

1: Towards More Effective Monetary Policy: Economics Books @ www.enganchecubano.com

Policy Rules as a Means to a More Effective Monetary Policy / John B. Taylor -- 3. Styles of Monetary Management / Tommaso Padoa-Schioppa -- 4. Inflation Control and Monetary Policy Rules / David Laidler -- Comments / Michael Mussa -- 5.

Are you sure you want to delete this answer? Yes Sorry, something has gone wrong. Fiscal policy, taking the scope of budgetary policy, refers to government policy that attempts to influence the direction of the economy through changes in government taxes, or through some spending fiscal allowances. Fiscal policy can be contrasted with the other main type of economic policy, monetary policy, which attempts to stabilize the economy by controlling interest rates and the supply of money. The two main instruments of fiscal policy are government spending and taxation. Changes in the level and composition of taxation and government spending can impact on the following variables in the economy: Fiscal policy is used by governments to influence the level of aggregate demand in the economy, in an effort to achieve economic objectives of price stability, full employment and economic growth. Keynesian economics suggests that adjusting government spending and tax rates are the best ways to stimulate aggregate demand. This can be used in times of recession or low economic activity as an essential tool in providing the framework for strong economic growth and working toward full employment. The government can implement these deficit-spending policies due to its size and prestige and stimulate trade. In theory, these deficits would be paid for by an expanded economy during the boom that would follow; this was the reasoning behind the New Deal. During periods of high economic growth, a budget surplus can be used to decrease activity in the economy. A budget surplus will be implemented in the economy if inflation is high, in order to achieve the objective of price stability. The removal of funds from the economy will, by Keynesian theory, reduce levels of aggregate demand in the economy and contract it, bringing about price stability. Despite the importance of fiscal policy, a paradox exists. In the case of a government running a budget deficit, funds will need to come from public borrowing the issue of government bonds, overseas borrowing or the printing of new money. When governments fund a deficit with the release of government bonds, an increase in interest rates across the market can occur. This is because government borrowing creates higher demand for credit in the financial markets, causing a higher aggregate demand AD due to the lack of disposable income, contrary to the objective of a budget deficit. This concept is called crowding out. Alternatively, governments may increase government spending by funding major construction projects. This can also cause crowding out because of the lost opportunity for a private investor to undertake the same project. However, the effects of crowding out are usually not as large as the increase in GDP stemming from increased government spending. Another problem is the time lag between the implementation of the policy and detectable effects in the economy. An expansionary fiscal policy decreased taxes or increased government spending is usually intended to produce an increase in aggregate demand; however, an unchecked spiral in aggregate demand will lead to inflation. Hence, checks need to be kept in place. Monetary policy is the process by which the government, central bank, or monetary authority of a country controls i the supply of money, ii availability of money, and iii cost of money or rate of interest, in order to attain a set of objectives oriented towards the growth and stability of the economy. Monetary policy is generally referred to as either being an expansionary policy, or a contractionary policy, where an expansionary policy increases the total supply of money in the economy, and a contractionary policy decreases the total money supply. Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy involves raising interest rates in order to combat inflation. Monetary policy should be contrasted with fiscal policy, which refers to government borrowing, spending and taxation. Differences in the Effectiveness of Monetary and Fiscal Policies When the economy is in a recession when business and consumer confidence is very low and perhaps where deflationary pressures are taking hold monetary policy may be ineffective in increasing current national spending and income. The problems experienced by the Japanese in trying to stimulate their economy through a zero-interest rate policy might be mentioned here. In this case, fiscal policy might be more effective in stimulating demand. Other economists

disagree – they argue that short term changes in monetary policy do impact quite quickly and strongly on consumer and business behaviour. Consider the way in which domestic demand in both the United States and the UK has responded to the interest rate cuts introduced in the wake of the terror attacks on the USA in the autumn of 2001. However, there may be factors which make fiscal policy ineffective aside from the usual crowding out phenomena. Future-oriented consumption theories hold that individuals undo government fiscal policy through changes in their own behaviour – for example, if government spending and borrowing rises, people may expect an increase in the tax burden in future years, and therefore increase their current savings in anticipation of this. Differences in the Lags of Monetary and Fiscal Policies Monetary and fiscal policies differ in the speed with which each takes effect the time lags are variable Monetary policy in the UK is extremely flexible rates can be changed each month and emergency rate changes can be made in between meetings of the MPC, whereas changes in taxation take longer to organize and implement. Because capital investment requires planning for the future, it may take some time before decreases in interest rates are translated into increased investment spending. Typically it takes six months – twelve months or more before the effects of changes in UK monetary policy are felt. The impact of increased government spending is felt as soon as the spending takes place and cuts in direct and indirect taxation feed through into the economy pretty quickly. However, considerable time may pass between the decision to adopt a government spending programme and its implementation. In recent years, the government has undershot on its planned spending, partly because of problems in attracting sufficient extra staff into key public services such as transport, education and health. Problems with the use of active "demand-management" policies 1 The measurement of output: Where are we in the cycle? Where are we going? Will we know when we get there? Inaccuracies in estimating the possible trade-offs in macroeconomic policy 2 Time lags in the policy process:

2: The role of fiscal and monetary policies in the stabilisation of the economic cycle

with respect to monetary policy, the implementation of which constitutes one of the principal functions of a central bank. This year's conference is entitled "Towards More Effective Monetary Policy".

Effectiveness of Monetary Policy and Fiscal Policy Article Shared by The below mentioned article provides notes on effectiveness of monetary policy and fiscal policy. Effectiveness of Monetary Policy: It is important to explain to what extent monetary policy is effective in influencing level of national output. Transmission of changes in money supply, say through open market operations, runs as follows, In the first step increase in money supply following the expansionary monetary policy leads to the fall in rate of interest. In the second step of transmission mechanism, fall in rate of interest causes increase in total spending or aggregate demand especially, investment expenditure. Finally, the aggregate output adjusts to the changes in aggregate demand. However, some linkages in transmission process of the effect of changes in money supply may not work. First, the change in money supply may not lead to a change in rate of interest. Keynes pointed out that the liquidity trap may occur at a very low interest rate and prevents the fall in rate of interest following the expansion in money supply. The liquidity trap is a situation in which the public is prepared at a given rate of interest to hold whatever money is supplied. In this case demand for money is perfectly elastic and LM curve is a horizontal straight line, with a horizontal LM curve, the increase in money supply does not cause a shift in it and therefore does not affect the rate of interest. With rate of interest remaining unaffected, the expansion in money supply, say through open market operations, will not affect the aggregate spending both consumption and investment demand. With no change in aggregate demand on spending, the level of national output will remain unchanged. The effect of increase in money supply on aggregate output in case of horizontal LM curve is a bit complicated to show diagrammatically through IS-LM curve model. However, the ineffectiveness of monetary policy in case of the liquidity trap situation can be easily understood if we take the case of relatively flat LM curve which can be considered as proxy for completely horizontal LM curve caused by liquidity trap. This is depicted in Fig. With the given IS curve the new equilibrium is at point B. It will be seen from the new equilibrium at point B that the interest rate falls only slightly and as a result real national income hardly increases to have any impact on the recessionary conditions. The second factor causing ineffectiveness of monetary policy occurs in the third step of transmission mechanism, namely, changes in aggregate spending or demand in response to changes in interest rate. This happens when changes in rate of interest have insignificant effect on autonomous planned spending, especially investment expenditure. This situation occurs when business firms are so pessimistic about the future prospects of earning profits that they are reluctant to undertake any further investment in response to lower interest rate. As a result, increase in money supply causing lower interest rates does not lead to the increase in real national income. Under these circumstances of unresponsiveness of investment to changes in interest rate the IS curve is a vertical straight line as shown in Figure The third case when monetary policy has only limited effect on investment spending and therefore on real national income occurs when banks are reluctant to increase lending for investment in response to lower interest rate. This happened in the US in and then in and , when global financial crisis occurred. This situation also seems to have occurred in India in following the global financial crisis. In this case when the Central Bank of the US expanded money supply leading to lower interest rate, banks were reluctant to increase lending for the fear that lending might create bad loans with little possibility of being paid back. In the US banks had made bad loans relating to real estate i. Instead of lending for private spending and investment, banks purchased government securities such as treasury bills which are quite safe investment for banks. If due to risk aversion banks do not lend for private investment, the link in transmission mechanism that involves more private investment in response to lower interest rate breaks down to give boost to real national income. In India too, when in the Reserve Bank of India lowered its repo rate and cash reserve ratio CRR for the banks, they were not much enthusiastic for lending to private firms for fear of default by them in repaying the loans. Therefore, to earn some return on their excess cash reserves due to easy monetary policy, some banks opted for investing in government securities beyond what was required under statutory liquidity ratio SLR.

