DOWNLOAD PDF PROBLEMS IN FISCAL AND MONETARY POLICY

Chapter 1 : Fiscal Policy vs. Monetary Policy: Pros & Cons | Investopedia

Problems with Monetary Policy and Fiscal policy Monetary policy and fiscal policy under a system of fixed output Initially, monetary policy and fiscal policy were introduced in an economy where changes in these policies would affect output.

Owing to this development, real economic growth has not increased to an optimal level. In order to remedy this undesirable economic syndrome, several government policies have been put in place. It uses specific instrument like the open market operation OMO , interest rate, special Bank Reserve Ratios, Exchange Rate foreign , special Directives and moral suasion. Fiscal policy therefore, uses taxation, borrowing through balanced, surplus and deficit budgeting as major instruments. Precisely, all the above mentioned instruments of monetary and fiscal policies will be analyzed in this study as an effort to curtail inflation. Adewunmi and Awoseka in their own view, approached inflation from the conceptual frame work of its cause, and opined that, it is the process resulting from the competition in attempting to maintain total real income, total real expenditure and total output at a level which has become physically impossible or attempting to increase any of them to a level which is physically impossible. Generally speaking, inflation refers to a process whereby, prices of goods and services rise steadily resulting in diminishing purchasing power of a given nominal sum of money. There are many types of inflation. Examples include, cost-push inflation, demand â€"pull inflation, Running inflation and hyperinflation. Essentially, the introductory background of inflation has been given to afford both the researcher and the reader an opportunity to appreciate the Nigerian practical situation in the period under review. It is intended to extensively analyse the impact of government economic policies monetary and fiscal policies on the rate of inflation in Nigeria since 19 years of a deregulated economic era. At the end of this research, such questions stated below should have been answered. Primarily, this research study has been designed to review existing literature on conventional theories on economic stabilization with emphasis on interest rate and government expenditure in relation to inflation. A careful synthesis will be drawn from the classical and Keynesian boundaries. The overriding principle of literature review will be within the context of theories, empirical evidence and practical realities of Nigeria economy. The government has introduced a lot of policy measures to control inflation in the country. Prominent among the measures are monetary and fiscal policies. Despite the intensified use of the policies, the rate of inflation in Nigeria is still very high. In the light of this crucial question, the researcher will attempt to see whether high interest rates can as well reduce the rate of inflation. That changes in interest rate have significant impact on the level of inflation. That changes in government expenditure has no significant impact on the level of inflation. That changes in government expenditure have significant impact on the level of inflation. In this research study, an object appraisal of the actual implementations of the said policy measures will be made. This provides an opportunity for both the researcher, monetary authorities CBN and other related implementation agencies to adjust where necessary. Above all, when alternative policy measures are made, it will afford both the central bank of Nigeria CBN and the federal ministry of finance the opportunity to achieve a stable price level. The research study is limited by several factors. These include time constraints, money and nature of data collection. As a result of this, inadequate finance hindered the quality of study. Conclusively, the nature of data used to analyse the research problem is that of secondary data which might have not been accurate. According to the Oxford Dictionary of Economics by Black On the other hand, stabilisation policy is defined as the use of economic policies to reduce fluctuations, John However, stabilisation could also be referred to as any amount of intervention into the affairs of any economy in order to prevent extreme fluctuations. Although the tem target other macroeconomic objectives like full employment, real optimal growth and balance of payment stabilisation in an ideal sense, means all conscious efforts made to avoid too much gap between the peak and through to minimise fluctuations. There is adequate literature on the concept of stabilisation policy. In this research work however, only the most relevant materials with respect to stabilisation policy in Nigerian economy have been reviewed in addition to the conventional theories. On the basis of the uncertainty faced by policy-makers in the Nigerian context, the effects of policies and other exogenous shocks experienced due to a persistent inflationary trend, the most frequent policies used are monetary and fiscal. While monetary policy refers to deliberate government efforts made through the manipulation of interest rate an other relevant instruments. It can also be referred to, as the policy of monetary authority of a country with regard to monetary matters Jhingan, He further argued that, monetary policy in can underdeveloped country play san important role in accelerating development by influencing the cost and availability of credit, by controlling inflation, and by maintaining balance of payments equilibrium Jhingan, However, he cautioned that, either of the above is a function of the economic peculiarities of the country in question. He use graphical illustrations for h two policies to make his analysis more effectively comprehensible as can be seen in the diagram below: A Study Of MTN Enugu Branch In the diagrams a and b , Samuelson explains that a combination of monetary and fiscal policies are the terminators of the rate of capital growth. When capital growth takes place in any economy, te society is bound to build up quickly and achieve the basis of macroeconomic desires, like full employment, increasing productivity and favourable balance of payment. According to diagrams a and b , by tightening fiscal and easy monetary policies, the economy attracts full employment of savings and investments at E. Finally, he postulated that low saving and investment matches with high consumption, which does no augur well for a smooth growth of the economy. It is important to stress a this juncture that, whichever angle an economy approaches this policy, two problems are certain to arise i. This apparently suggests why one of the hypothesis proposed in this study is that, changes in interest rate have no significant impact on the level of inflation in Nigeria. In doing this, security prices are caused to rise contractionary or fall expansionary. Where the rate of interest is raised, the demand for loans and advances falls. When this happens, aggrete monetary demand falls which can check inflation this is best illustrated graphically as indicated below; In the graph drawn above, the vertical axis represents the rate of interest i. While the horizontal axis represents the stock of money that is, supply of money. The demand curve sloping from left to right shows the level of interaction between the demand for and supply of money at various interest rates. It should also, be noted that, for the above diagram, at an interest rate of IR1, the demand for money is MS1 settling at an equilibrium position of E1. When the rate of interest increases to IR2, the demand for money contracts to M2 and the money supply accommodates this development accordingly. This is an indication that the demand for money and its supply are the determinants of interest rate. The reverse of this can be used to analyse a fall in interest rate which is expansionary in nature. Government budgeting can be surplus when revenue exceeds expenditure, deficit when expenditure exceeds revenue and balanced hen he latter is equal to he former. Since the epoch of economic deregulation in Nigeria, government budgets have been surplus projections so as to stabilise the price level. It is in consonance with this philosophy that the second hypothesis that changes in government has no significant impact on the level of inflation has been tested in the study. In accordance with the theoretical background surveyed for the major variables in this research, a synthesis of related literature on stabilisation policies can be made. On the strength of this purpose, interest rates and government expenditure have been analysed in line with their application to the Nigerian economy. Interest rate is the price of borrowed money, which has featured frequently as a dependable instrument of monetary policy since the deregulation of the monetary system in Nigeria. This, therefore, no doubt as to why monetary authorities have introduced high interest rate guidelines within this period to discourage borrowing. The final analysis is that when borrowing is discouraged, the supply of money in the economy reduces which in turn checks inflation. This postulation however, is predicated on the premise that, if inflation is curtailed reasonably, all other macroeconomic indicators like, full employment, optimal real growth, favourable balance of payment and increase in productivity can be achieved. Adam Smith and other classicists commented on this issue but with particular attention on free competition or non-governmental interference which gave little or no concession to inflation as obtainable in Nigeria context. While most of the classicists share J. Monetary risks themselves share a common view that, prior increase in the stock of money, which obviously causes an increase in the rate of inflation, can be controlled by checking the growth of money supply. In the light of this recommendation, Powell The primary objective of literature review in this work is the existing gap between related literature on economic stabilisation policies at every considerable cost. It is important to point out clearly in this analysis that monetary and fiscal policies in Nigeria today differ from what is obtained in the UK at the time of classical and Keynesian theories. Despite this, proponents of Keynesian theories did not locate the cause of inflation in the growth of the money supply and therefore, control of this variable was not an integral part of Keynesian monetary policy prescription. This cannot be the case in Nigeria because unlike the Keynesian who regarded monetary and fiscal policies as independent policies, the effects of the stock money arising form an expansionary fiscal policy budget deficit will always be stimulant of inflation as argued by Powell. It is in view of the argument that he Keynesian postulation in the s does no have valid applicability to the deregulatory economic era of Nigeria. In discussing issues of economic crises, Burns Emphasis is made on the minimising of persistent inflationary trend because it has adversely affected all other macroeconomic indicators in the Nigerian system. According to Burns To a large extent, the failure of stabilisation policies to curtail inflation in Nigeria may not be far from some of the weaknesses of the critical formulation from the onset. This is truly representative of monetary and fiscal policies in Nigeria. More often than not, serious mistakes have been made in the pre and post deregulatory eras. Two probable weaknesses are responsible for the failure of stabilisation policies like it was identified in the United States of America in Firstly, total unwillingness to address, as a matter of urgency, the need