



# A Historical Perspective on Monetary Policy

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## Monetary Policy

*Managing the growth rate of  
the money supply to keep  
inflation low and foster  
economic growth.*



# Money

December 2006

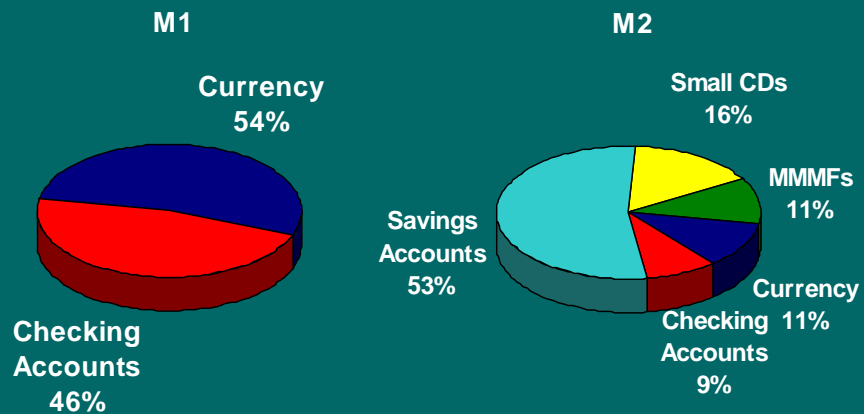
**M1 = Currency + Checking Accounts  
(\$1.4 Trillion)**

**M2 = M1 + Savings Deposits + Small CDs  
+ Money Market Mutual Funds  
(\$6.8 Trillion)**



## Components of M1 and M2

December 2006





## Monetary Policy Tools

- Reserve requirements
- Discount rate
  - Initially most important tool
  - Differed across Reserve Banks
- Open market operations
  - First purchase December 31, 1914
  - Mostly to increase Reserve Bank earnings



## Monetary Policy Tool

- Open market operations
  - Codified into law by Banking Act of 1933
  - Buying government securities increases bank reserves
  - Selling government securities decreases bank reserves

## Implementing Monetary Policy by Targeting:

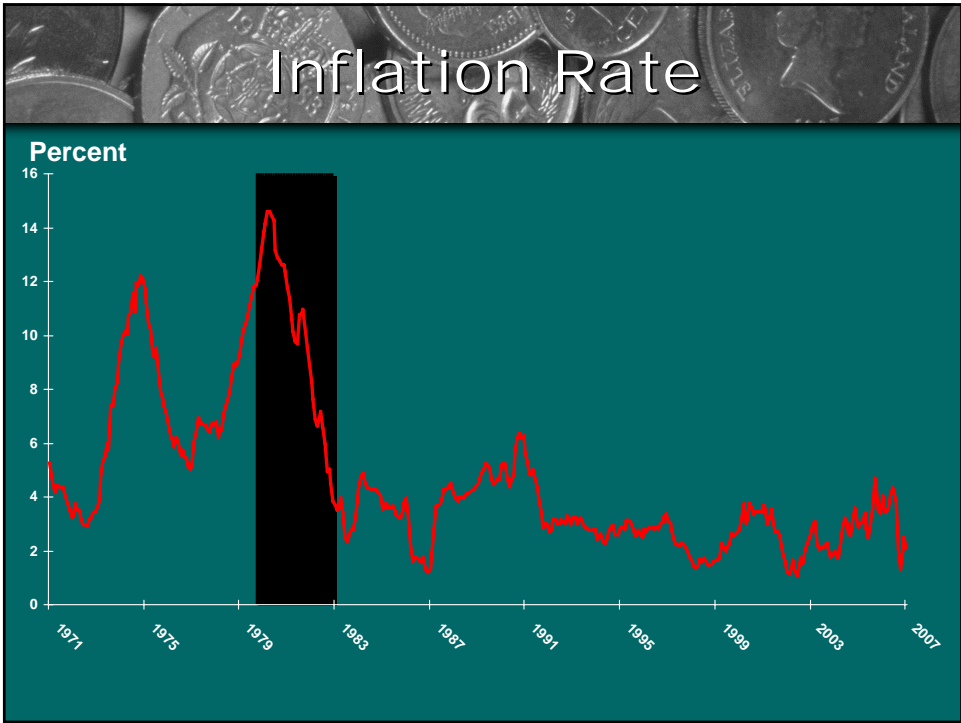
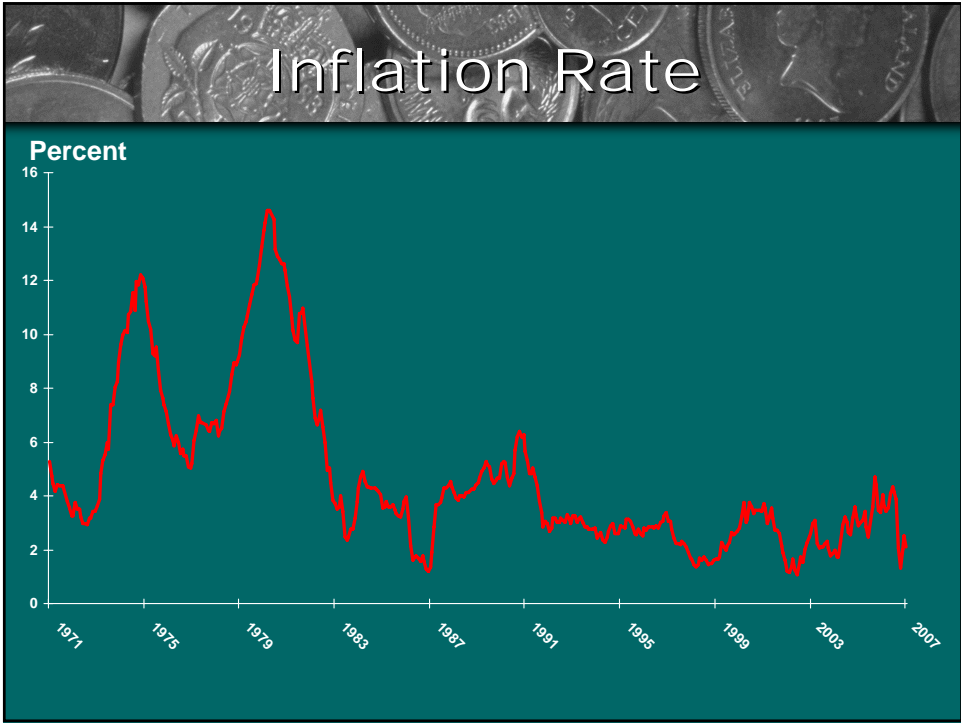
- Bank reserves