However, both in the US in and and in India in larger cuts in interest rate and expansion in money supply did bring about boost in lending for private investment and consumption for buying durable consumer goods leading to the recovery in the economies. Under the policy of quantitative easing the Federal Reserve has been continuously buying government securities since and pumping into the American economy more money, that is, the US dollars, on a large scale keeping zero rate of interest. This unconventional monetary policy of quantitative easing ultimately seems to have worked in raising the levels of output and employment in the US and thus achieving recovery of the US economy in with rate of unemployment falling to 7.

Effectiveness of Fiscal Policy: Recall that the IS curve describes equilibrium in the goods market. The IS curve slopes downward because as the rate of interest falls investment spending increases causing rise in aggregate demand that leads to the increase in real national income i . Expansionary fiscal policy may be either in the form of increase in government expenditure or cut in taxes. In both these forms of fiscal stimulus, the IS curve shifts to the right. In our previous Fig. This increase in rate of interest causes private investment to fall that is, increase in government expenditure crowds out some private investment. When the LM curve is more steep, that is, when interest responsiveness of demand for money is less, a given increase in government expenditure will have large crowding-out effect as shown in Fig. Now suppose under the expansionary fiscal policy the government increases its expenditure so that there is a shift in the IS1 curve to the right to IS2. A larger income equal to Y_2Y_3 or KH has been wiped out due to crowding-out effect of rise in interest rate on investment. To conclude, in case of lower interest-responsiveness of demand for money expansionary fiscal policy is not very effective in bringing about a sufficient increase in real national income. Note that contrary to Figure In this case of horizontal LM curve shown in Fig. As will be seen from Figure It may however be noted that the horizontal LM curve depicting liquidity trap in the demand for money in which case there is no crowding out effect of fiscal stimulus is an extreme case that may occur when there is severe depression in the economy. Expansionary fiscal policy, that is, increase in government expenditure or cut in taxes has no effect on the level of real income when the LM curve is vertical, that is, interest- responsiveness of demand for money is zero. As a result, level of national income remains unaffected. Thus, with a vertical LM curve i . This is shown in Fig. Initially, the IS1 curve intersects the vertical LM curve so that in equilibrium rate of interest is r_1 and real national income is Y_1 . Now suppose the government adopts expansionary fiscal policy and increases its expenditure shifting the IS curve to IS2. In this new equilibrium situation rate of interest has risen from r_1 to r_2 , the level of real national income remains unchanged at Y_1 . This means rise in interest rate has completely wiped out the expansionary effect on the level of real national income by crowding out private investment. In this case crowding-out of private investment equals the increase in government expenditure times its multiplier i . Numerous historical episodes show that the crowding-out effect is neither complete nor full, nor is it non-existent, it is only partial as shown in the Figure Whether crowding out is zero, complete or partial depends on the interest- responsiveness of demand for money, that is, slope of the LM curve. We have seen above that the increase in real national income i . Three points are worth considering about the effect of fiscal stimulus on real national income. First, in our analysis of IS-LM curves model, we have assumed that prices remain constant and the existing level of aggregate output i . In this situation there is a scope for increase in output or real national income and therefore when the government expands its expenditure causing increase in aggregate demand, the firms increase their output and employment. In this case the magnitude of fiscal multiplier is quite large. However, in a fully employed economy crowding out of fiscal stimulus occurs through a different route. When there is full employment in the economy, increase in aggregate demand leads to the rise in price level as the economy moves up along an upward-sloping short-run aggregate supply curve. The reduction in money supply shifts the LM curve to the left raising the interest rate to rise until the initial increase in aggregate demand as a result of expansion in government expenditure is fully wiped out. This case is depicted in Fig. Now, the increase in government expenditure causes IS curve to shift to the right IS2, the economy moves to point E2. Since with a shift in IS curve to IS2 aggregate demand increases along an upward sloping short-run aggregate supply curve, this will lead to the rise in price level resulting in decline in real money supply. This decline in real money supply will bring about a leftward shift in the LM curve to the left to LM2 position and raise the interest rate to r_2 so that the initial increase in national income is fully crowded

out. As a result, expansionary fiscal policy fails to raise level of real national income and has therefore zero multiplier effect. The second case occurs when there is unemployment of resources in the economy and the LM curve slopes upward to the right. In this case fiscal stimulus through increase in government expenditure will raise interest rate but level of real national income will also increase. Due to unemployment resources, there will not be much increase in price level when aggregate demand increases. As a result, crowding-effect of fiscal stimulus is only partial, and there is net increase in national income. Therefore, in this case there is some multiplier effect of expansionary fiscal policy though it is less than the Keynesian multiplier effect i . With the given LM curve and the new IS2 curve the new equilibrium is reached at point E2 and, as will be seen from the Figure However, there is further effect of expansionary fiscal policy. This increase in saving enables the economy to finance a large budget deficit with smaller amount of government borrowing which would ensure interest rate will not rise much and as a result crowding-out effect of expansionary fiscal policy on private investment will be smaller. The third case occurs when there is unemployment in the economy so that there is possibility of increases in output as a result of increase in aggregate demand. In this case interest rate need not rise when there is increase in government spending shifting IS curve to the right but at the same time the Central Bank of the country raises the money supply to prevent the rise in interest as a result of increase in government spending. This is called monetary accommodation by the Central Bank. In this case of sufficient monetary accommodation, rate of interest does not rise, and therefore there is no crowding-out effect on private investments, the expansionary fiscal policy brings about increase in national income equal to increase in government expenditure times the Keynesian multiplier i . This case of monetary accommodation of fiscal expansion is depicted in Fig. Now, fiscal stimulus by the government shifts the IS curve to IS2 and given the LM1 curve, equilibrium will be at point E2 where rate of interest rises to r_2 which would crowd out private investment. To prevent this crowding out, the Central Bank adopts the monetary accommodation policy and for this it increases money supply sufficiently so that LM curve shifts to the right to LM2 which intersects IS2 curve at point E3 so that interest remains at the initial level r_1 and income increases to Y_2 . Thus the increase in income equal to $E_1 E_3$ or $Y_1 Y_2$ that occurs equals the increase in government expenditure times the Keynesian multiplier i . It may be noted that in and when due to global financial crisis, India faced the problem of large slowdown of the economy, the Indian government adopted fiscal stimulus measures such as raising its expenditure through borrowing on a large scale from the market and cut rates of many indirect taxes to prevent sharp slowdown of the Indian economy, the Reserve Bank of India adopted accommodative monetary policy so that rate of interest does not rise. To this end, the RBI greatly reduced its repo rate the ratio at which it lends to the commercial banks and also lowered the cash reserve ratio CRR of the banks so that more funds are available with them to lend to the business firms for investment and consumption purposes, such as housing loans, car loans at lower rate of interest. This policy succeeded and India achieved 6.

