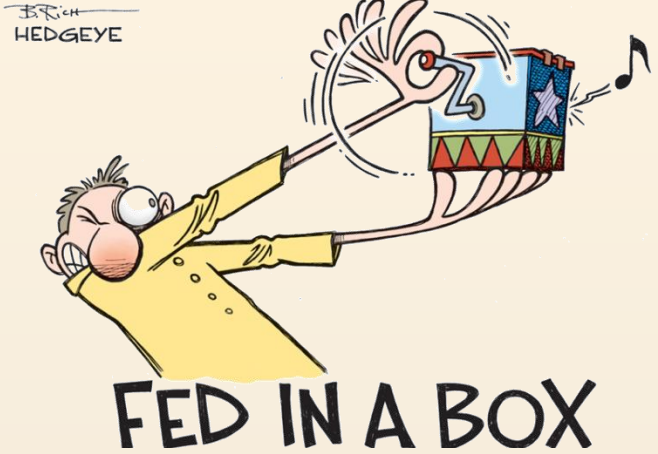
Monetary Policy: How the Fed Controls the US Economy



Monetary Policy: Tools

- Fed acts on the economy through the operations of its 12 district banks.
- Open Market Committee (FOMC): oversees and sets policy on open market operations, the principal tool of national monetary policy. FOMC operations affect the amount of Fed balances available to depository institutions, thereby influencing overall monetary and credit conditions.
- The primary tools for controlling the money supply:
  - open market operations
  - reserve requirements
  - discount rate

Monetary Policy: Tools



- open market operations
  - buying and selling government securities/bonds in the open market in order to expand or contract the amount of money in the banking system
  - most flexible and most common tool that the Fed uses to implement and control monetary policy
- reserve requirement / cash reserve ratio
  - governmental requirements that a portion of member banks' deposits must be kept in reserve to back loans made
  - If the percentage of deposits that banks are required to hold in reserve changes, it affects the amount banks are able to loan.

Monetary Policy: Tools

- discount / federal funds / bank rate
  - the interest rate that the Fed charges a bank to borrow funds when a bank is temporarily short of funds
  - an indicator of the direction in which the Fed is trying to push the economy: low rate indicates Fed is trying to promote growth, high rate shows Fed is concerned about inflationary pressures on the economy and is trying to reduce the amount of money in the economy

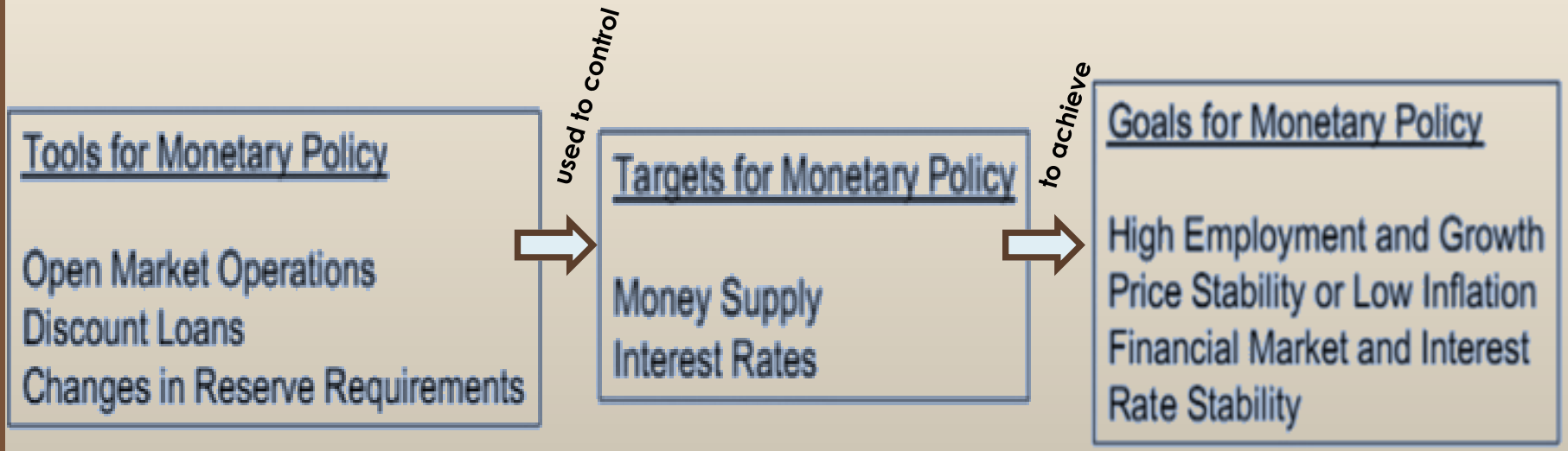
Monetary Policy: Federal Funds Rate and Inflation, since 1970

The overnight fed-funds rate compared to the measure of Consumer price index based inflation over time. As measured by the consumer price index, reflects the annual percentage change in cost to the average consumer of acquiring a fixed basket of goods.