OR

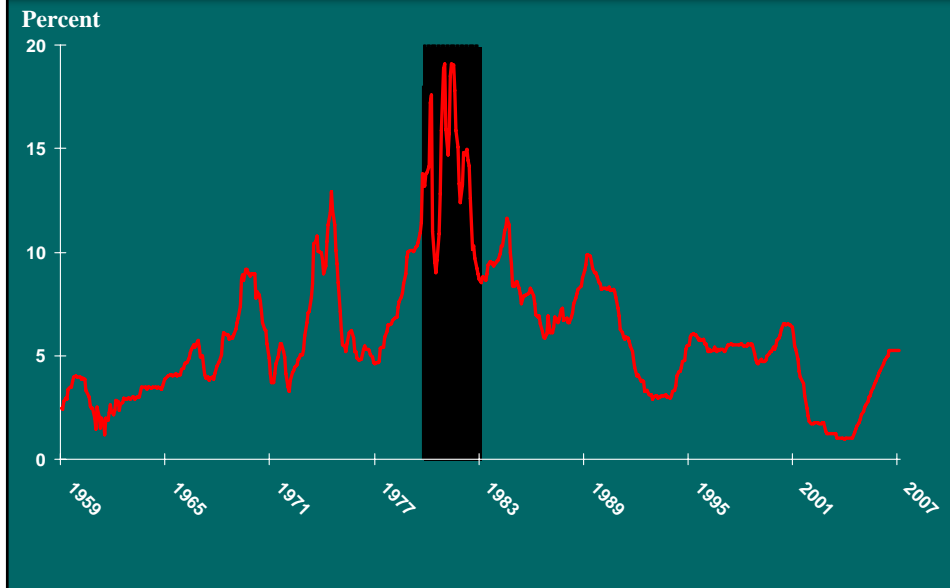
- Interest rates

## Implementing Monetary Policy by Targeting:

- Bank reserves
  - Vault cash
  - Deposits at regional Federal Reserve Banks
- 1979-1982
- Money supply multiplier