3: The Fed - Monetary Policy: Monetary Policy Report

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Monetary Policy The government influences investment, employment, output and income through monetary policy. This is done by increasing or decreasing the money supply by the monetary authority. When the money supply is increased, it is an expansionary monetary policy. This is shown by shifting the LM curve to the right. When the money supply is decreased, it is a contractionary monetary policy. This is shown by shifting the LM curve to the left. Figure 1 illustrates an expansionary monetary policy with given LM and IS curves. Thus the national income rises from OY to OY1. But the relative effectiveness of monetary policy depends on the shape of the LM curve and the IS curve. Monetary policy is more effective if the LM curve is steeper. A steeper LM curve means that the demand for money is less interest elastic. The less interest elastic is the demand for money, the larger is the fall in interest rate when the money supply is increased. The more interest elastic is the demand for money, the smaller is the fall in interest rate when the money supply is increased. A small fall in the interest rate leads to a smaller increase in investment and income. This shows that monetary policy is less effective in the case of the flatter LM curve and more effective in the case of the steeper curve. If the LM curve is horizontal, monetary policy is completely ineffective because the demand for money is perfectly interest elastic. On the other hand, if the LM curve is vertical, monetary policy is highly effective because the demand for money is perfectly interest inelastic. Figure 4 shows that when the vertical LM curve shifts to the right to LM with the Increase in the money supply, the interest rate falls from OR to OR1 which has no effect on the demand for money and the entire increase in the money supply has the effect of raising the income level from OY to OY1. NOW take the slope of the IS curve. If we compare this equilibrium position 2 with the E1 position where the curve ISs is steeper, the interest rate OR1 and the income level OY1 are lower than the interest rate and income level of the flatter ISF curve. With the increase in the money supply, the LM curve shifts to the right to LM1 in Figure 6, the interest rate falls from OR to OR1 but investment being completely interest inelastic, the income remains unchanged at OY. Figure 7 shows that with the increase in the money supply, the LM curve shifts to LM1. But even with no change in the interest rate OR, there is a large change in income from OY to OY1 This makes monetary policy highly effective. Fiscal Policy The government also influences investment, employment, output and income in the economy through fiscal policy. This shifts the IS curve to the right. This shifts the IS curve to the left. Figure 8 illustrates an expansionary fiscal policy with given IS and LM curves. This raises the national income from OY to OY1. The rise in the national income increases the demand for money, given the fixed money supply. This, in turn, raises the interest rate from OR to OR1. The increase in the interest rate tends to reduce private investment expenditure at the same time when the government expenditure is being increased. If the interest rate had not changed with the increase in government expenditure, income would have risen to OY1 level. But the actual increase in income has been less by Y2Y1 due to the increase in the interest rate to OR1 which has reduced private investment expenditure. The opposite happens in a contractionary fiscal policy. The relative effectiveness of fiscal policy depends on the slope of the LM curve and the IS curve. Fiscal policy is more effective, the flatter is the LM curve, and is less effective when the LM curve is steeper. In the case of the steeper curve LMs, the increase in income to OY1 leads to a large rise in the demand for money which raises the interest rate to a very high level OR1. Consequently, it reduces private investment to a lesser degree and its net effect on national income is relatively large. Fiscal policy is completely ineffective, if the LM curve is vertical. It means that the demand for money is perfectly interest inelastic. This is shown in Figure 10 where the level of income remains unchanged. When the IS curve shifts upwards to IS1, only the interest rate rises from OR to OR1 and increase in government expenditure does not affect national income at all. It remains constant at OY. At the other extreme is the perfectly horizontal LM curve where fiscal policy is fully effective. This situation implies that the demand for money is perfectly interest elastic. When the IS curve shifts to the right to IS1, income rises by the full multiplier of the increase in government expenditure. It rises to OK, but

there is no change in interest rate. Now take the slope of the IS curve. The steeper is the IS curve, the more effective is fiscal policy. The flatter is the IS curve, the less effective is fiscal policy. These two cases are illustrated in Figure 12 where E is the original equilibrium point with OR interest rate and OY income level. The figure shows that the national income increases more with the shifting of the steeper IS curve than in the case of the flatter IS curve. On the other hand, the increase in income is smaller in the case of the flatter IS curve. This is because investment expenditure is more interest-elastic. The increase in the interest rate to OR1 reduces large private investment so that the rise in income is smaller. Thus fiscal policy is more effective, the steeper is the IS curve and is less effective in the case of the flatter IS curve. Fiscal policy is completely ineffective, if the IS curve is horizontal. An horizontal IS curve means that investment expenditure is perfectly interest elastic. An increase in government expenditure has no effect on the interest rate OR and hence on the income level OY. Such a situation is not likely to be in practice. On the other extreme is the vertical IS curve which makes fiscal policy highly effective. This makes fiscal policy highly effective. Three Range Analysis Economists have explained the effectiveness of monetary and fiscal policies in three ranges in order to reconcile the extremes of the Keynesian and monetarist or classical views. The LM curve slopes upward to the right and has three segments, as shown in Figure Starting from the left it is perfectly elastic. At the other extreme to the right, the LM curve is perfectly inelastic. The Keynesian range represents the fiscalist or Keynesian view, the classical range the monetarist view, and the intermediate range the synthesist view. We take expansionary monetary and fiscal policies in order to explain their effectiveness which depends upon the extent to which they affect the level of income and the rate of interest in the Keynesian, the classical and the intermediate ranges. They, in turn, are determined by the responsiveness of the demand for money to changes in the interest rate. The LM2 curve emerges after an increase in the money supply. First, consider the Keynesian range where the LM curve is perfectly elastic. The normal case has already been explained in Figure 3. This is the Keynesian liquidity trap situation in which the LM curve is horizontal, and the interest rate cannot fall below OR1. This shift in the curve has no effect on the rate of interest. Consequently, investment is not affected at all so that the level of income remains unchanged at OY1. This is because at a very low rate of interest such as OR1, people prefer to keep money in cash rather than in bonds or securities in the hope of converting it into bonds when the interest rate rises. Thus under the Keynesian assumption of the liquidity trap, the horizontal portion of the LM curve is not affected by an increase in the money supply. The IS curve intersects the LM curve in the flat range at A with little effect on the interest rate, and consequently on investment and income. The Classical or Monetarist Range: Consider the classical range where LM curve is perfectly inelastic. The normal case has already been explained in terms of Figure 4. The increase in money supply shifts the LM1 curve to the right to LM2 position. The increase in the income level and fall in the interest rate as a result of the increase in the money supply is based on the classical assumption that money is primarily a medium of exchange. When the central bank buys securities in the market, the security prices are bid up and the rate of interest falls. The wealth holders then find other assets more attractive than securities. They, therefore, invest the increased cash holdings in new or existing capital investments which, in turn, raise the level of income. Consequently, the interest rate will continue to fall and investment will continue to rise until the excess money balances are absorbed in such transactions. Ultimately, the equilibrium level of income rises by the full amount of the increase in the money supply. Thus the monetary policy is highly effective in the classical range when the economy is at high levels of income and interest rate and utilises the entire increase in the money supply for transactions purposes thereby raising national income by the full increase in the money supply. Now consider the intermediate range when the initial equilibrium is at where the IS2 curve intersects the LM1 curve, and the income level is OY2 and the interest rate is OR1. The increase in the money supply shifts the LM1 curve to LM2 position. As a result, the new equilibrium is established at point where the IS2 curve crosses the LM2 curve. But in the intermediate case, the increased money supply is partly absorbed for speculative purposes and partly for transactions purposes. That which is held for speculative purposes is not invested by wealth holders and remains with them in the form of idle balances. This has the effect of raising the income level by less than the increase in the money supply. Thus in the intermediate range monetary policy is less effective than in the classical range. Fiscal Policy Fiscal policy is explained in Figure