Source: Federal Reserve Economic Data & World Bank. Updated Daily

Monetary Policy: Types

- Types of Monetary Policy:
  - contractionary / tight monetary policy: used to curb inflation by contracting/reducing the money supply
  - expansionary / easy monetary policy: used to encourage growth by expanding/increasing the money supply



Monetary Policy: How the Fed Controls the Money Supply

these tools:

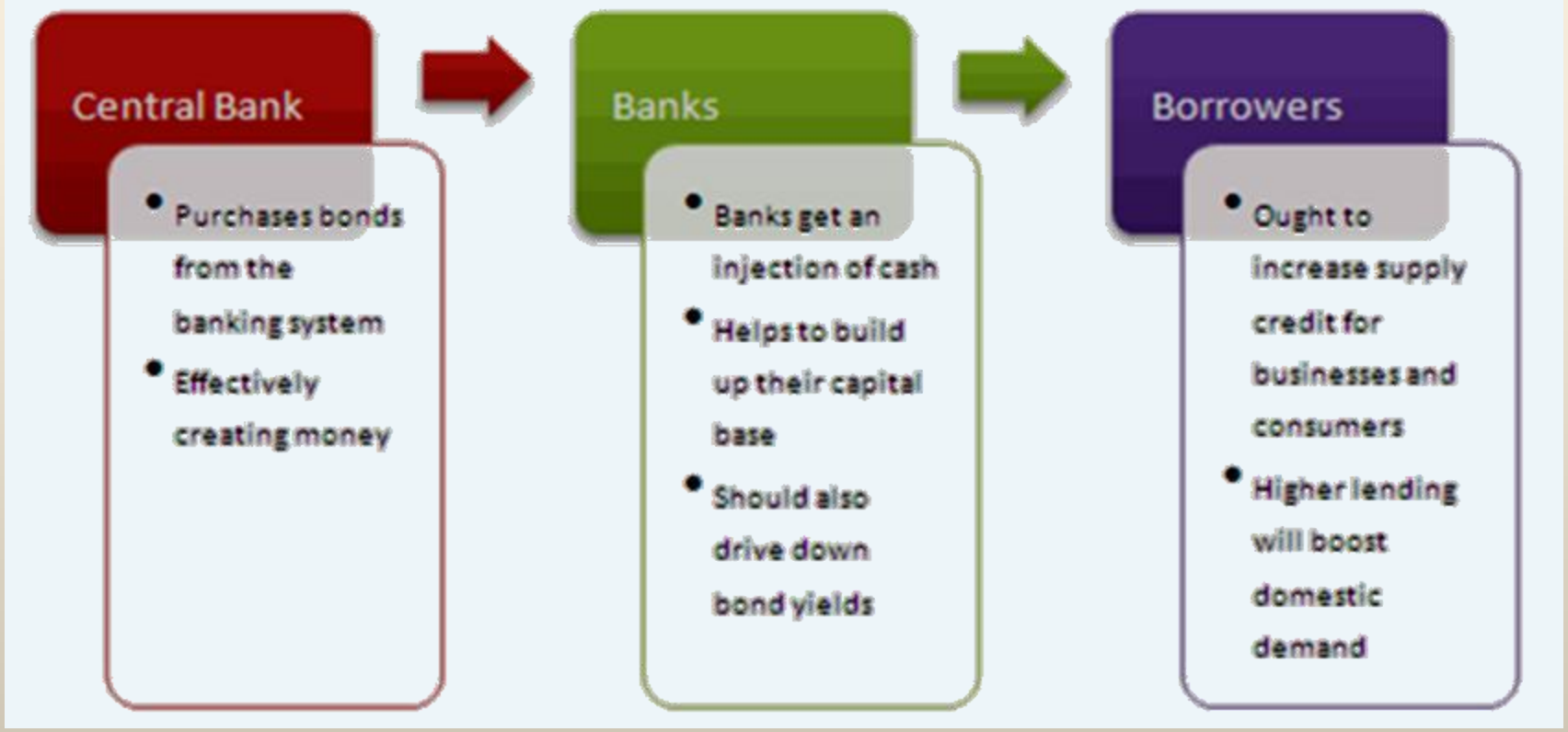
Fed Tools	Macroeconomic Effects
Reserve Requirement	
Increase	Contractionary:
	Money supply ↓
	Interest rate ↑
	Investment ↓
Decrease	Expansionary:
	Money supply ↑
	Interest rate ↓
	Investment ↑
Discount Rate	
Increase	Contractionary:
	Money supply ↓
	Interest rate ↑
	Investment ↓
Decrease	Expansionary:
	Money supply ↑
	Interest rate ↓
	Investment ↑
Open Market Operations	
Sell securities	Contractionary:
	Money supply ↓
	Interest rate ↑
	Investment ↓
Buy securities	Expansionary:
	Money supply ↑
	Interest rate ↓
	Investment ↑

are used in these ways:

Tight Money Policy (Problem: Inflation)	Easy Money Policy (Problem: Recession)
Bank rate, cash reserve ratio are increased, securities are sold	Bank rate, cash reserve ratio are lowered, securities are bought
↓	↓
Money supply falls	Money supply rises
↓	↓
Interest rate rises	Interest rate falls
↓	↓
Investment declines	Investment rises
↓	↓
Economy cools down	Economy revives
↓	↓
Inflation declines	GDP rises

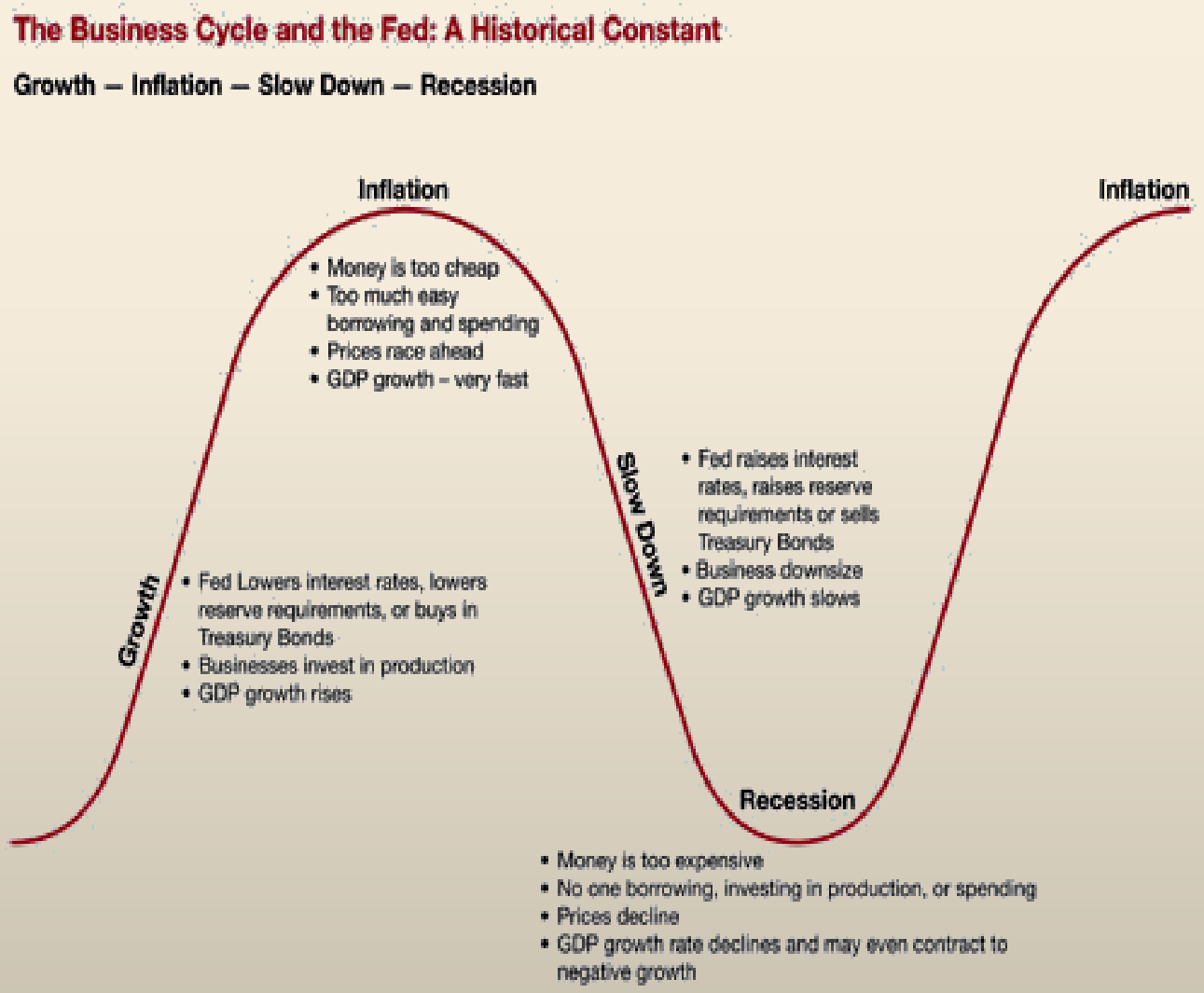
Monetary Policy: How the Fed Controls the Money Supply

Let's take one action from the previous slide and follow it to see how it works.



Monetary Policy: Stabilizing the Economy

- economic stability: situation in which there is economic growth, rising national income, high unemployment and steadiness in the general level of prices
- inflation: rise in the general prices levels of an economy
- recession: short-term decline in the economy that occurs as investment sags, production falls off and unemployment increases



Monetary Policy: Who Controls the Fed?

- Generally thought to be very independent
  - 14-year terms for board members
  - only removed through impeachment process
  - chair serves a 4-year term
  - gained confidence of business
  - experts rather than political appointees
  - belief that an independent Fed has improved the management of the economy
- The Fed is "independent within the government" (an independent government agency that is ultimately accountable to the public and Congress).