## Federal Funds Rate

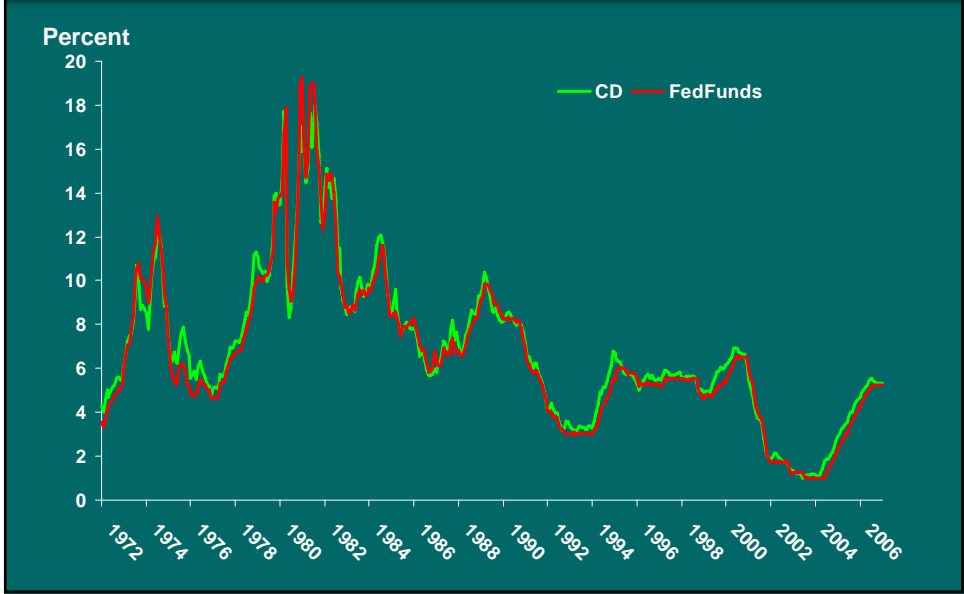


## Implementing Monetary Policy by Targeting:

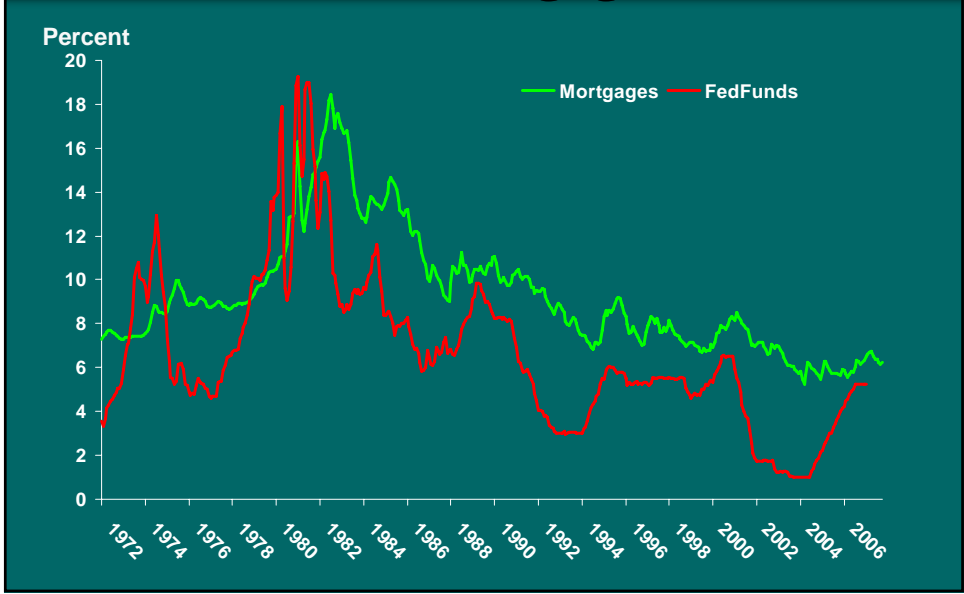
- Interest rates
  - Federal funds rate
  - Initially to influence “demand for money”
    - Mid-1960s-1970s
    - To obtain the desired money supply



## Federal Funds Rate and 6-Month CD Rate



## Federal Funds Rate and 30-Year Mortgage Rate

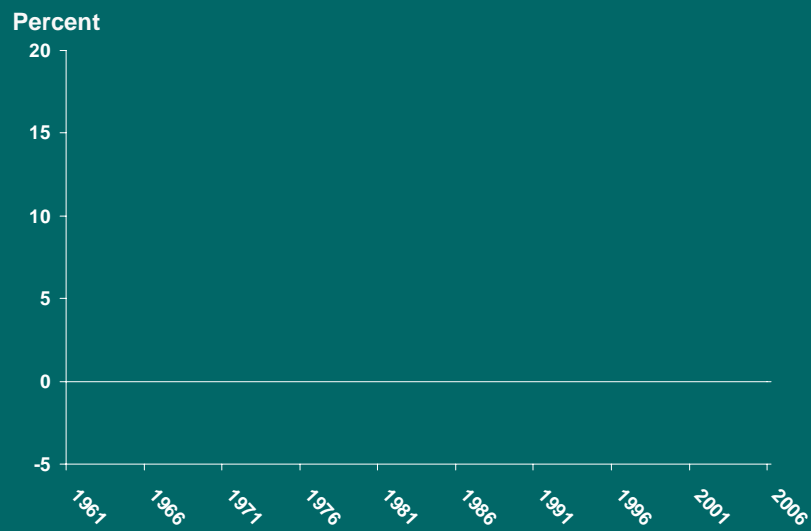


# Monetary Policy

*Managing the growth rate of the money supply to keep inflation low and foster economic growth.*

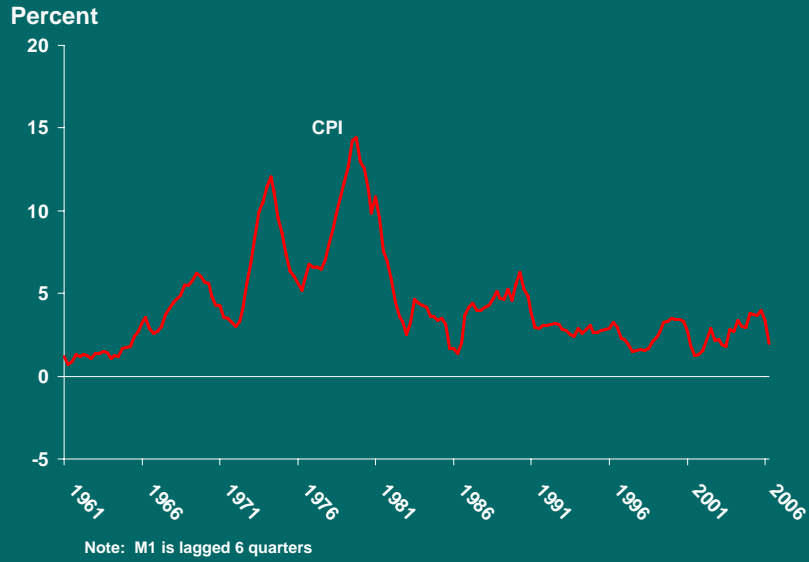


# Inflation and Lagged M1 Growth 1961-2006



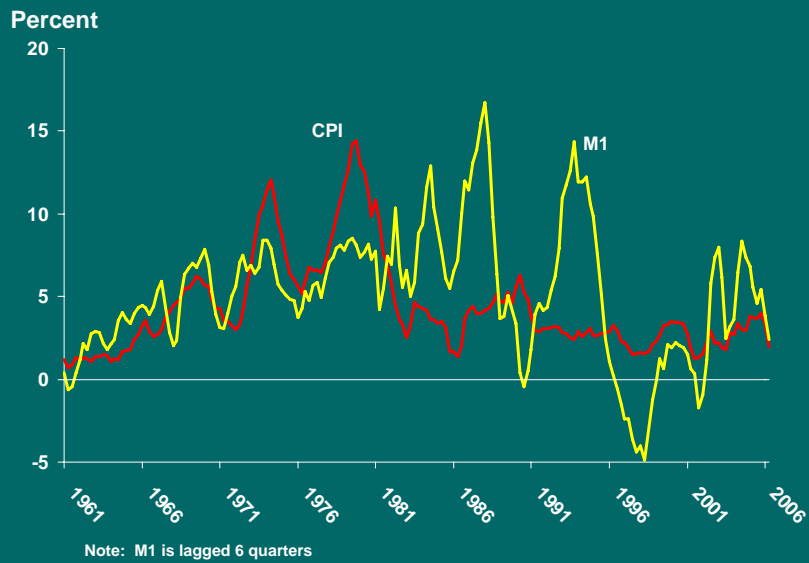
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1961-2006