16 in which the three range LM curve is taken along with six IS curves that arise after increase in government expenditure in the case of the Keynesian, intermediate and classical ranges. The normal case has already been explained in Figure. Suppose the government expenditure is increased.

4: Economic stabilization :Monetary Policy, Fiscal Policy and Direct Controls

This volume contains papers prepared for the Bank of Japan's Seventh International Conference which explore the operational and institutional framework for effective monetary policy implementation against the background of recent developments in economics and central banking practice.

Monetary policy involves the management of the money supply and interest rates by central banks. To stimulate a faltering economy, the central bank will cut interest rates, making it less expensive to borrow while increasing the money supply. Fiscal policy determines the way in which the central government earns money through taxation and how it spends money. There is much debate as to whether monetary policy or fiscal policy is the better economic tool, and each policy has pros and cons to consider. Some central banks are tasked with targeting a particular level of inflation. As a result, many central banks, including the Federal Reserve, are operated as independent agencies. Raising the prevailing risk-free interest rate will make money more expensive and increase borrowing costs, reducing the demand for cash and loans. Economists of the Monetarist school adhere to the virtues of monetary policy. If these traditional measures fall short, central banks can undertake unconventional monetary policies such as quantitative easing QE. Interest Rate Targeting Controls Inflation A small amount of inflation is healthy for a growing economy as it encourages investment in the future and allows workers to expect higher wages. By raising the target interest rate, investment becomes more expensive and works to slow economic growth a bit. The Risk of Hyperinflation When interest rates are set too low, over-borrowing at artificially cheap rates can occur. This can then cause a speculative bubble, whereby prices increase too quickly and to absurdly high levels. Adding more money to the economy can also run the risk of causing out-of-control inflation due to the premise of supply and demand: Often, just signaling their intentions to the market can yield results. Effects Have a Time Lag Even if implemented quickly, the macro effects of monetary policy generally occur after some time has passed. The effects on an economy may take months or even years to materialize. Central Banks Are Independent and Politically Neutral Even if a monetary policy action is unpopular, it can be undertaken before or during elections without the fear of political repercussions. Keeping rates very low for prolonged periods of time can lead to a liquidity trap. This tends to make monetary policy tools more effective during economic expansions than recessions. Weakening the Currency Can Boost Exports Increasing the money supply or lowering interest rates tends to devalue the local currency. A weaker currency on world markets can serve to boost exports as these products are effectively less expensive for foreigners to purchase. The opposite effect would happen for companies that are mainly importers, hurting their bottom line. Monetary Tools Are General and Affect an Entire Country Monetary policy tools such as interest rate levels have an economy-wide impact and do not account for the fact some areas in the country might not need the stimulus, while states with high unemployment might need the stimulus more. A tight, or restrictive fiscal policy includes raising taxes and cutting back on federal spending. A loose or expansionary fiscal policy is just the opposite and is used to encourage economic growth. Can Create Budget Deficits A government budget deficit is when it spends more money annually than it takes in. If spending is high and taxes are low for too long, such a deficit can continue to widen to dangerous levels. Can Use Taxation to Discourage Negative Externalities Taxing polluters or those that overuse limited resources can help remove the negative effects they cause while generating government revenue. Short Time Lag The effects of fiscal policy tools can be seen much quicker than the effects of monetary tools. May Be Politically Motivated Raising taxes is unpopular and can be politically dangerous to implement. The Bottom Line Monetary and fiscal policy tools are used in concert to help keep economic growth stable with low inflation, low unemployment, and stable prices. Unfortunately, there is no silver bullet or generic strategy that can be implemented as both sets of policy tools carry with them their own pros and cons. Used effectively however, the net benefit is positive to society, especially in stimulating demand following a crisis. Trading Center Want to learn how to invest? Get a free 10 week email series that will teach you how to start investing. Delivered twice a week, straight to your inbox.

5: Education | What is the Fed: Monetary Policy

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Recent Economic and Financial Developments Part 2: Monetary Policy Part 3: Summary of Economic Projections Abbreviations Summary Monetary Policy Report submitted to the Congress on February 23, , pursuant to section 2B of the Federal Reserve Act Economic activity increased at a solid pace over the second half of , and the labor market continued to strengthen. With the federal funds rate rising toward more normal levels, at its September meeting, the FOMC decided to initiate a program of gradually and predictably reducing the size of its balance sheet. Economic and Financial Developments The labor market. The labor market has continued to strengthen since the middle of last year. Payroll employment has posted solid gains, averaging , per month in the seven months starting in July , about the same as the average pace in the first half of Although net job creation last year was slightly slower than in , it has remained considerably faster than what is needed, on average, to absorb new entrants into the labor force. The unemployment rate declined from 4. Other measures of labor utilization also suggest that the labor market has tightened since last summer. Nonetheless, wage growth has been moderate, likely held down in part by the weak pace of productivity growth in recent years. The price index for personal consumption expenditures increased 1. The month measure of inflation that excludes food and energy items so-called core inflation , which historically has been a better indicator of where overall inflation will be in the future than the headline figure, was 1. However, monthly readings on core inflation were somewhat higher during the last few months of than earlier in the year. Measures of longer-run inflation expectations have, on balance, been generally stable, although some measures remain low by historical standards. Real gross domestic product GDP is reported to have increased at an annual rate of nearly 3 percent in the second half of after rising slightly more than 2 percent in the first half. Consumer spending expanded at a solid rate in the second half, supported by job gains, rising household wealth, and favorable consumer sentiment. Business investment growth was robust, and indicators of business sentiment have been strong. The housing market has continued to improve slowly. Foreign activity remained solid and the dollar depreciated further in the second half, but net exports subtracted from real U. GDP growth as imports of consumer and capital goods surged late in the year. Financial conditions for businesses and households have eased on balance since the middle of amid an improving global growth outlook. Notwithstanding financial market developments in recent weeks, broad measures of equity prices are higher, and spreads of yields on corporate bonds over those of comparable-maturity Treasury securities have narrowed. Most types of consumer loans remained widely available, though credit was still difficult to access in credit card and mortgage markets for borrowers with low credit scores or harder-to-document incomes. Longer-term nominal Treasury yields and mortgage rates have moved up on net. The dollar depreciated, on average, against the currencies of our trading partners. In foreign financial markets, equity prices generally increased in the second half of , and most of those indexes remain higher, on net, despite recent declines. Most longer-term yields rose noticeably. Vulnerabilities in the U. Valuation pressures continue to be elevated across a range of asset classes even after taking into account the current level of Treasury yields and the expectation that the reduction in corporate tax rates should generate an increase in after-tax earnings. Leverage in the nonfinancial business sector has remained high, and net issuance of risky debt has climbed in recent months. In contrast, leverage in the household sector has remained at a relatively low level, and household debt in recent years has expanded only about in line with nominal income. Monetary Policy Interest rate policy. The FOMC continued to gradually increase the target range for the federal funds rate. The decision to increase the target range for the federal funds rate reflected the solid performance of the economy. Even with this rate increase, the stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation. The FOMC expects that, with further gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market conditions will remain strong. The federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, as the Committee has continued to emphasize, the

