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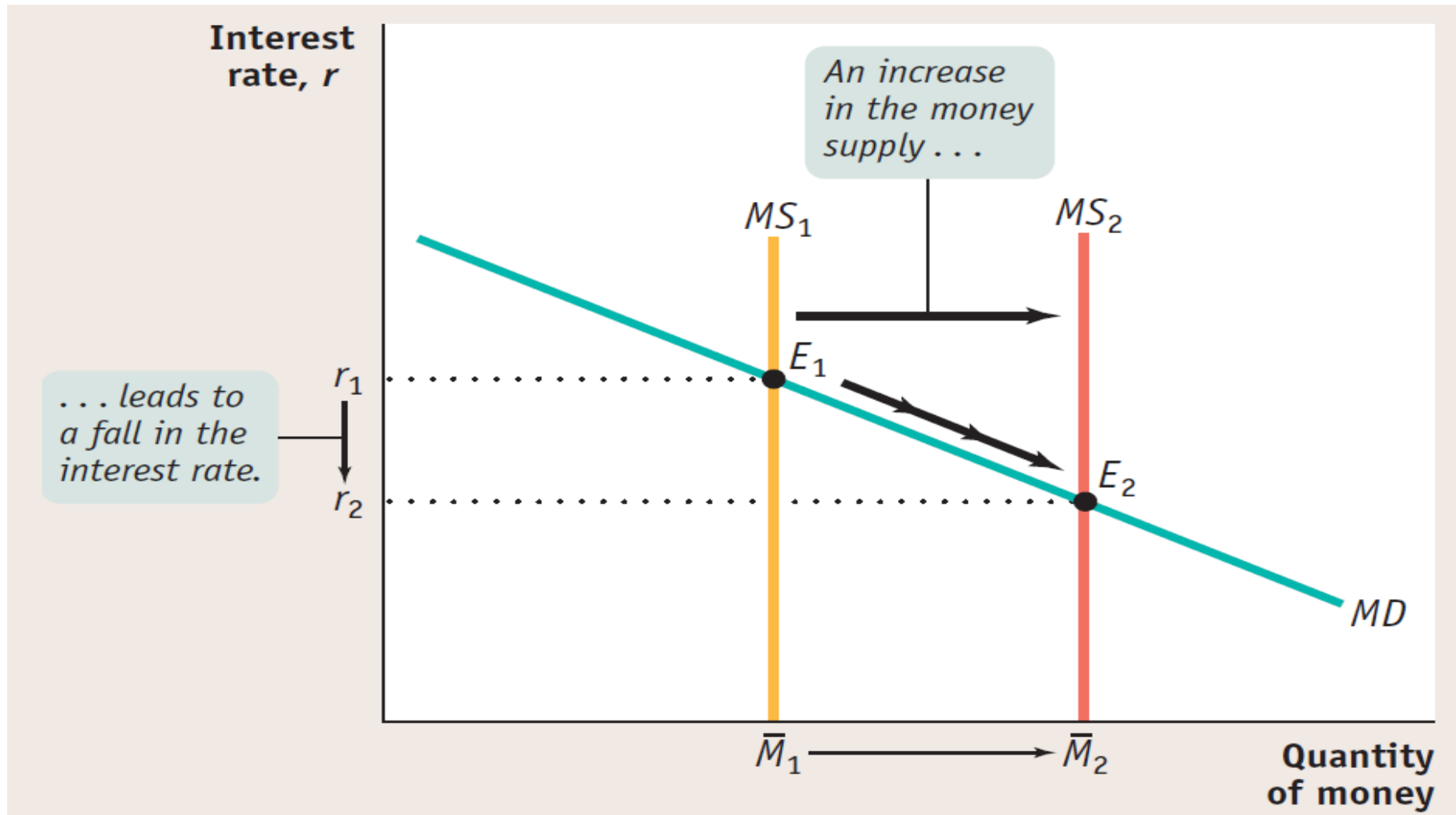
MODULE