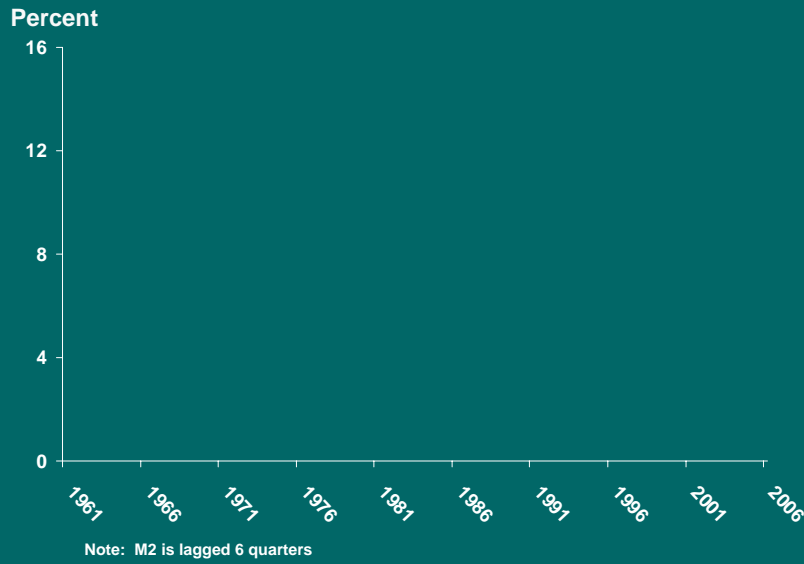
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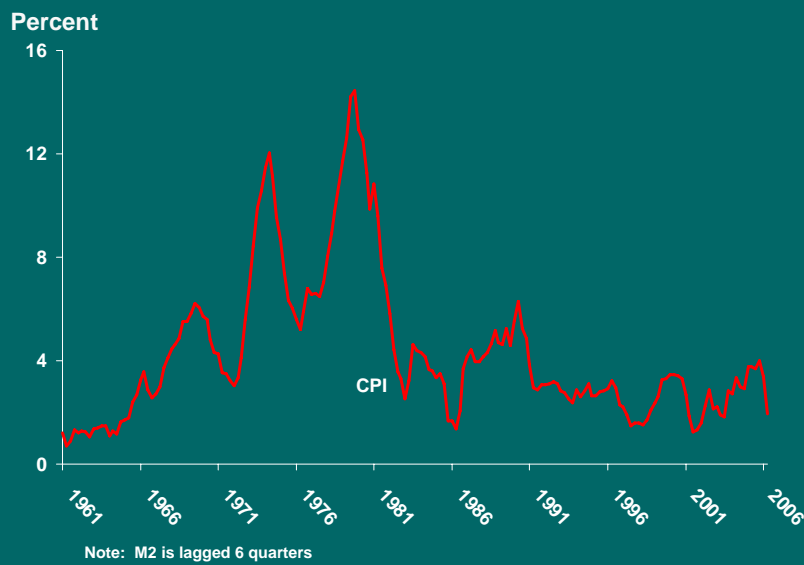
# Inflation and Lagged M2 Growth