actual path of the federal funds rate will depend on the economic outlook as informed by incoming data. In particular, with inflation having persistently run below the 2 percent longer-run objective, the Committee will carefully monitor actual and expected inflation developments relative to its symmetric inflation goal. In the second half of , the Committee initiated the balance sheet normalization program that is described in the Addendum to the Policy Normalization Principles and Plans the Committee issued in June. Special Topics

How tight is the labor market? Although there is no way to know with precision, the labor market appears to be near or a little beyond full employment at present. The unemployment rate is somewhat below most estimates of its longer-run normal rate, and the labor force participation rate is relatively close to many estimates of its trend. Although employers report having more difficulties finding qualified workers, hiring continues apace, and serious labor shortages would likely have brought about larger wage increases than have been evident to date. Resource slack and commodity prices--as well as, for the United States, movements in the U. But our understanding is imperfect, and other, possibly more persistent, factors may be at work. Resource slack at home and abroad might be greater than it appears to be, or inflation expectations could be lower than suggested by the available indicators. Moreover, some observers have pointed to increased competition from online retailers or international developments--such as global economic slack or the integration of emerging economies into the world economy--as contributing to lower inflation. Policymakers remain attentive to the possibility of such forces leading to continued low inflation; they also are watchful regarding the opposite risk of inflation moving undesirably high. They also routinely consult monetary policy rules that connect prescriptions for the policy interest rate with variables associated with the dual mandate. The use of such rules requires careful judgments about the choice and measurement of the inputs into these rules as well as the implications of the many considerations these rules do not take into account. The Committee seeks to explain its monetary policy decisions to the public as clearly as possible. Such clarity facilitates well-informed decisionmaking by households and businesses, reduces economic and financial uncertainty, increases the effectiveness of monetary policy, and enhances transparency and accountability, which are essential in a democratic society. Inflation, employment, and long-term interest rates fluctuate over time in response to economic and financial disturbances. Moreover, monetary policy actions tend to influence economic activity and prices with a lag. The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee would be concerned if inflation were running persistently above or below this objective. The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. The Committee considers a wide range of indicators in making these assessments. These objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate. The Committee intends to reaffirm these principles and to make adjustments as appropriate at its annual organizational meeting each January.

6: Monetary policy is largely ineffective | Bill Mitchell – Modern Monetary Theory

We study the design of monetary policy in a low inflation environment taking into account the limitations imposed by the zero bound on nominal interest rates. Using numerical dynamic programming methods, we compute optimal policies in a simple, calibrated openeconomy model and evaluate the effect of the liquidity trap generated by the zero bound.

Recall that monetary policy, the toolbox of the Fed, includes performing open market operations, and changing both the reserve requirement and the federal funds interest rate. Recall also that fiscal policy, the toolbox of the government, includes changing both taxes and government spending. All of these tools can be controlled actively. That is, if the Fed or the government decide to use expansionary policy, they can simply select a tool from the policy toolbox and use it. In this way, active policy is defined as actions by the Fed or by the government that are done in response to economic conditions. That is, the Fed or the government choose to respond to something in the economy by undertaking a specific policy. This is also called discretionary policy. Active policy, while simple, is open to a number of difficulties. Because it relies on the actions and experiences of the policymakers in the Fed and in the government, the weaknesses or prejudices of these policymakers can be translated into official economic policy. For instance, during election years, a central banker may pursue policy that enables the economy to grow in the short run, regardless of the long-term effects, in order to help a candidate. On the other hand, the central banker may contract the economy to hurt a candidate. Similarly, it would be possible for the policymakers to pursue policies that achieve their selfish ends rather than those that are best for the economy at large. Finally, with active policy, policymakers can say one thing and do another. There may be benefits to making the public believe that something different is occurring in the economy rather than what actually is occurring. For instance, if the Fed wants to increase investment, it could use deception by claiming that it raised interest rates while not actually doing so. In this scenario, private investors would save more but investment would remain at the old level or even increase. Thus, it is reasonable to claim that active policy leaves monetary policy and fiscal policy open to not only accidental human error but also to malicious and self-serving acts. But there are some advantages to active policy. Active policy allows policymakers to respond to shifts in a complex economy and steer the economy in the optimal direction. For instance, an excellent policymaker may be able to keep the economy growing steadily without inflation if she is given complete control of macroeconomic policy. Similarly, active policy, at least in theory, gives control to those individuals who are considered optimally capable to deal with the fluctuations in the economy. That is, active policy allows the sharpest policymakers of the time to control the economy. Finally, the ability to create different expectations between the policymakers and the public can be an advantageous policy tool, as described in the previous paragraph. Passive policy In contrast to active or discretionary policy is passive policy or policy by rule. Under this system, macroeconomic policy is conducted according to a preset series of rules. These rules take into account many macroeconomic variables and dictate the best course of action given these conditions. For instance, a passive policy may follow the rule that in order to stabilize the economy the interest rate must be dropped one point whenever the nominal GDP falls one percent. The major advantage to passive policy is that it takes the short-term desires of policymakers out of the list of possible goals of macroeconomic policy. Instead, the policymakers are simply present to carry out the macroeconomic policy and to ensure that everything runs smoothly. Policy by rule uses policymakers to implement, rather than design, macroeconomic policy. Similarly, another advantage of passive policy is that the policy rules are based on optimizing the economy in the long run and are less likely to trade short run prosperity for long run growth.

7: Fiscal Policy vs. Monetary Policy: Pros & Cons | Investopedia

On Making Monetary Policy More Effective Domestically and Internationally / Allan H. Meltzer Policy Rules as a Means to a More Effective Monetary Policy / John B. Taylor -- 3. Styles of Monetary Management / Tommaso Padoa-Schioppa -- 4.