Monetary Policy: Who Controls the Fed?

- Congress has some influence.
  - Fed created by congressional statute
  - Nominees to Board must be approved by Senate.
  - Fed must make quarterly reports to banking committees in House and Senate.
- The Board, the 12 Reserve Banks and the Federal Reserve System as a whole are subject to several levels of audit and review, and financial statements are published periodically.
- Congress sets goals for monetary policy, but decisions of the Board and the FOMC about how to reach those goals do not require approval by anyone in government.

Monetary Policy: Who Controls the Fed?

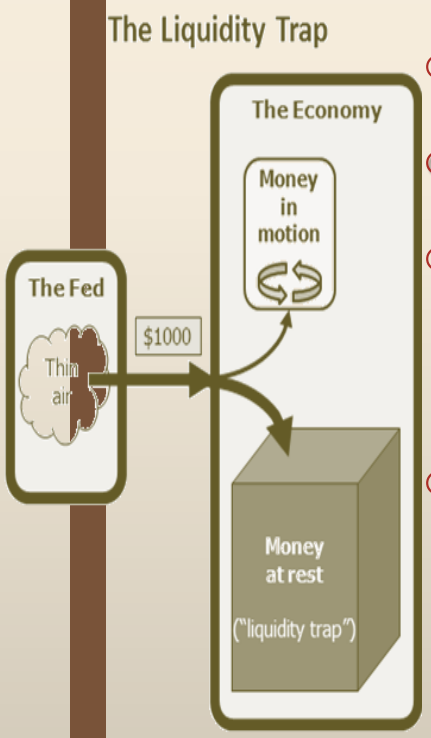
- The Fed is relatively insulated from electoral pressure. Monetary policy tends to be more effective in supporting stable prices and strong employment when it is shielded from short-term political influence.
- The Fed's budget is not congressionally determined or funded.
  - Fed raises its own revenue by creating money and using this money to buy US Treasury bonds.
  - After paying its expenses, the Fed turns the rest of its earnings over to the US Treasury.
- Other influences include:
  - banker dominance in Fed
  - presidential influence (partisanship, election cycles)

The Limitations of Monetary Policy

- In recent decades, monetary policy has become more popular because:
  - set by the Central Bank and therefore reduces political influence
  - Expansionary *fiscal* policy (larger budget deficits) may cause crowding out.
  - Expansionary *fiscal* policy may lead to interest groups pushing for spending which isn't really helpful and is difficult to reduce when recession is over.
  - quicker to implement

The Limitations of Monetary Policy

- However, the recent recession shows that monetary policy can have many limitations.



- Targeting inflation is too narrow.
- liquidity trap
- Creating money may be ineffective if banks just want to keep the extra money in their balance sheets.
- In a deep recession, relying on monetary policy alone, may be insufficient … government spending directly creates demand in the economy.
- In a deep recession, expansionary *fiscal* policy may be important for confidence.

Comparing Fiscal and Monetary Policy

- Economic policymakers have two kinds of tools to influence a country's economy: fiscal and monetary.
  - Fiscal policy involves the government changing tax rates and levels of government spending to influence aggregate demand in the economy.
  - Monetary policy involves changing the interest rate and influencing the money supply.
- Both fiscal and monetary policy can be either *expansionary* or *contractionary*.
- Both tools carry with them their own pros and cons.
- A Look at Fiscal and Monetary Policy (1:51)

Comparing Fiscal and Monetary Policy

	Fiscal Policy	Monetary Policy
Definition	Fiscal policy is the use of government expenditure and revenue collection to influence the economy.	Monetary policy is the process by which the monetary authority controls the supply of money, often targeting a rate of interest to attain a set of objectives oriented towards the growth and stability of the economy.
Principle	Manipulating the level of aggregate demand in the economy to achieve economic objectives of price stability, full employment, and economic growth.	Manipulating the supply of money to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment.
Policy-maker	Executive Branch and Congress	Central Bank
Policy Tools	Taxes; amount of government spending	Interest rates; reserve requirements; currency peg; discount window; quantitative easing; open market operations; signalling

Comparing Fiscal and Monetary Policy

Policy	Definition	Goals	Actors	Tools (*most effective)	in a Recession	when we have Inflation
Fiscal	the use of government spending and taxes to stabilize the economy	fund programs, manage growth, administration	Congress, President	government spending* taxation [transfer payments, borrowing]	increase decrease increase	decrease increase decrease
Monetary	managing the money supply to influence interest rates and the availability of credit	price stability, full employment, growth	Federal Reserve	open market ops* discount rate reserve requirements	buy reduce reduce	sell raise raise

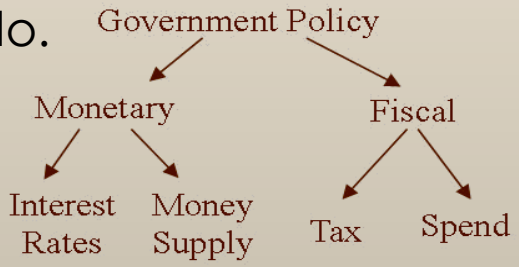
Comparing Fiscal and Monetary Policy

Why don't you analyze a few economic situations and decide how we should use fiscal and monetary policies to correct certain economic problems?