**38**

# Monetary Policy and the Interest Rate

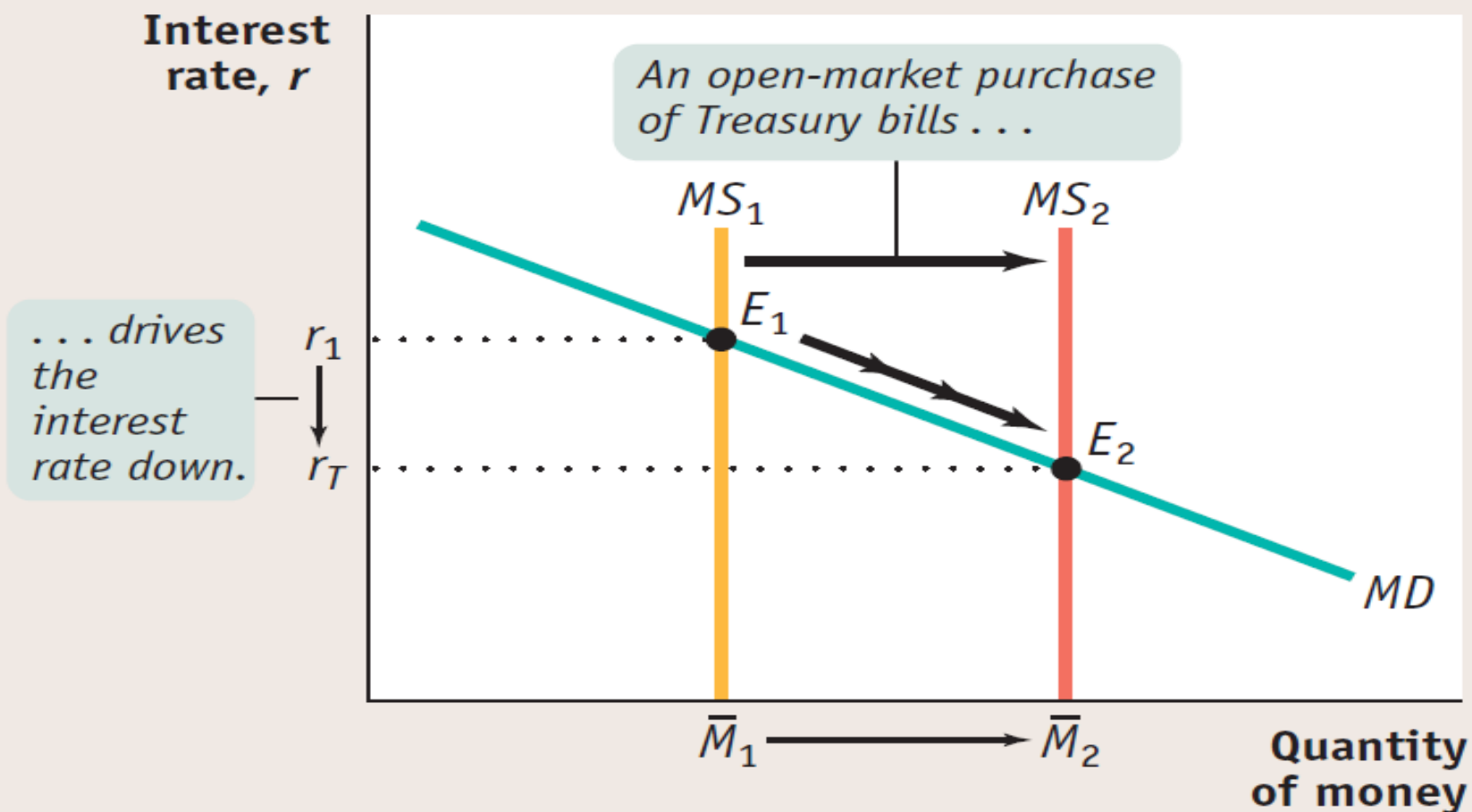
- By increasing or decreasing the money supply, the Federal Reserve can set the interest rate.
- In practice, the Federal Open Market Committee (FOMC) sets a target federal funds rate.
  - The **Open Market Desk** then adjusts the money supply through open-market operations.