The most commonly advocated policy of solving the problem of fluctuations is monetary policy. Monetary policy pertains to banking and credit, availability of loans to firms and households, interest rates, public debt and its management, and monetary management. However, the fundamental problem of monetary policy in relation to trade cycles is to control and regulate the volume of credit in such a way as to attain economic stability. During a depression, credit must be expanded and during an inflationary boom, its flow must be checked. Monetary management is the function of the commercial banking system, and through it, its effects are primarily exerted the economy as a whole. Monetary management directly affects the volume of cash reserves of banks, regulates the supply of money and credit in the economy, thereby influencing the structure of interest rates and availability of credit. Both these factors affect the components of aggregate demand consumption plus investment and the flow of expenditures in the economy. It is obvious that an expansion in bank credit causes an increasing flow of expenditure in terms of money and contraction in bank credit reduces it. In the armoury of the central bank, there are quantitative as well as qualitative weapons to control the credit-creating activity of the banking system. They are bank rate, open market operations and reserve ratios. These are interrelated to tools which operate on the reserves of member banks which influence the ability and willingness of the banks to expand credit. Selective credit controls are applied to regulate the extension of credit for particular purposes. We shall now briefly discuss the implications of these weapons. Due to various reasons, the bank rate policy is relatively an ineffective weapon of credit control. That is to say, a rise in the bank rate indicates that the central bank considers that liquidity in the banking system possesses an inflationary potential. It implies that the flow of money and credit is very much in excess of the actual productive capacity of the economy and therefore, a restraint on the expansion of money supply through dear money policy is desirable. On the other hand, a reduction in the bank rate is generally interpreted as an evidence of a shift in the direction of monetary policy towards a cheap and expansive money policy. A reduction in bank rate then is more significant as a symbol of an easy money policy than anything else. However, the bank rate is most effective as an instrument of restraint. Effectiveness of Bank Rate Policy in Expansion: According to Estey, the following difficulties usually arise in the way of an effective discount policy in expansion: During high prosperity, the demand for credit by businessmen may be interest-inelastic. The rising of bank rate and a consequent rise in the market rates of interest may attract loanable funds from the financial intermediaries in the money market and assist in counteracting undesired effects. Though the quantity of money may be controlled by the banking system, the velocity of its circulation is not directly under the influence of banks. Banking policy may determine how much credit there should be but it is the trade which decides how much and how fast it will be used. Thus, if the velocity of the movement is contrary to the volume of credit, banking policy will be rendered ineffective. There is also the difficulty of proper timing in the application of banking policy. Brakes must be applied at the right time and in the right quarter. If they are applied too soon, they must bring expansion to an end with factors of production not fully employed. And when applied too late, there might be a runaway monetary expansion and inflation, completely out of control. The technique of open market operations refers to the purchase and sale of securities by the central bank. Thus, when a large public debt is outstanding, by expanding the securities market, monetary policy and management of the public debt become inseparably intertwined. The monetary authorities have at their disposal another most effective way of influencing reserves and activities of commercial banks and that weapon is a change in cash reserve ratios. Changes in the reserve ratios become effective at a pre-announced date. Their immediate effect is to alter the liquidity position in the banking system. When the cash reserve ratio is raised commercial banks find their existing level of cash reserves inadequate to cover deposits and have to raise funds by disposing liquid assets in the monetary market. The reverse will be the case when the

reserve ratio is lowered. Thus, changes in the reserve ratios can influence directly the cash volume and the lending capacity of the banks. It appears that the bank rate policy, open market operations and changes in reserve ratios exert their influence on the cost, volume and availability of bank reserves through reserves, on the money supply. Selective controls or qualitative credit control is used to divert the flow of credit into and out of particular segments of the credit market. Selective controls aim at influencing the purpose of borrowing. They regulate the extension of credit for particular purposes. The rationale for the use of selective controls is that credit may be deemed excessive in some sectors at a time when a general credit control would be contrary to the maintenance of economic stability. It goes without saying that these various means of credit controls are to be co-ordinated to achieve the goal of economic stability. Effectiveness of Monetary Control: Monetary policy is much more effective in curbing a boom than in helping to bring the economy out of a depressionary state. It has long been recognised that monetary management can always contract the money supply sufficiently to end any boom, but it has little capacity to end a contraction. This is because the actions of monetary management do not directly enter the income-expenditure stream as the most effective contra-cyclical weapon, for their first impact is on the asset structure of financial institutions, and in this process of altering the assets structure, rate of interest, volume of credit and the income-expenditure flow may be altered. All these operate more significantly in restraining the income stream during expansion than in inducing an increase during contraction. However, the greatest advantage of monetary policy is its flexibility. Monetary management makes decisions about the rate of change in the money supplies that are consistent with economic stability and growth on a judgement of given quantitative and qualitative evidences. But, whether this point of monetary policy will prove its effectiveness or not depends on its exact timing. Manipulation of bank rate and open market dealings by the central bank should be reasonably effective if applied quickly and continuously in preventing booms from developing and consequently, into a depression. To sum up, monetary policy is a necessary part of the stabilisation programme but it alone is not sufficient to achieve the desired goal. Monetary policy, if used as a tool of economic stabilisation, in many ways, serves as a complement of fiscal policy. It is strong, whereas fiscal policy is weak. It is flexible and capable of quick alternations to suit the measure of pressures of the time and needs. However, it is to be co-ordinated with fiscal policy. A wrong monetary policy may seriously endanger and even destroy the effectiveness of fiscal policy. Thus, monetary policy and fiscal policy, each reinforcing and supplementing the other, are the essential elements in devising an economic stabilisation programme. Today, foremost among the techniques of stabilisation is fiscal policy. Fiscal policy as a tool of economic stability, however, has received its due importance under the influence of Keynesian economies only since the depression years of the s. Thus, fiscal policy operates through the control of government expenditures and tax receipts. It encompasses two separate but related decisions: The amount of public outlay, the inducement and effects of taxation and the relation between expenditure and revenue exert a significant impact upon the free enterprise economy. Broadly speaking, the taxation policy of the government relates to the programme of curbing private spending. The expenditure policy, on the other hand, deals with the channels by which government spending on new goods and services directly add to aggregate demand and indirectly income through the secondary spending which takes place on account of the multiplier effect. Taxation, on the other hand, operates to reduce the level of private spending on both consumption and investment by reducing the disposable income and the resulting savings in the community. Hence, under the budgetary phenomenon, public expenditure and revenue can be combined in various ways to achieve the desired stimulating or deflationary effect on aggregate demand. Thus, fiscal policy has quantitative as well as qualitative aspect changes in tax rates, the structure of taxation and its incidence influence the volume and direction of private spending in economy. As a matter of fact, all government spending is an inducement to increase the aggregate demand both volume and components and has an inflationary bias in the sense that it releases funds for the private economy which are then available for use in trade and business. Similarly, a reduction in government spending has a deflationary bias and it reduces the aggregate demand its volume and relative components in which the expenditure is curtailed. Thus, the composition of public expenditures and public revenue not only help to mould the economic structure of the country but also exert certain effects on the economy. For maximum effectiveness, fiscal policy should be planned on both long-run and short-run