The Fiscal and Monetary Policy Tools Self Test covers 5 economic situations, each of which is followed by several questions. For each question choose the policy action you think is most likely to correct that economic situation.

You'll get immediate feedback. If you choose the wrong action, you'll get an *Oops!* and should stop and think about why your choice was wrong.

By the time you finish, I think you'll have a good understanding of what the government and the Fed do.



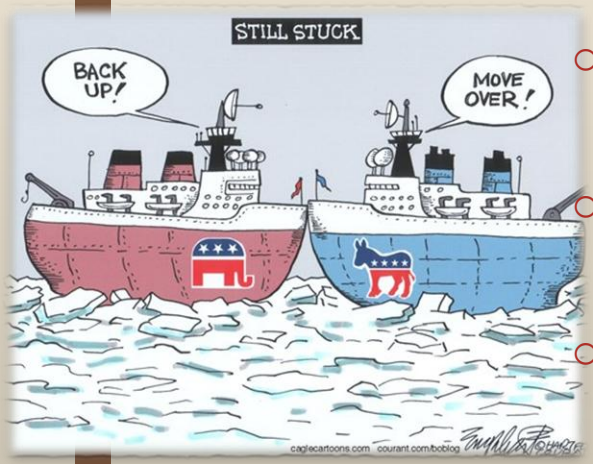
Combining Fiscal and Monetary Policy Tools

the problem	fiscal policy solution	budget impact	potential consequence	monetary policy compliment	keep an eye on...
deep recession and high unemployment	tax cuts *and* increased spending to rapidly increase AD and real GDP	large deficit	higher interest rates, crowding out private investment, lower net exports, weaker AD	expand MS to keep interest rates from rising, increase AD to assist fiscal policy	higher inflation
mild recession and moderate unemployment	tax cuts *or* increased spending to gradually increase AD and real GDP	moderate deficit	rising prices, mild crowding out, lower net exports, weakening AD	contract MS to keep inflation from rising, decrease AD to offset fiscal policy	rising interest rates
inflation	tax hikes *and/or* decreased spending to rapidly decrease AD and real GDP	surplus	lower interest rates, crowding in private investment, higher net exports, even stronger AD	contract MS to keep interest rates from falling, decrease AD to assist fiscal policy	higher unemployment

MS – money supply
AD – aggregate demand

Fiscal and Monetary Policy Pros and Cons

- Fiscal Policy
  - *pro*: Can direct spending to specific purposes ... specific projects, sectors or regions where it is most needed.
  - *con*: Can create budget deficits.
  - *pro*: Can use taxation to discourage negative externalities (example: taxing polluters or overuse of limited resources removes negative effects they cause and generates government revenue).



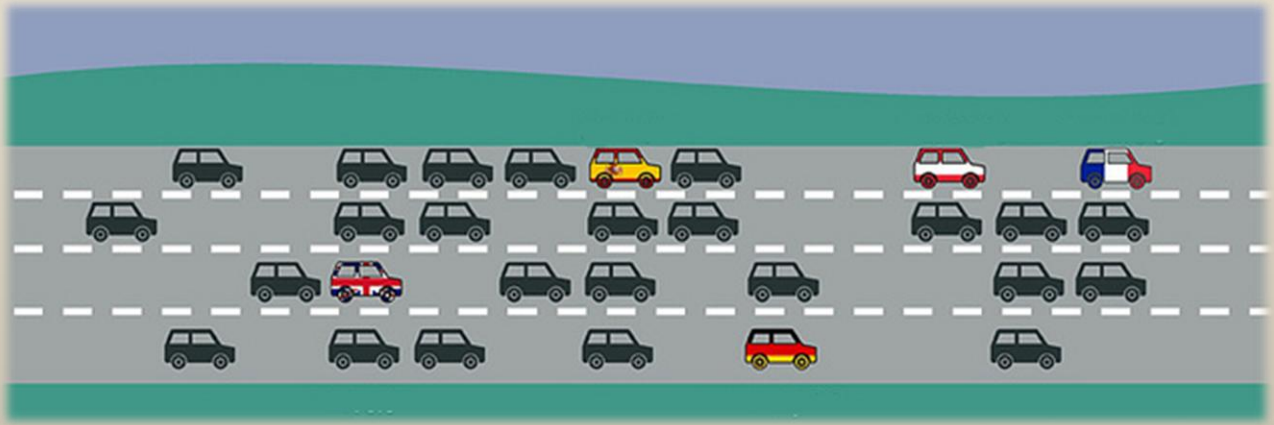
  - *con*: Tax incentives and spending may be spent on imports.
  - *pro*: Effects of fiscal tools can be seen much quicker than effects of monetary tools.
  - *con*: May be politically motivated.