1961-2006



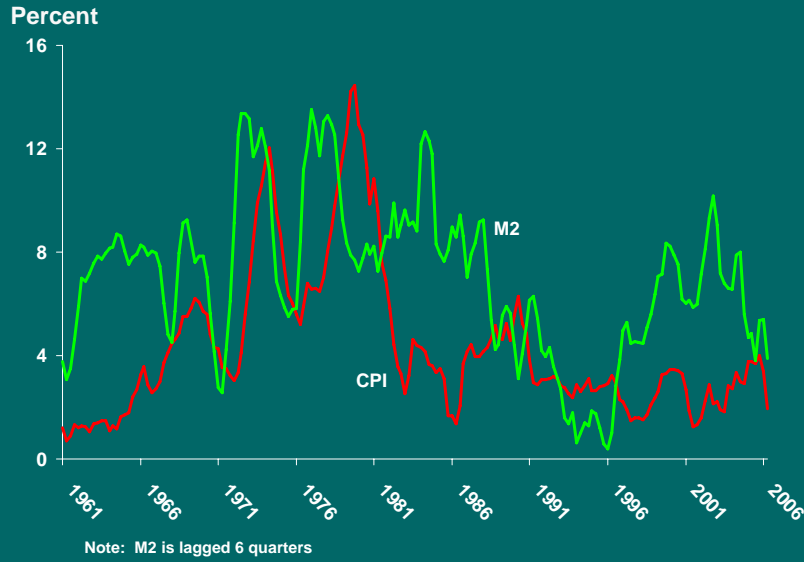
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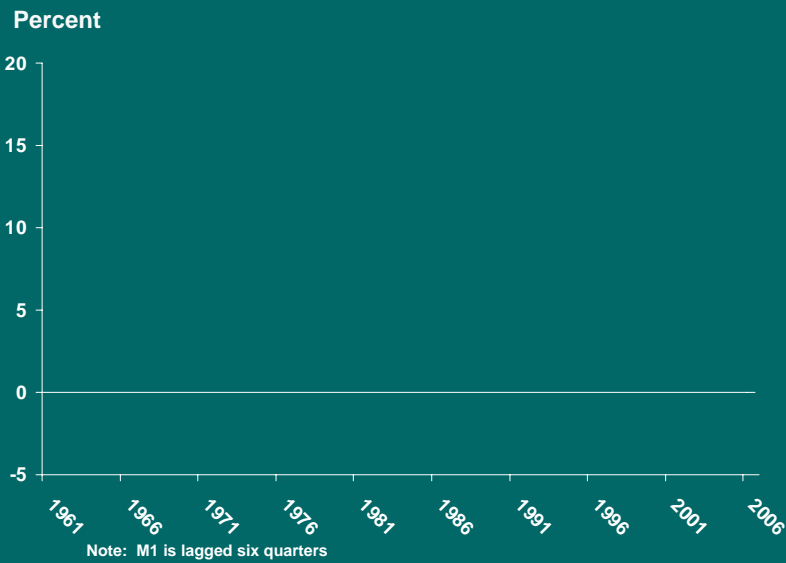
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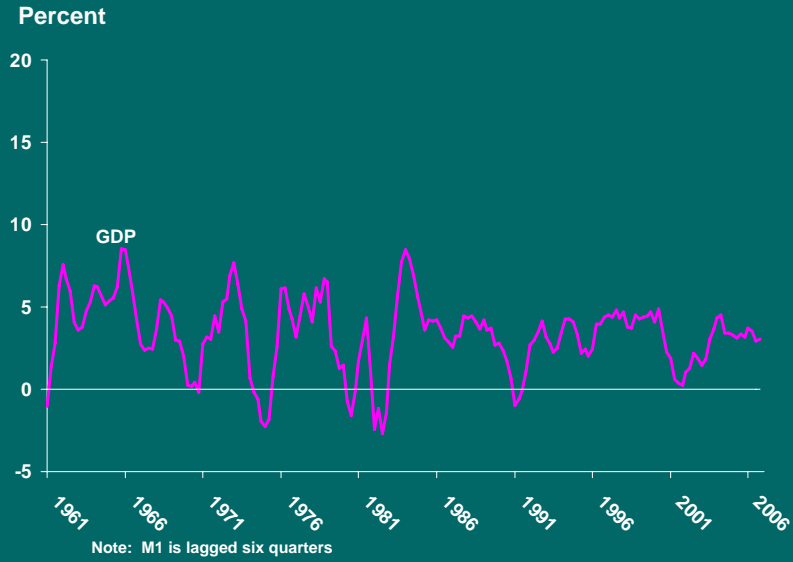
# Growth in GDP and Lagged M1

1961-2006



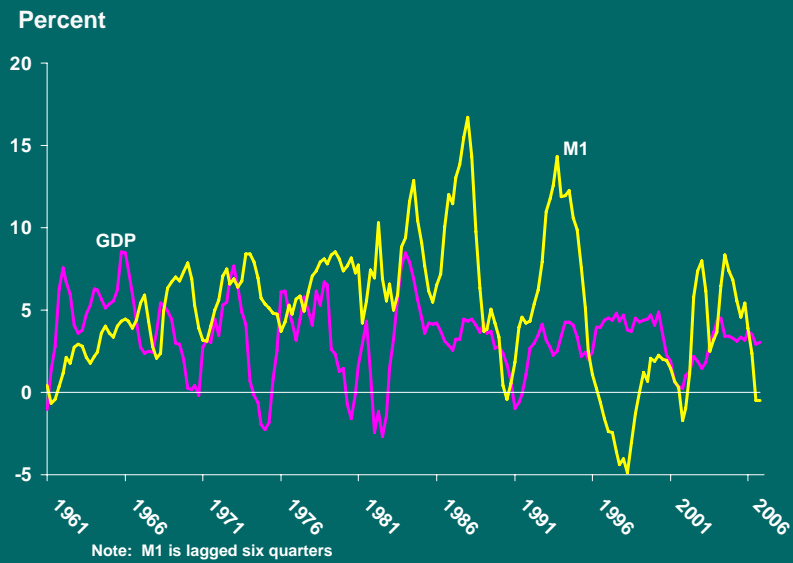
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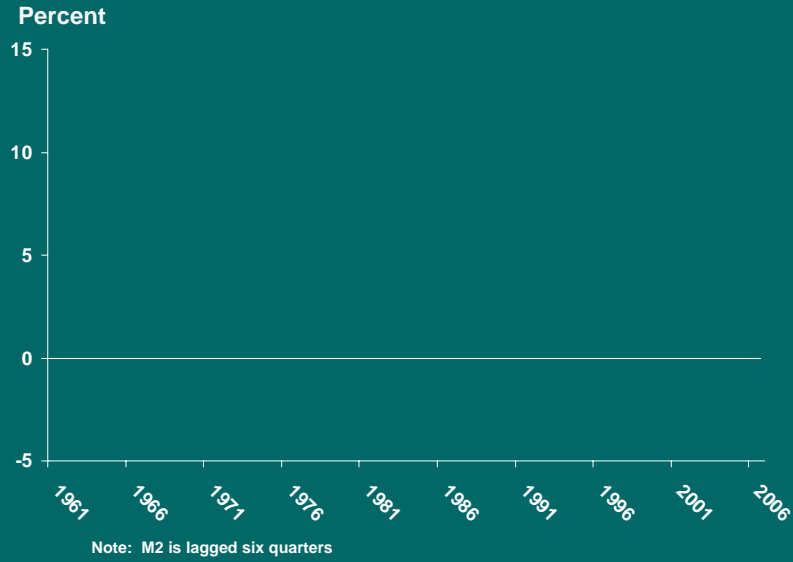
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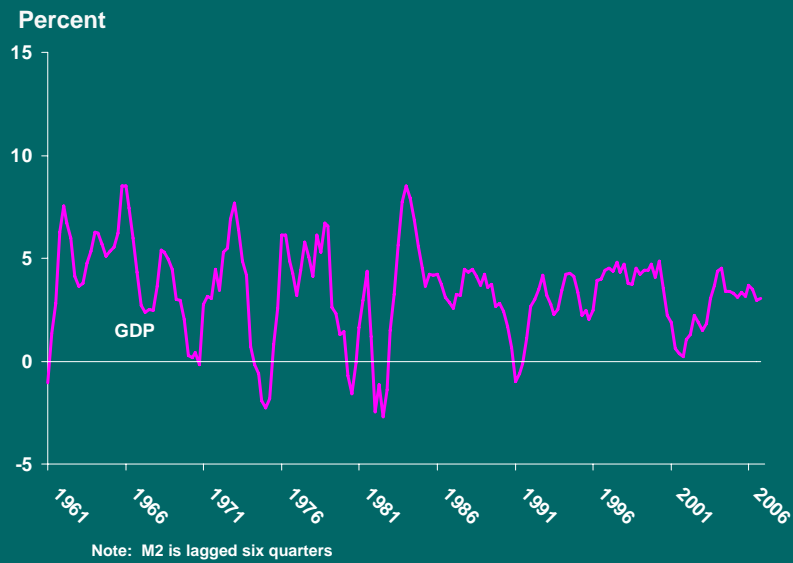
# Growth in GDP and Lagged M2