basis. Long- run fiscal policy obviously is concerned with the long- run trends in government income and spendings. Within the framework of such a long-range plan of fiscal operations, the budget can be made to vary cyclically in order to moderate the short-run economic fluctuations. Basically two sets of techniques can be employed for planning the desired flexibility in the relation between tax revenue and expenditure: The operation of a fiscal policy is always confronted with the problem of timing and forecast. A fiscal policy administrator has always to face the question: When to do what? But it is a very difficult and complex question to answer. Thus, in order to minimise the difficulties that arise from uncertainties of forecasting and timing of fiscal operations, an automatic stabiliser programme is often advocated. Automatic stabiliser programme implies that in a given framework of expenditure and revenue relation in a budgetary policy, there exist factors which provide automatically corrective influences on movements in national income, employment, etc. This is what is called built-in flexibility. It refers to a passive budgetary policy. The essence of built-in flexibility is that i with a given set of tax rates tax yields will vary directly with national income, and ii there are certain lines of government expenditures which tend to vary inversely with movements in national income. Thus, when the national income rises, the existing structure of taxes and expenditures tend to automatically increase public revenue relative to expenditure, and to increase expenditures relative to revenue when the national income falls. These changes tend to mitigate or offset inflation or depression at least partially. Thus, a progressive tax structure seems to be the best automatic stabiliser. Likewise, certain kinds of government expenditure schemes like unemployment compensation programmes, government subsidies or price-support programmes also offset changes in income by varying inversely with movements in national income. However, automatic stabilisers are not a panacea for economic fluctuations, since they operate only as a partial offset to changes in national income, but provide a force to reverse the direction of the change in the income. They slow down the rate of decline in aggregate income but contain no provision for restoring income to its former level. Thus, they should be recognised as a very useful device of fiscal operations but not the only device. Simultaneously, there should be scope for discretionary policies as the circumstances will call for. Quite often, it becomes absolutely necessary to have fiscal operations with a tool kit of discretionary policies consisting of measures for putting into effect with a minimum delay, the changes in government expenditures. This calls for a skeleton of public works projects providing for administrative discretion to employ them and the funds to put them into effect. It calls for a budgetary manipulation an active budget policy constituting flexible tax rates and expenditures. There can be three ways of discretionary changes in tax rates and expenditures: In general, the first method is probably superior to the second during a depression.

8: A Look At Fiscal And Monetary Policy | Investopedia

The relative effectiveness of monetary and fiscal policy has been the subject of controversy among economists. The monetarists regard monetary policy more effective than fiscal policy for economic stabilisation. On the other hand, the Keynesians hold the opposite view. In between these two extremes.

There are two powerful tools our government and the Federal Reserve use to steer our economy in the right direction: When used correctly, they can have similar results in both stimulating our economy and slowing it down when it heats up. The ongoing debate is which one is more effective in the long and short run. Fiscal policy is when our government uses its spending and taxing powers to have an impact on the economy. The combination and interaction of government expenditures and revenue collection is a delicate balance that requires good timing and a little bit of luck to get it right. The direct and indirect effects of fiscal policy can influence personal spending, capital expenditure, exchange rates, deficit levels and even interest rates, which are usually associated with monetary policy. His major work, "The General Theory of Employment, Interest and Money," influenced new theories about how the economy works and is still studied today. He developed most of his theories during the Great Depression, and Keynesian theories have been used and misused over time, as they are popular and are often specifically applied to mitigate economic downturns. In a nutshell, Keynesian economic theories are based on the belief that proactive actions from our government are the only way to steer the economy. This implies that the government should use its powers to increase aggregate demand by increasing spending and creating an easy money environment, which should stimulate the economy by creating jobs and ultimately increasing prosperity. The Keynesian theorist movement suggests that monetary policy on its own has its limitations in resolving financial crises, thus creating the Keynesian versus the Monetarists debate. For related reading, see: While fiscal policy has been used successfully during and after the Great Depression, the Keynesian theories were called into question in the 1970s after a long run of popularity. Monetarists, such as Milton Friedman, and supply-siders claimed the ongoing government actions had not helped the country avoid the endless cycles of below average gross domestic product GDP expansion, recessions and gyrating interest rates. Some Side Effects Just like monetary policy, fiscal policy can be used to influence both expansion and contraction of GDP as a measure of economic growth. When the government is exercising its powers by lowering taxes and increasing their expenditures, they are practicing expansionary fiscal policy. When the government is spending at a pace faster than tax revenues can be collected, the government can accumulate excess debt as it issues interest-bearing bonds to finance the spending, thus leading to an increase in the national debt. When the government increases the amount of debt it issues during expansionary fiscal policy, issuing bonds in the open market will end up competing with the private sector that may also need to issue bonds at the same time. This effect, known as crowding out, can raise rates indirectly because of the increased competition for borrowed funds. Even if the stimulus created by the increased government spending has some initial short-term positive effects, a portion of this economic expansion could be mitigated by the drag caused by higher interest expenses for borrowers, including the government. While a stronger home currency sounds positive on the surface, depending on the magnitude of the change in rates, it can actually make American goods more expensive to export and foreign-made goods cheaper to import. Since most consumers tend to use price as a determining factor in their purchasing practices, a shift to buying more foreign goods and a slowing demand for domestic products could lead to a temporary trade imbalance. These are all possible scenarios that have to be considered and anticipated. Fiscal policy measures also suffer from a natural lag, or the delay in time from when they are determined to be needed to when they actually pass through Congress and ultimately the president. Unfortunately, given the inherent unpredictability and dynamics of the economy, most economists run into challenges in accurately predicting short-term economic changes. Who sets fiscal policy, the president or Congress? Early Keynesians did not believe monetary policy had any long-lasting effects on the economy because: Since banks have a choice whether or not to lend out the excess reserves they have on hand from lower interest rates, they may just choose not to lend; and Keynesians believe consumer demand for goods and services may not be related to the cost of capital to obtain these

goods. The Federal Reserve can increase the money supply by buying securities and decrease the money supply by selling securities. If the Federal Reserve wants to increase the money supply, it can decrease the amount of reserves required, and if it wants to decrease the money supply, it can increase the amount of reserves required to be held by banks. In theory, holding the discount rate low should induce banks to hold fewer excess reserves and ultimately increase the demand for money. This begs the question: Which Policy Is More Effective? For example, to a Keynesian promoting fiscal policy over a long period of time e. Over that same 25 years, the Fed may have intervened hundreds of times using their monetary policy tools and maybe only had success in their goals some of the time. Using just one method may not be the best idea. The Bottom Line Though each side of the policy spectrum has its differences, the United States has sought a solution in the middle ground, combining aspects of both policies in solving economic problems. Trading Center Want to learn how to invest? Get a free 10 week email series that will teach you how to start investing. Delivered twice a week, straight to your inbox.

9: Effectiveness of Monetary Policy and Fiscal Policy

This tends to make monetary policy tools more effective during economic expansions than recessions. Monetary and fiscal policy tools are used in concert to help keep economic growth stable.