Fiscal and Monetary Policy Pros and Cons

- Monetary Policy
  - *pro*: Interest rate targeting controls inflation.
  - *con*: risk of hyperinflation
  - *pro*: Can be implemented fairly easily.
  - *con*: Effects have a time lag.
  - *pro*: Central banks are independent and politically neutral.
  - *con*: technical limitations (example: interest rates can only be lowered nominally to 0%)
  - *pro*: Weakening the currency can boost exports.
  - *con*: Monetary tools are general and affect an entire county ... can't be directed to solve a specific problem or boost a specific industry or region (example: some areas might not need a stimulus while others might need a larger stimulus).

The US Economy: an International Comparison

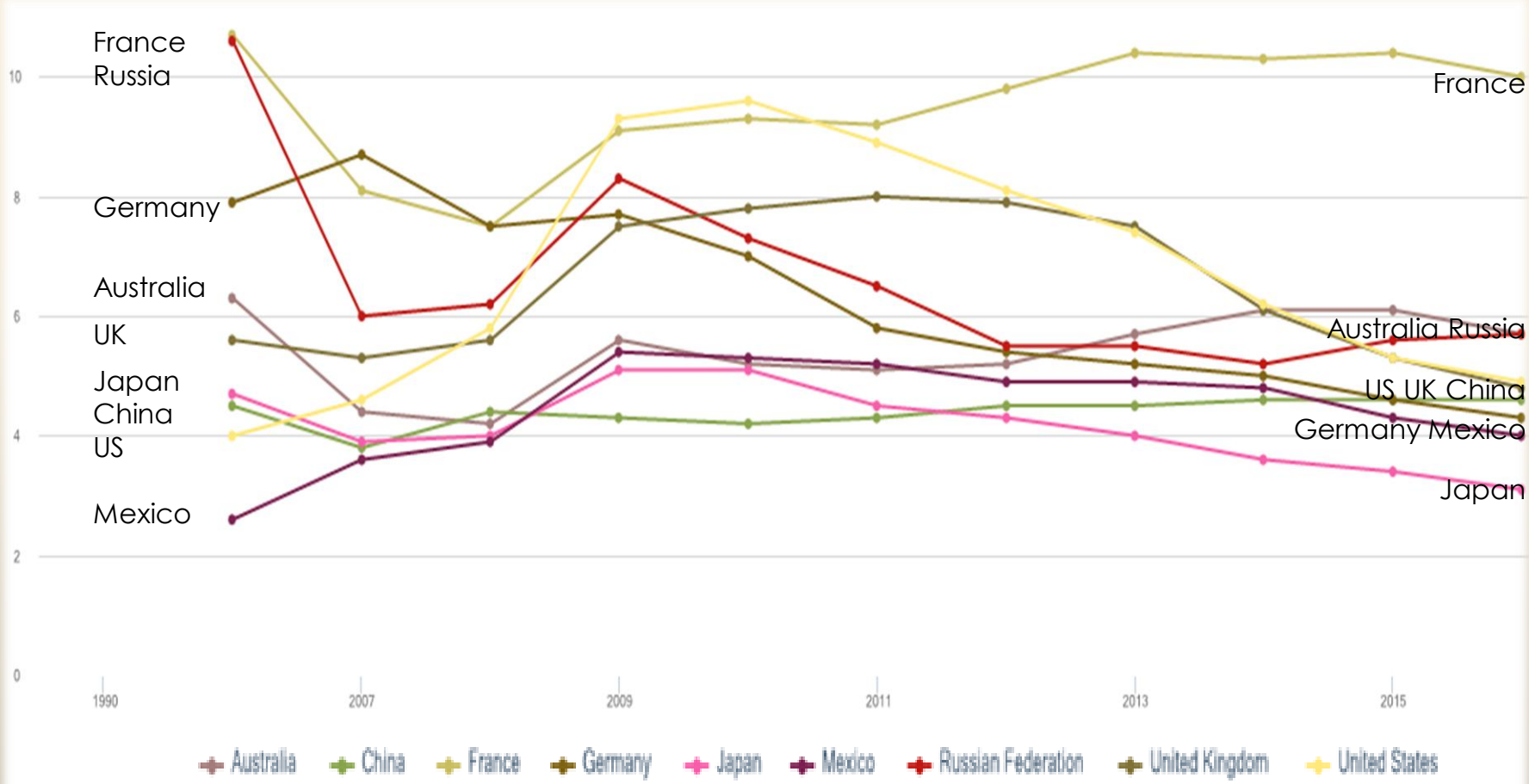
- When the Fed loosens or tightens the money supply, it is reacting to national *and* international economic forces.
- Sometimes, regardless of effort, it may not be successful.
- But how does the US compare overall with other advanced democracies? Reasonably well…



International Comparisons: Unemployment

- In the past, the US has done a better job than most countries of incorporating new workers into the economy.
  - US allowed immigration to increase in the 1980s and absorbed them successfully.
  - Some European countries required *guest workers* to return to their country of origin.
- That may be changing. Since the Great Recession, the number of long-term unemployed has grown and those included haven't experienced a recovery.
- Good jobs or *McJobs* (a low-paid job with few prospects, typically one taken by an overqualified person)?
  - Evidence suggests they were higher paying occupations in the past ... but that seems to be changing.

