38 Monetary Policy and the Interest Rate

MODULE 38

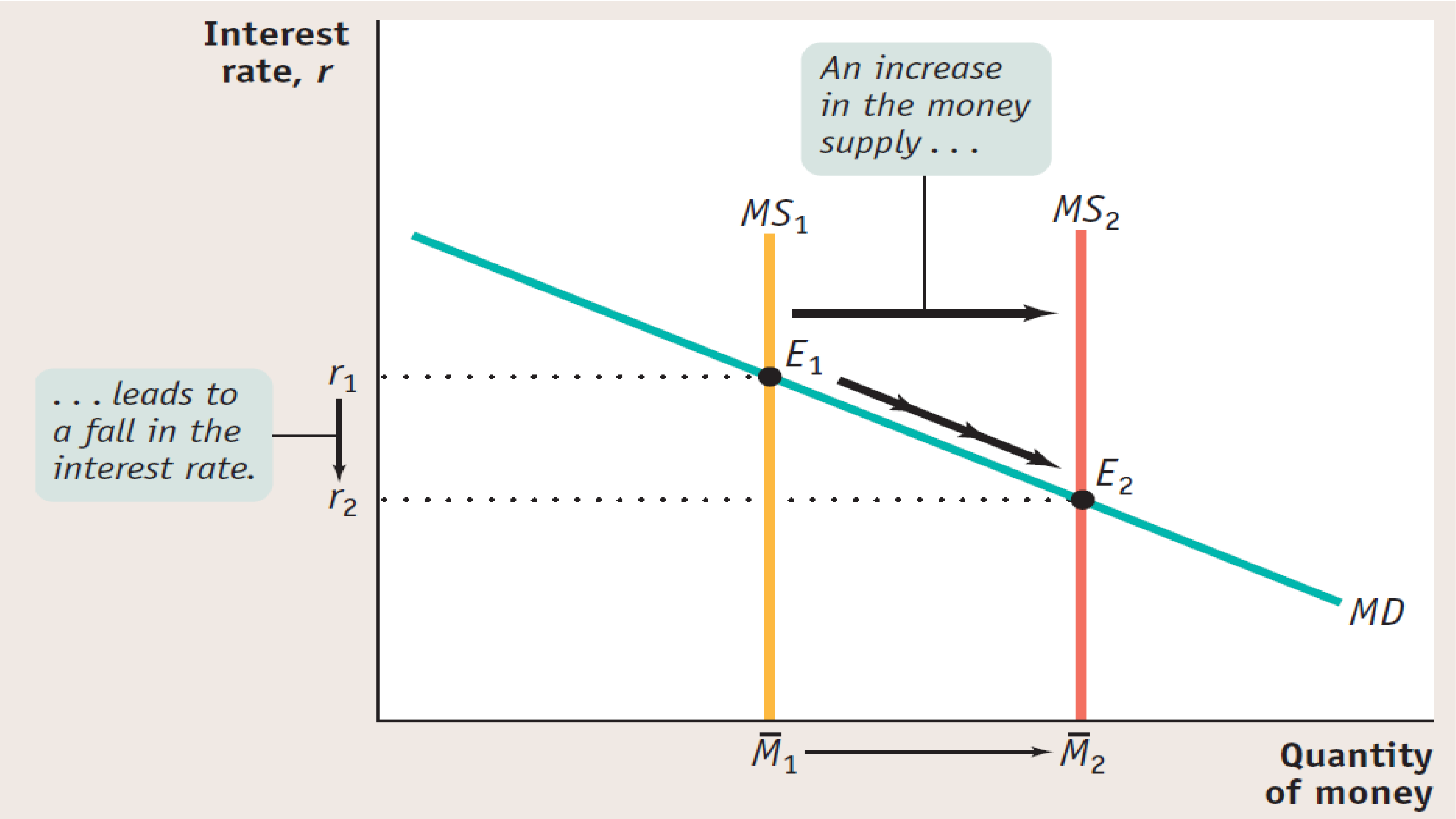
Monetary Policy and the Interest Rate

- By increasing or decreasing the money supply, the Federal Reserve can set the interest rate.