for restricting action on the fiscal and monetary front. Secondly, in th course of policy formulation that is in Nigeria there is always the tendency to over-rely on monetary restriction as a strategy to check inflation. It is only heavy reliance on a balanced programmes of fiscal and monetary restraints that we can achieve the desired policy objectives. Why did the researcher say the earlier mentioned policy devices are partially workable in Nigeria? There ae some distortions in the Nigerian economy like excessive demand, absolute decline in real output, unemployment, and economic suggestions. Inflation can hope to be cured when adequate stabilisation efforts are tailored towards the removal of these distortions. The contrasting recommendations by the post Keynesian and monetarists economy in the early 80s are also relevant for review here. His further analysis of post Keynesians and monetarist is more particularly relevant here. With the failure of the free market system globally, the only alternative theoretical recommendation considering the peculiarities of the Nigerian economy is modified fiscal monetary stabilisation policy devoid of external interference. This argument is a diametrically opposition approach to current classical theories which grossly failed to provide empirical basis for appraisal due to insufficient implementation, unlike Keynesian before the s. For the purpose of juxtaposition in addition to conventional theories of stabilisation policies, the researcher has thoroughly reviewed existing literature by Nigerian economic analysts. These analyses pose the questions of whether to curb inflation and forfeit real optimal growth o the reverse of it. Suffice to caution that he degree of success of any policy will depend entirely on thorough and realistic crises in the distant and immediate parts. In views of the very grave economic crises facing the Nigerian economy now, some of the constitutional structures as well as theoretical frameworks borrowed from Western countries are no longer applicable. The validity of this argument id reinforced in research work on the causes and solution of the Nigerian economic crises spearheaded by Alksum et al Though this research work was undertaken before the deregulation of the Nigerian economy, its contentions are sill relevant to date. This assertion deserves a close attention by every Nigerian both positive and normative economists if we are willing to take determined action to cope with inflation and ensure the achievement of other macroeconomic indicators. In the same appendix, federally collected revenue rose from N

Chapter 2 : Top 13 Limitations of Fiscal Policy

Monetary policy refers to the actions taken by a country's central bank to achieve its macroeconomic policy objectives. Some central banks are tasked with targeting a particular level of inflation.

Explain and illustrate graphically how crowding out and its reverse influences the impact of expansionary or contractionary fiscal policy. Discuss the controversy concerning which types of fiscal policies to use, including the arguments from supply-side economics. The discussion in the previous section about the use of fiscal policy to close gaps suggests that economies can be easily stabilized by government actions to shift the aggregate demand curve. However, as we discovered with monetary policy in the previous chapter, government attempts at stabilization are fraught with difficulties. Lags Discretionary fiscal policy is subject to the same lags that we discussed for monetary policy. It takes some time for policy makers to realize that a recessionary or an inflationary gap existsâ€"the recognition lag. Recognition lags stem largely from the difficulty of collecting economic data in a timely and accurate fashion. The current recession was not identified until October , when the Business Cycle Dating Committee of the National Bureau of Economic Research announced that it had begun in December Then, more time elapses before a fiscal policy, such as a change in government purchases or a change in taxes, is agreed to and put into effectâ€"the implementation lag. Finally, still more time goes by before the policy has its full effect on aggregate demandâ€"the impact lag. Changes in fiscal policy are likely to involve a particularly long implementation lag. A tax cut was proposed to presidential candidate John F. Kennedy in as a means of ending the recession that year. He recommended it to Congress in It was not passed until , three years after the recession had ended. Some economists have concluded that the long implementation lag for discretionary fiscal policy makes this stabilization tool ineffective. Fortunately, automatic stabilizers respond automatically to changes in the economy. They thus avoid not only the implementation lag but also the recognition lag. The implementation lag results partly from the nature of bureaucracy itself. The CBO estimate that only a portion of the spending for the stimulus plan passed in will be spent in the next two years is an example of the implementation lag. Government spending requires bureaucratic approval of that spending. For example, a portion of the stimulus plan must go through the Department of Energy. One division of the department focuses on approving loan guarantees for energy-saving industrial projects. It was created early in as part of another effort to stimulate economic activity. A Minnesota company, Sage Electrochromics, has developed a process for producing windows that can be darkened or lightened on demand to reduce energy use in buildings. Its application has not been approved. In fact, the loan approval division, which will be crucial for projects in the stimulus plan, has never approved any application made to it in its two years in existence! In an interview with the Wall Street Journal, Dr. Chu said that his agency would have