# Effect of an Increase in the Money Supply on the Interest Rate



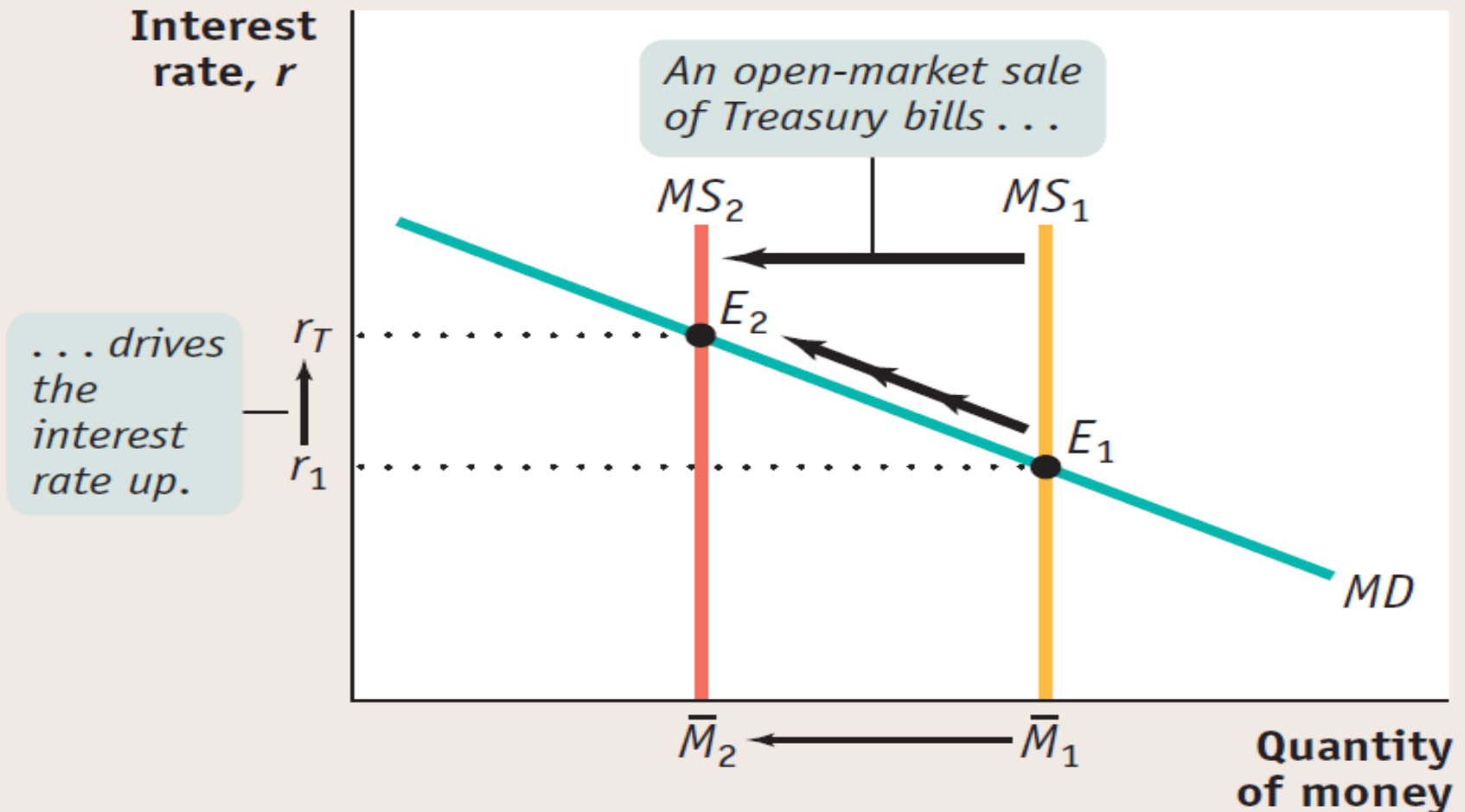
# Setting the Federal Funds Rate

(a) Pushing the Interest Rate Down to the Target Rate



# Setting the Federal Funds Rate

(b) Pushing the Interest Rate Up to the Target Rate



# Long-Term Interest Rates

- Long-term interest rates are typically higher than short-term rates in order to compensate buyers for the higher risk they face.
- Long-term rates usually move with short-term rates, but not always.

# Monetary Policy and Aggregate Demand

- **Expansionary monetary policy** is monetary policy that increases aggregate demand.
- **Contractionary monetary policy** is monetary policy that reduces aggregate demand.

# Expansionary and Contractionary Monetary Policy

## EXPANSIONARY

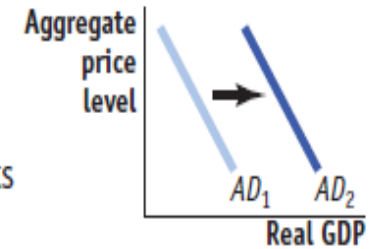
Increase money supply

Lower interest rate

Higher investment spending raises income

Higher consumer spending (via multiplier)

Increase in aggregate demand and AD curve shifts to the right



## CONTRACTIONARY

Decrease money supply

Higher interest rate

Lower investment spending reduces income

Lower consumer spending (via multiplier)

Decrease in aggregate demand and AD curve shifts to the left