International Comparisons: Unemployment



Series : Unemployment, total (% of total labor force) (modeled ILO estimate)

Source: World Development Indicators

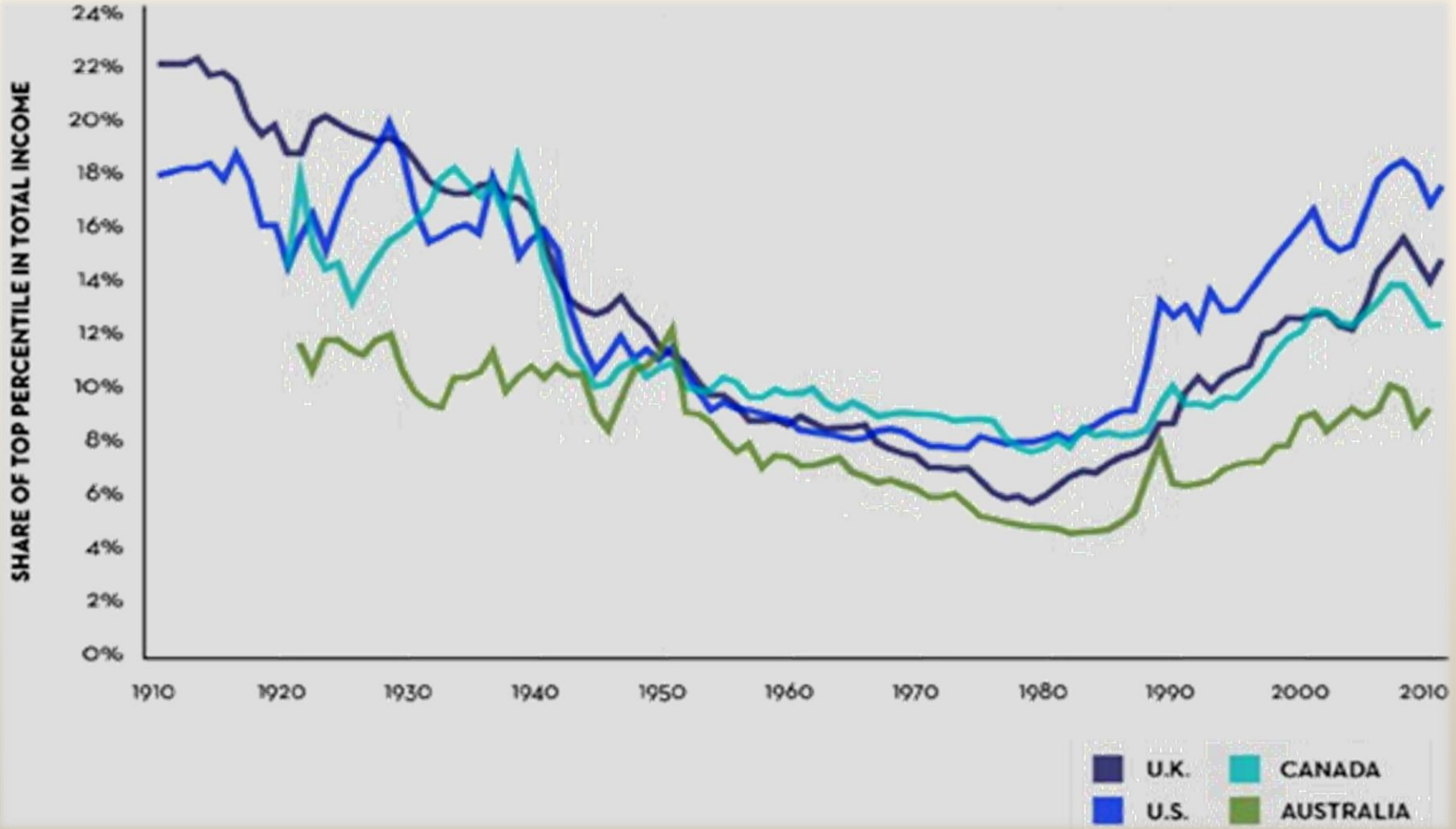
International Comparisons: Inequality

- Price of limited government seems to be greater social inequality.
- Compared with other advanced democracies, income inequality in the US is higher and growing.
- Emergent "class war"?
  - But where is the popular demand to intervene?
  - few candidates with this platform elected
  - no public demand for policies from Congress or state legislatures

International Comparisons: Inequality

- Two economic issues loom especially large in the US today and are a prime concern of ordinary citizens.
  - widespread economic insecurity
  - soaring levels of income inequality
- The US is in danger of becoming an economically polarized society in which a small percentage of the population is free from economic risk, while a vast majority encounter poverty as a normal part of life.
  - Try the new Poverty Risk Calculator to find out how at risk you are.