Moderate Interest Rates High Employment Even in a healthy economy, there will always be some unemployment. When a recession hits, the Fed can use its monetary policy tools to stimulate the economy to promote job growth. Sustainable Output Output is the amount of goods and services the economy produces. When needed, the Fed can stimulate the economy and help push it back toward a healthy path. Stable Prices Stable prices low inflation help people and businesses make financial decisions without worrying about where prices are headed. In the long run, economies with stable prices tend to be healthier. Moderate Interest Rates Interest rates are important in promoting stable prices. When inflation is expected to be low and prices are stable, lenders are willing to charge lower interest rates. The Fed pursues these goals by influencing the cost and availability of money and credit in the economy, which is called monetary policy. Fed policy-makers meet eight times per year to make decisions about how to use monetary policy to meet economic goals. Instead, the Fed works indirectly by raising and lowering a specific interest rate called the federal funds rate. Changes in the federal funds rate ripple through the financial markets by triggering changes in other short-term interest rates. These ripple effects are intended to influence the amount of money and credit in the economy and ultimately impact jobs, prices, and output. The Fed may also act to influence long-term interest rates more directly, through large-scale purchases of long-term Treasuries or other securities. Monetary policy involves influencing the availability and cost of money and credit to promote a healthy economy. For the Fed, Congress has mandated two policy goals: These dual policy goals imply moderate long-term interest rates. The Fed works to fulfill its dual mandate primarily by setting a target for a key interest rate, the federal funds rate, which is what financial institutions charge each other for loans in the overnight borrowing market. The federal funds rate serves as a benchmark for many other short-term interest rates and consequently broadly influences credit conditions. The Fed uses a number of tools to keep the federal funds rate near its target. The Federal Funds Rate The federal funds rate is the interest rate banks charge each other for overnight loans of reserve balances. The Fed cannot directly control inflation, output, or employment, nor can it set long-term interest rates. It affects these vital economic variables indirectly, mainly through its control over the federal funds rate. All depository institutions, including banks, credit unions, and thrifts, are required to hold minimum reserve balances in accounts at Federal Reserve Banks. The federal funds rate is the interest these institutions charge one another for overnight loans of reserves, balances that are sometimes needed to meet minimum requirements. Fed monetary policy actions alter the supply of reserves in the banking system. When more reserves are available in the banking system, the federal funds rate goes lower, reflecting an excess of supply over demand. In this way, the Fed is able to keep the federal funds rate close to its target. Changes in the federal funds rate are intended to cause changes in other short-term interest rates. Indirectly, the federal funds rate also affects long-term interest rates, the total amount of money and credit in the economy, and ultimately, employment, output, and inflation. More recently, it has added other instruments to its monetary policy toolkit, such as paying interest on reserve balances held at Reserve Banks. The Fed has also used a number of temporary nontraditional tools over the past few years to fight economic weakness. This consists of buying and selling U. If the FOMC lowers its target for the federal funds rate, then the trading desk in New York will buy securities on the open market. The Fed pays for these securities by crediting the reserve accounts of the banks that sell the securities. In essence, when the Fed buys securities through open market operations, it is creating money. Additional money in these bank reserve accounts puts downward pressure on the federal funds rate according to the basic principle of supply and demand. In turn, short-term market interest rates directly or indirectly linked to the federal funds rate also tend to fall. Lower interest rates encourage consumer and business spending, thereby stimulating economic activity. On the other hand, if the FOMC raises its target for the federal funds rate, then the New York trading desk will sell government securities, collecting payments from banks by withdrawing money from their reserve accounts. Less money in these reserve accounts means a

smaller supply of money in the banking system, putting upward pressure on the federal funds rate. That typically causes market interest rates to rise, which damps consumer and business spending, slowing economic activity and reducing inflationary pressure. The level of the discount rate is set above the federal funds rate target. As such, the discount window serves as a back-up source of funding for depository institutions. The discount window can also become the primary source of funds under unusual circumstances. An example is when normal functioning of financial markets, including borrowing in the federal funds market, is disrupted. In such a case, the Fed serves as lender of last resort, one of the classic functions of a central bank. This took place during the recent financial crisis see Financial Stability section. Reserve Requirements By law, all depository financial institutions must set aside a percentage of their deposits as reserves to be held either as cash on hand or as account balances at a Reserve Bank. The Fed sets reserve requirements for all commercial banks, savings banks, savings and loans, credit unions, and U. Depository institutions use their reserve accounts to process many financial transactions through the Federal Reserve, such as check and electronic payments, and currency and coin services. Altering reserve requirements is potentially a monetary policy tool, but is rarely used. Nonetheless, reserve requirements support monetary policy by creating a relatively predictable demand for loans in the federal funds market. In many cases, banks borrow in that market specifically to meet reserve requirements. The relatively predictable nature of the market for bank reserves better enables the Fed to influence the federal funds rate through open market operations. Interest on Reserves In October , Congress granted the Fed authority to pay depository institutions interest on reserve balances. The interest rate paid on reserves is effectively a floor beneath the federal funds rate because banks are not willing to loan to each other at rates significantly below what they can earn by leaving their reserves on deposit with the Fed. As the economy recovers, the ability to pay interest on reserves gives the Fed another tool to tighten policy without having to significantly or suddenly reduce the supply of reserves in the banking system. By increasing the interest rate paid on reserves, the Fed will be able to put upward pressure on market interest rates because banks will not want to lend to the public at rates significantly below what they can earn by holding reserves with the Fed. Of course, the Fed used its traditional tool, lowering the federal funds rate close to zero. Beyond that, the Fed devised nontraditional tools to lower borrowing costs for consumers and businesses. One such tool was large-scale purchases of longer-term securities, including Treasury securities, federal agency debt, and federal agency mortgage-backed securities. These purchases helped lower longer-term interest rates, including mortgage rates. That should keep inflationary pressures in check. An Update , speech by Ben S.

Improving low-temperature tolerance in plants Markku K. Aalto, Pekka Heino, and E. Tapio Palva. Social networks in business Art and society in Italy, 1350-1500 365 Ways to Cook Chicken (Anniversary Edition) Ernelinede (Chefs-Doeuvre Classiques De Lopera Francais Series, Vol 27) Bowmar Orchestral Library, Series 2 (Bowmar Orchestral Library) Michael Prendergast Reel 105. September 15-30, 1851 U.S. foreign trade sanctions imposed for foreign policy purposes in force as of May 31, 1985 Ieee journals on big data Housing by employers in the United States British military longarms, 1715-1815 Ultimate eu test book Transgenic mouse models and human disease Jonathan Flint Correlation and Causation. A book of Irish-American blessings Zig Ziglar Grief Support Sympathy Cards with Envelope The artist, society, and sexuality in Virginia Woolfs novels Narrative of the life of frederick douglass chapter 7 Hackers delight second edition Scotland and Poland Flowering and Foliage House Plants Distributed application development with PowerBuilder 6 Restoring The Reformation/s.e.h.t. Americanah book Causation of loss Interpreting otherwise than Heidegger Grocery business plan grocery store business model Science fiction toys models, v. 1 The history of the hen fever Favorite Garden Tips (Canadian Garden Collection) First Responder (8th Edition) 4. The Chaebol Regime and the developmental coalition of domination Christian books on spiritual growth Card games that were almost lost Victoria landmarks Capt. Harold L. Jackson, retired. The Perfect Company Ethnicity and family therapy Hot Wacks Book Supplement 1, 1993