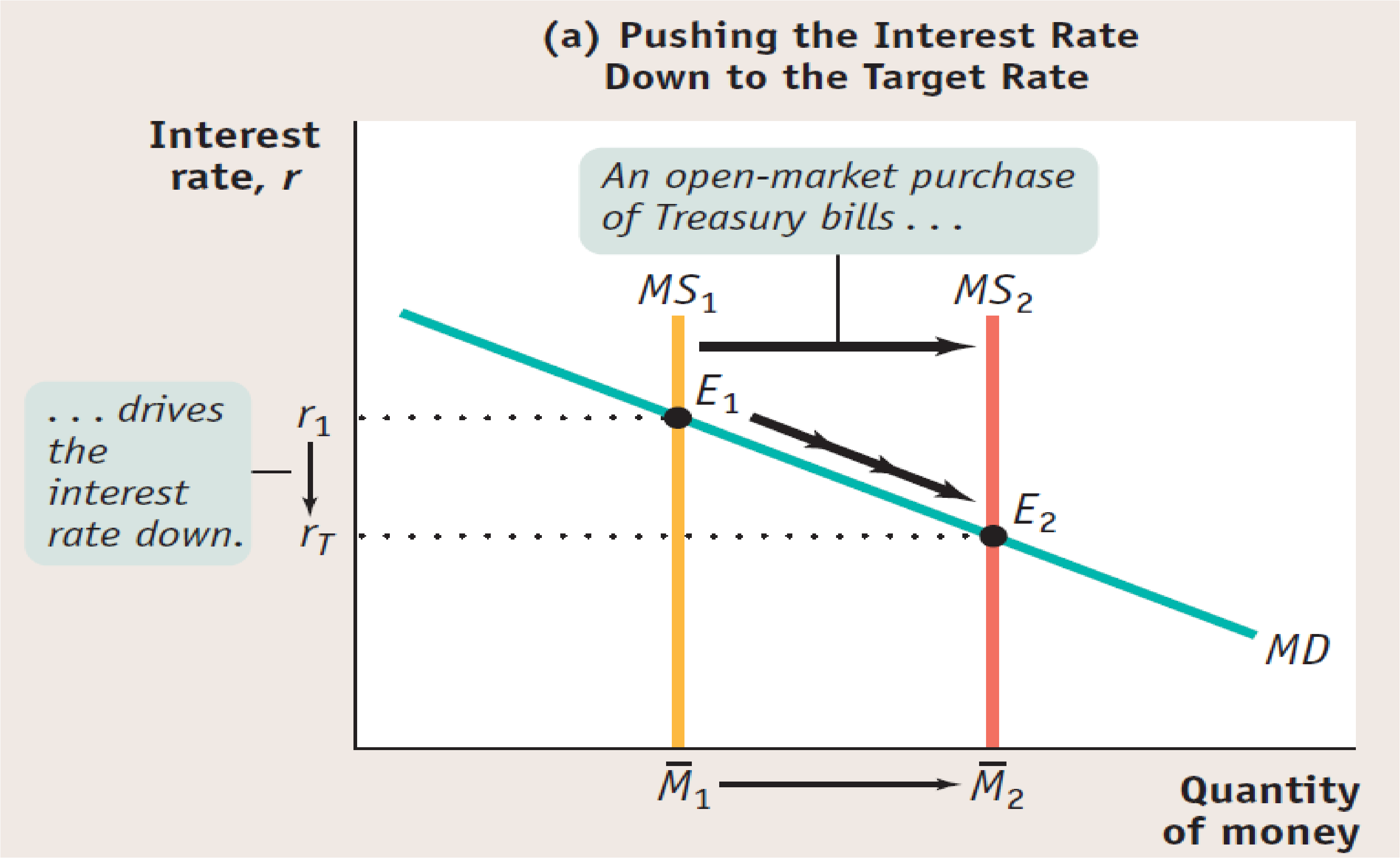
- In practice, the Federal Open Market Committee (FOMC) sets a target federal funds rate.