1961-2006

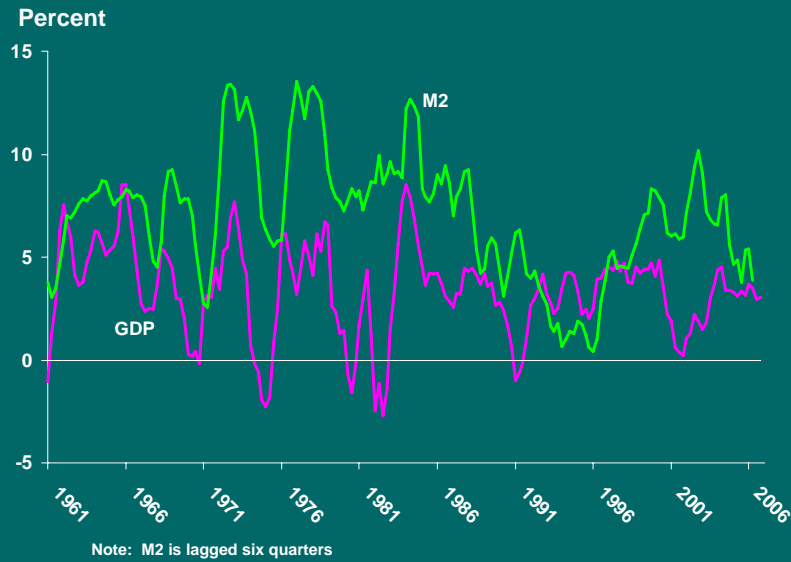


# Growth in GDP and Lagged M2

1961-2006



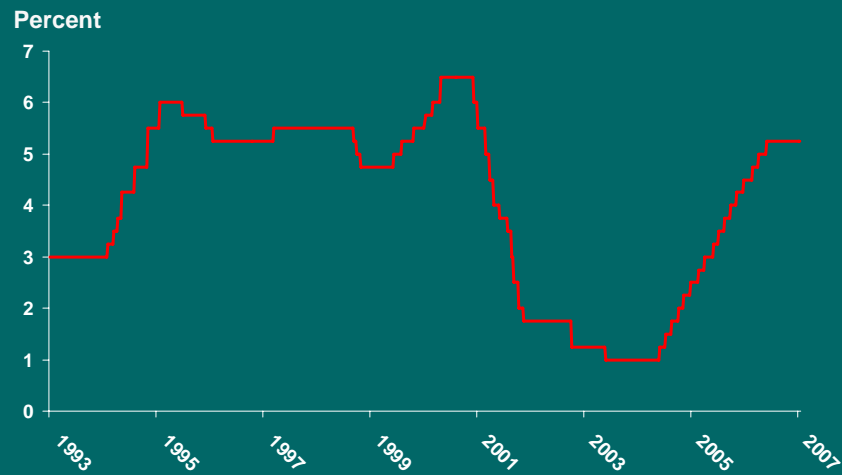
## Growth in GDP and Lagged M2 1961-2006



## What's the Fed Up To?

- Why does the Fed change the federal funds rate?
- Taylor Rule
- Fed seems to “react” to both inflation and economic activity

## Federal Funds Rate Target



## Taylor Rule

**Fed funds rate = inflation +  
inflation target +  
0.5x(inflation-inflation target) +  
0.5x(actual GDP-potential GDP)**