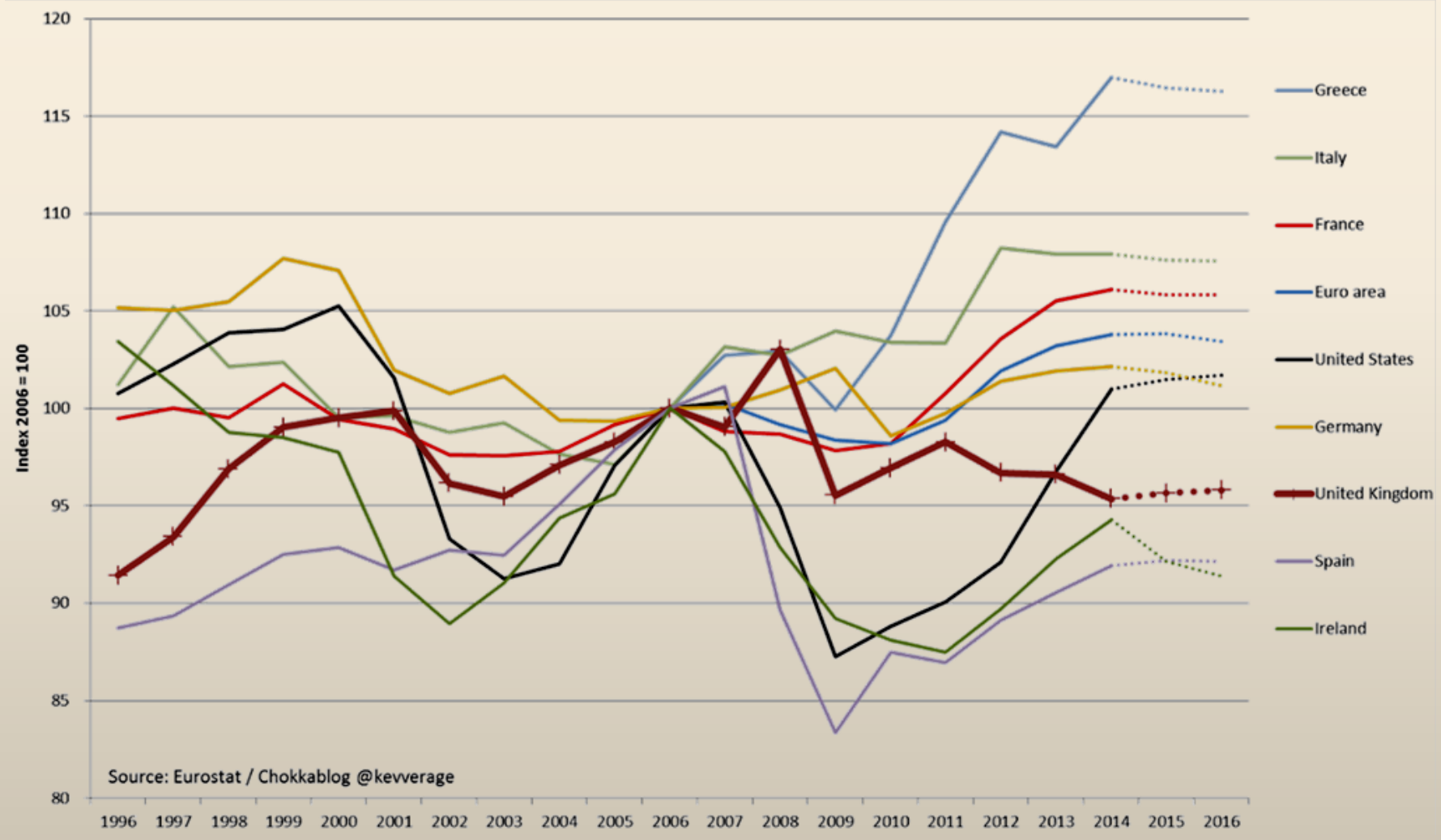
International Comparisons: Inequality



International Comparisons: Taxes

- US tax burden compares favorably with that in the world's other developed countries.
  - among the lowest of the 13 major industrialized countries
  - roughly 32% of GDP
- US tax system is less progressive than those of the world's other developed countries
  - US relies more on income and payroll taxes.
  - Other countries rely more heavily on consumption taxes.
- Other countries tax more but provide more services.

International Comparisons: Taxes



The Effects of Globalization

- Increased competition benefits consumers.
- Expands market for American products.
- Labor unions are strongest critics of free trade.
  - stress need to restrict dumping: a kind of predatory pricing, occurring when manufacturers export a product to another country at a price either below the price charged in its home market or below its cost of production in order to increase market share in a foreign market or to drive out competition
  - "fair trade rather than free trade"
- Analysis suggests that globalization further segments the market into winners and losers, the latter tending to be smaller businesses and workers.

The End