    - 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



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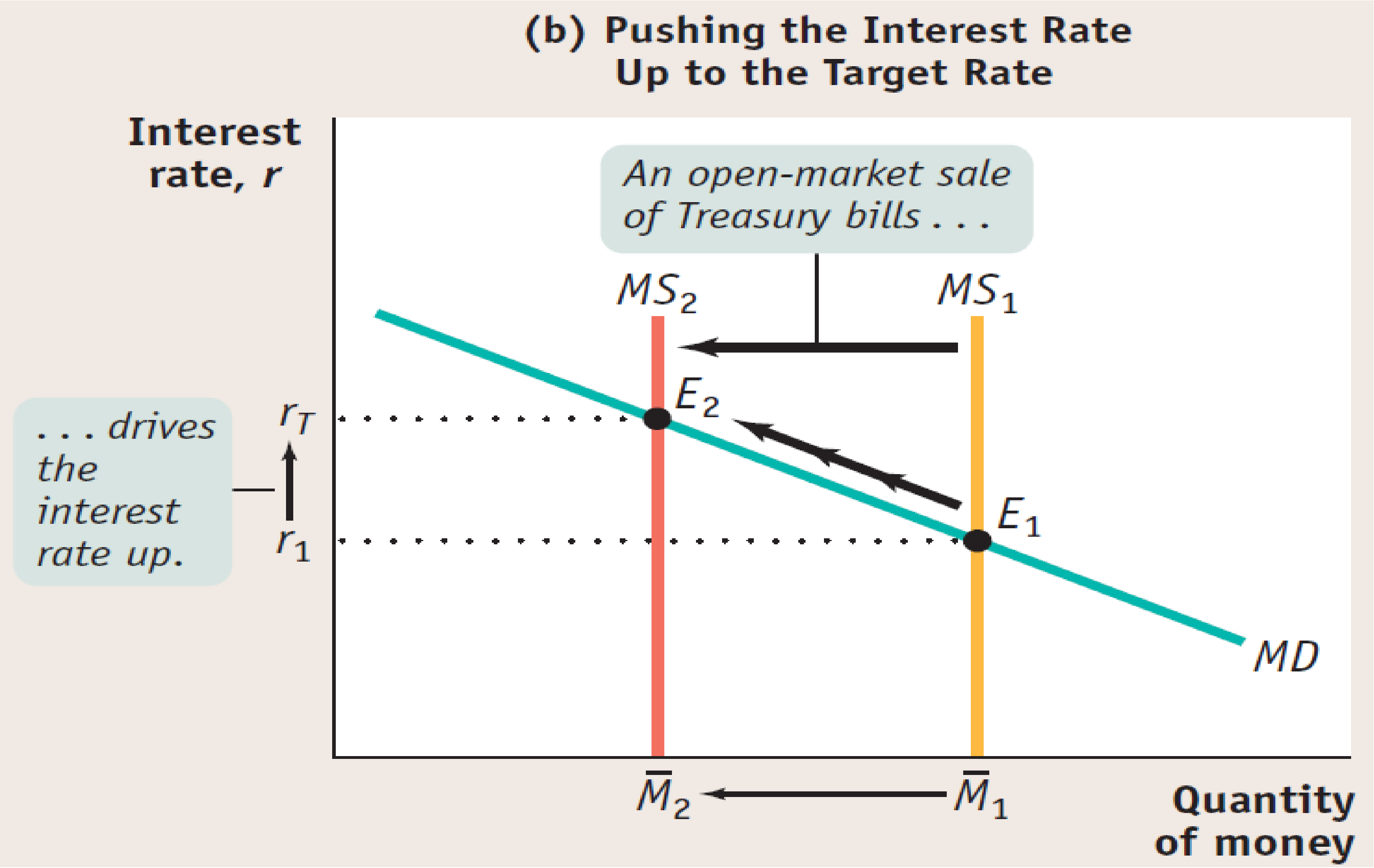

Long-Term Interest Rates

- 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