## Taylor Rule

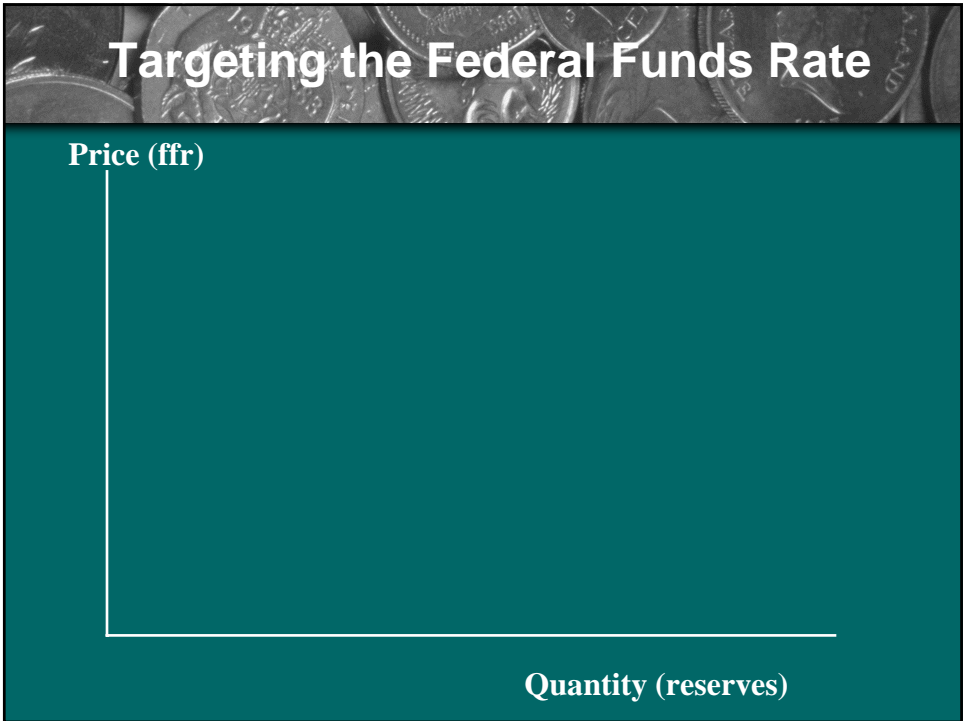
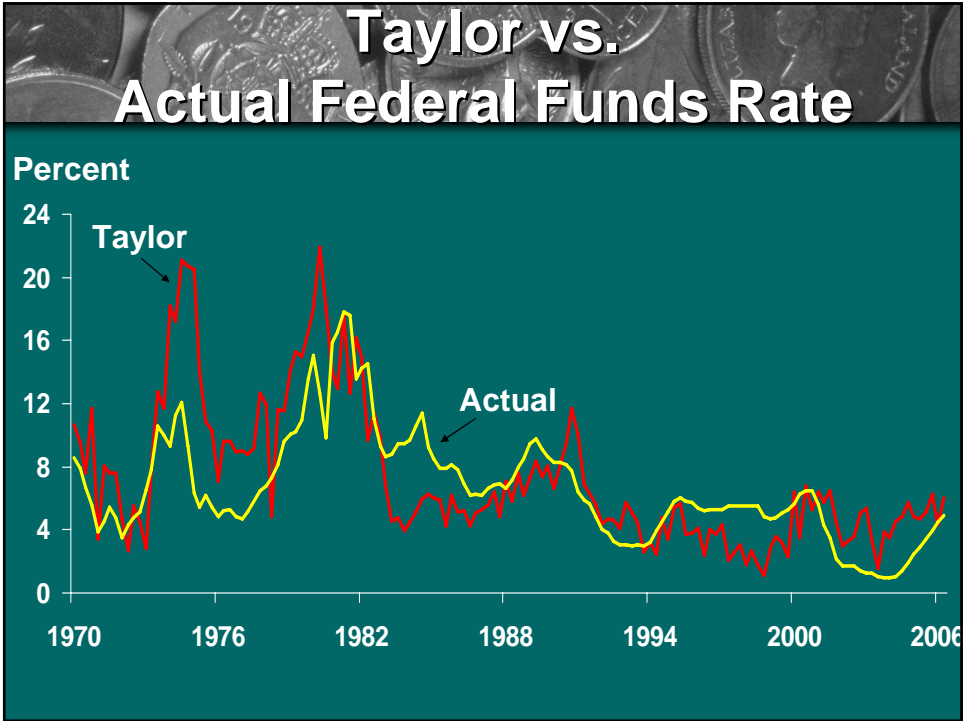
**Fed funds rate = inflation + inflation target + 0.5x(inflation-inflation target) + 0.5x(actual GDP-potential GDP)**

**Suppose: Inflation = 2% and the Fed's inflation target is 2% and actual GDP=potential GDP???**

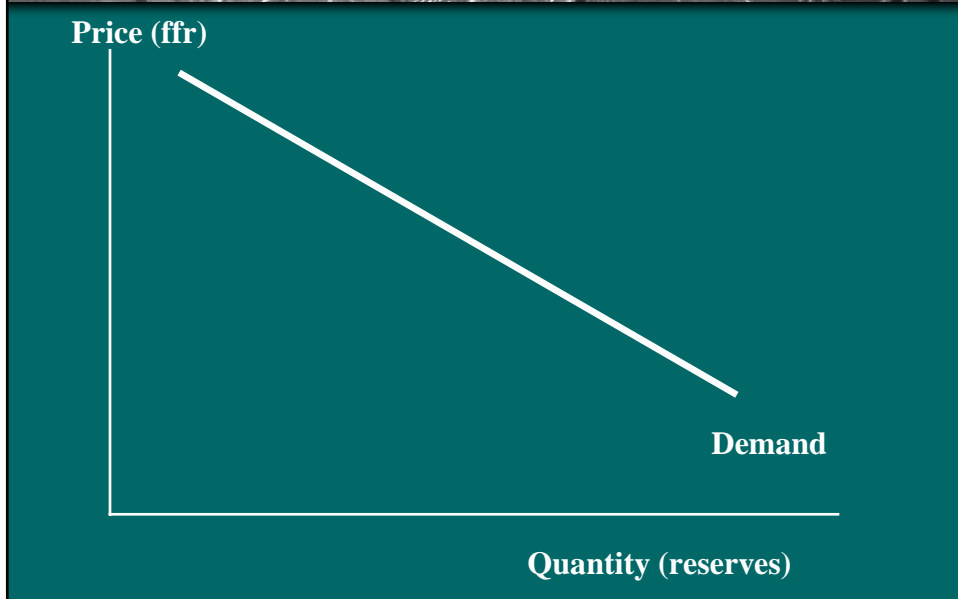
**Fed funds rate = 4%  
(the "neutral" funds rate)**

