Chapter 22 – The Monetary Policy and Aggregate Demand Curves

The Federal Reserve and Monetary Policy

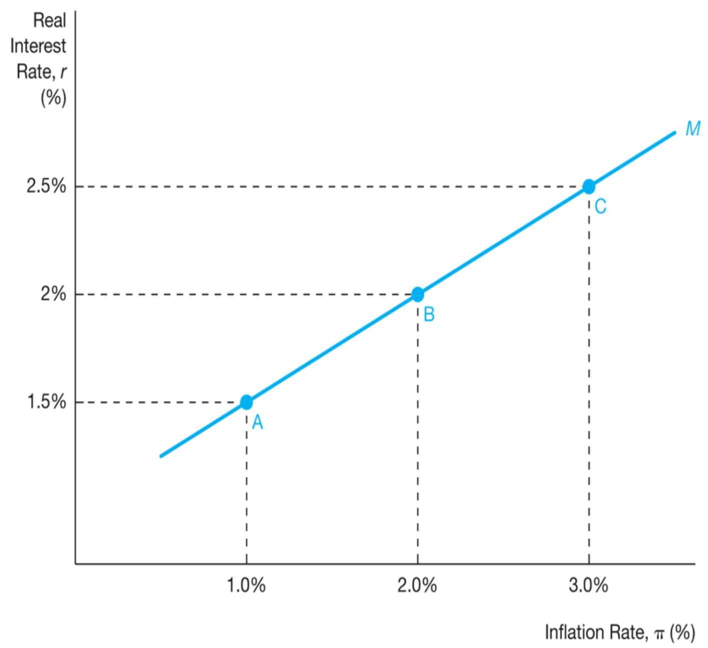
- The Fed of the United States conducts monetary policy by setting the federal funds rate—the interest rate at which banks lend to each other
- When the Federal Reserve lowers the federal funds rate, real interest rates fall; and when the Federal Reserve raises the federal funds rate, real interest rates rise

The Monetary Policy Curve

- The monetary policy (*MP*) curve shows how monetary policy, measured by the real interest rate, reacts to the inflation rate:

- The *MP* curve is upward sloping: real interest rates rise when the inflation rate rises

Figure 1 The Monetary Policy Curve



- The key reason for an upward sloping *MP* curve is that central banks seek to keep inflation stable

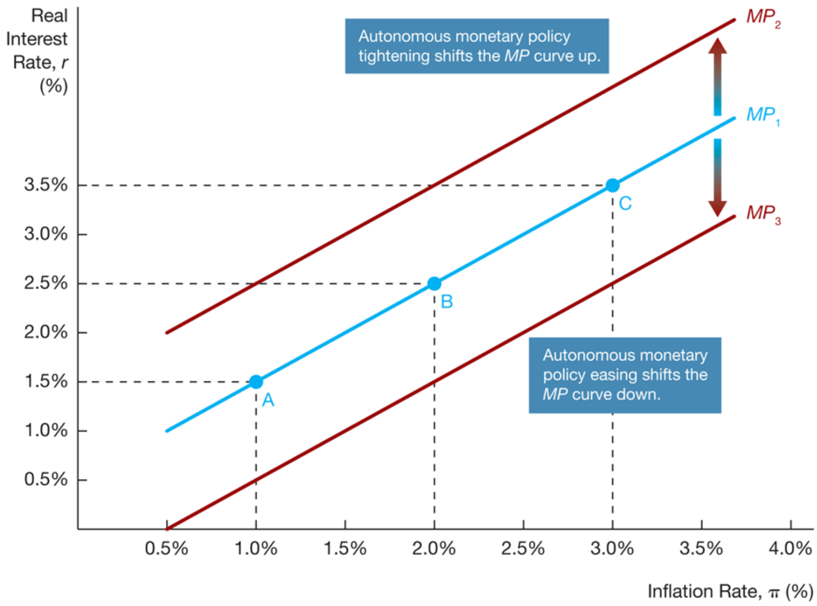
- Taylor principle:

Shifts in the *MP* Curve

- Two types of monetary policy actions that affect interest rates:
  - *Automatic* (Taylor principle) changes as reflected by movements along the *MP* curve
  - Autonomous changes that shift the *MP* curve
    - Autonomous tightening of monetary policy that shifts the *MP* curve upward (in order to reduce inflation)

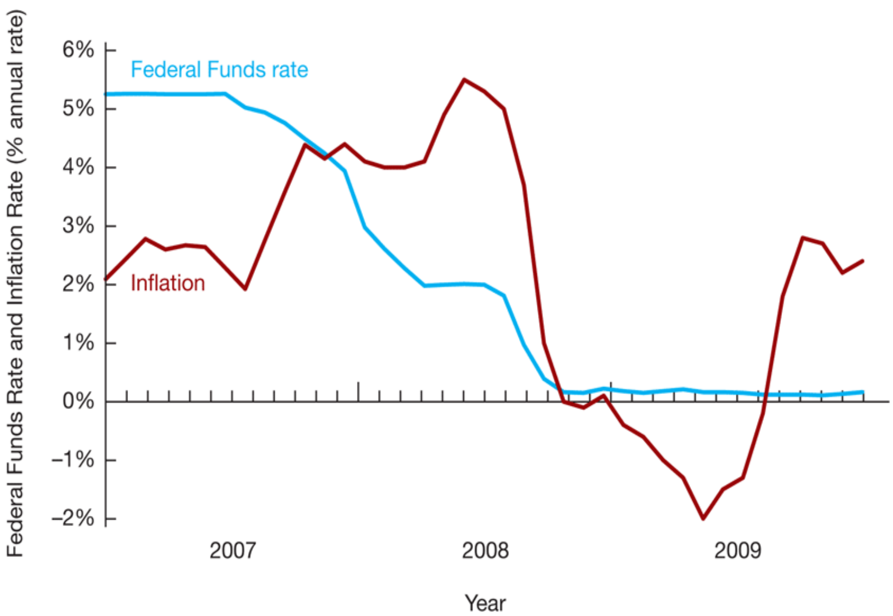
    - Autonomous easing of monetary policy that shifts the *MP* curve downward (in order to stimulate the economy)

Figure 2 Shifts in the Monetary Policy Curve



Application: Autonomous Monetary Easing at the Onset of the 2007-2009 Financial Crisis

Figure 3 The Inflation Rate and the Federal Funds Rate, 2007–2010



The Aggregate Demand Curve

- The aggregate demand curve represents the relationship between the inflation rate and aggregate demand when the goods market is in equilibrium

- The aggregate demand curve is central to aggregate demand and supply analysis, which allows us to explain short-run fluctuations in both aggregate output and inflation

Deriving the Aggregate Demand Curve Graphically

- The *AD* curve is derived from:
  - The *MP* curve
  - The *IS* curve
- The *AD* curve has a downward slope: As inflation rises, the real interest rate rises, so that spending and equilibrium aggregate output fall

Factors that Shift the Aggregate Demand Curve

- Shifts in the *IS* curve
  - Autonomous consumption expenditure
  - Autonomous investment spending
  - Government purchases
  - Taxes
  - Autonomous net exports
- Any factor that shifts the *IS* curve shifts the aggregate demand curve in the same direction

- Shifts in the *MP* curve
  - An autonomous tightening of monetary policy, that is a rise in real interest rate at any given inflation rate, shifts the aggregate demand curve to the left
  - Similarly, an autonomous easing of monetary policy shifts the aggregate demand curve to the right