36 The Federal Reserve and Monetary Policy

37 The Money Market

38 Monetary Policy and the Interest Rate

39 Money, Output, and Prices in the Long Run
Money, Output, and Prices

• Because of its **shorter lags**, monetary policy is generally the policy tool of choice to help stabilize the economy.

• The economy is **self-correcting** in the long run: a demand shock has only a temporary effect on aggregate output.
Monetary Neutrality

• In the long run, changes in the money supply affect the aggregate price level but not real GDP.

• In fact, there is monetary neutrality in the long run. Changes in the money supply have no affect on the real economy in the long run.
The SR and LR Effects of Monetary Policy

An increase in the money supply reduces the interest rate and increases aggregate demand...

...but the eventual rise in nominal wages leads to a fall in short-run aggregate supply and aggregate output falls back to potential output.
Economics in Action

The Long-Run Relationship Between Money and Inflation

Slide 5