## Taylor Rule

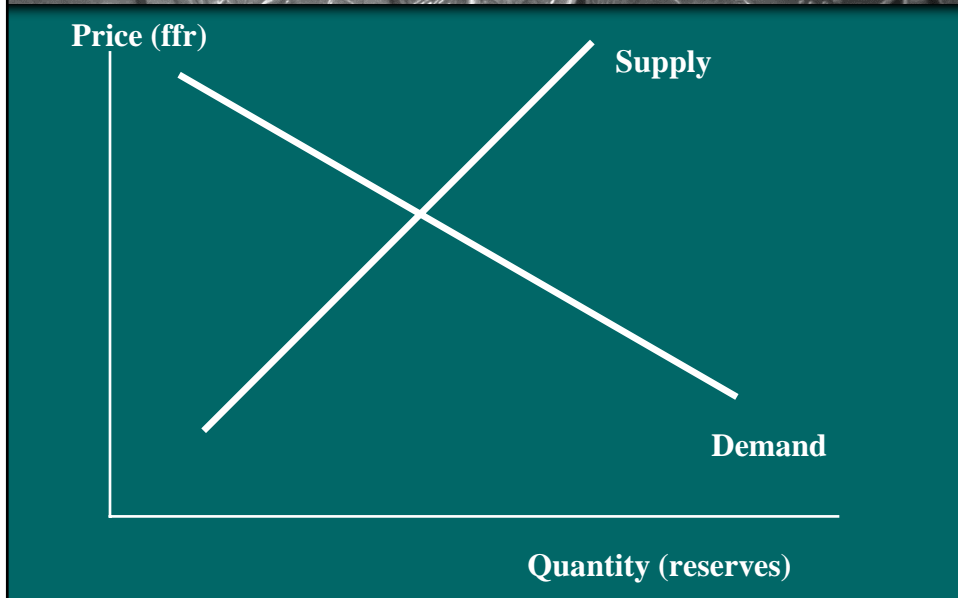
- **Fed funds rate = inflation + inflation target + 0.5x(inflation-inflation target) + 0.5x(actual GDP-potential GDP)**
- **Suppose: Inflation = 4% and the Fed's inflation target is 2% and actual GDP=potential GDP???**
- **Fed funds rate = 4% + 2% + 0.5x(4%-2%) + 0 = 7%**



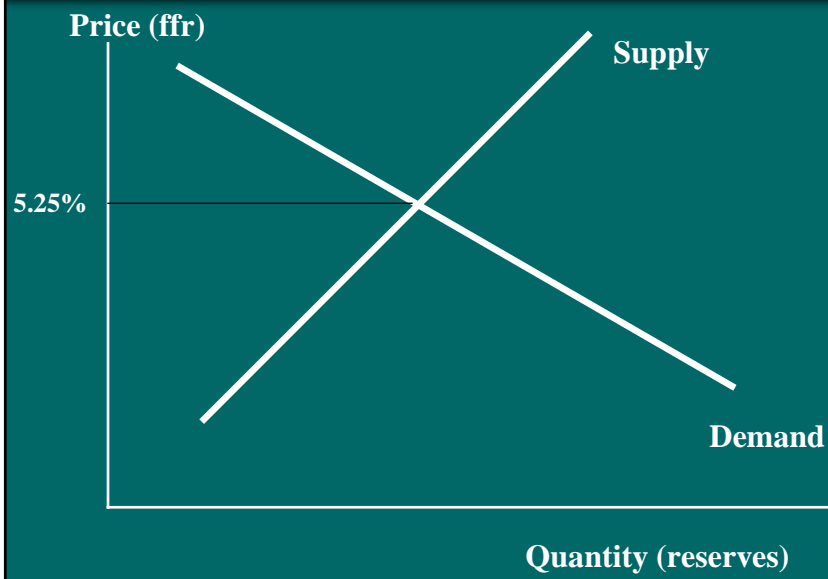
## Targeting the Federal Funds Rate



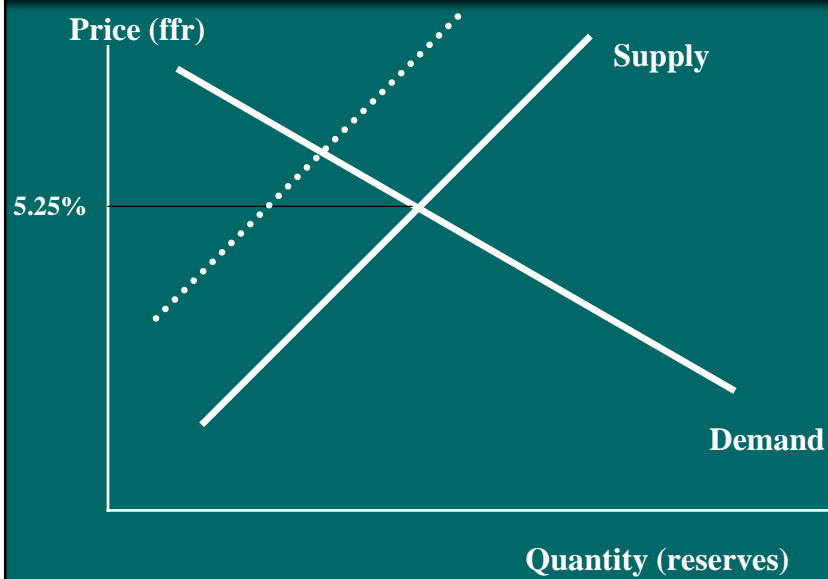
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