to do better. Stephen Power and Neil King, Jr. Crowding Out Because an expansionary fiscal policy either increases government spending or reduces revenues, it increases the government budget deficit or reduces the surplus. A contractionary policy is likely to reduce a deficit or increase a surplus. In either case, fiscal policy thus affects the bond market. Our analysis of monetary policy showed that developments in the bond market can affect investment and net exports. We shall find in this section that the same is true for fiscal policy. The increase in government purchases increases the deficit or reduces the surplus. In either case, the Treasury will sell more bonds than it would have otherwise, shifting the supply curve for bonds to the right in Panel a. That reduces the price of bonds, raising the interest rate. The increase in the interest rate reduces the quantity of private investment demanded. The higher interest rate increases the demand for and reduces the supply of dollars in the foreign exchange market, raising the exchange rate in Panel b. A higher exchange rate reduces net exports. Panel c shows the effects of all these changes on the aggregate demand curve. Before the change in government purchases, the economy is in equilibrium at a real GDP of Y1, determined by the intersection of AD1 and the short-run aggregate supply curve. The increase in government expenditures would shift the curve outward to AD2 if there were no adverse impact on investment and net exports. But the reduction in investment and net exports partially offsets this increase. Taking the reduction in investment and net exports into account means that the aggregate demand curve shifts only to AD3. The tendency for an expansionary fiscal policy to reduce other components of aggregate demand is called crowding out The tendency for an expansionary fiscal policy to reduce other components of aggregate demand.. In Panel b , the higher interest rate causes the exchange rate to rise, reducing net exports. Increased government purchases would shift the aggregate demand curve to AD2 in Panel c if there were no crowding out. Crowding out of investment and net exports, however, causes the aggregate demand curve to shift only to AD3. Then a higher price level means that GDP rises only to Y2. Crowding out reduces the effectiveness of any expansionary fiscal policy, whether it be an increase in government purchases, an increase in transfer payments, or a reduction in income taxes. Each of these policies increases the deficit and thus increases government borrowing. The supply of bonds increases, interest rates rise, investment falls, the exchange rate rises, and net exports fall. Note, however, that it is private investment that is crowded out. The expansionary fiscal policy could take the form of an increase in the investment component of government purchases. As we have learned, some government purchases are for goods, such as office supplies, and services. But the government can also purchase investment items, such as roads and schools. In that case, government investment may be crowding out private investment. The reverse of crowding out occurs with a contractionary fiscal policyâ€”a cut in government purchases or transfer payments, or an increase in taxes. Such policies reduce the deficit or increase the surplus and thus reduce government borrowing, shifting the supply curve for bonds to the left. Interest rates drop, inducing a greater quantity of investment. Lower interest rates also reduce the demand for and increase the supply of dollars, lowering the exchange rate and boosting net exports. An expansionary fiscal policy has less punch; a contractionary policy puts less of a damper on economic activity. Some economists argue that these forces are so powerful that a change in fiscal policy will have no effect on aggregate demand. Because empirical studies have been inconclusive, the extent of crowding out and its reverse remains a very controversial area of study. Also, the fact that government deficits today may reduce the capital stock that would otherwise be available to future generations does not imply that such deficits are wrong. If, for example, the deficits are used to finance public sector investment, then the reduction in private capital provided to the future is offset by the increased provision of public sector capital. Future generations may have fewer office buildings but more schools. Choice of Policy Suppose Congress and the president agree that something needs to be done to close a recessionary gap. We have learned that fiscal policies that increase government purchases, reduce taxes, or increase transfer paymentsâ€”or do a combination of theseâ€”all have the potential, theoretically, to raise real GDP. The government must decide which kind of fiscal policy to employ. Because the decision makers who determine fiscal policy are all elected politicians, the choice among the policy options available is an intensely political matter, often reflecting the ideology of the politicians. For example, those who believe that government is too big would argue for tax cuts to close recessionary gaps and for spending cuts to close inflationary gaps. Those who believe that the private sector has failed to provide adequately a host of services that would benefit society, such as better education or public transportation systems, tend to advocate increases in government purchases to close recessionary gaps and tax increases to close inflationary gaps. Another area of contention comes from those who believe that fiscal policy should be constructed primarily so as to promote long-term growth. Supply-side economics The school of thought that promotes the use of fiscal policy to stimulate long-run aggregate supply. Supply-side economists advocate reducing tax rates in order to encourage people to work more or more individuals to work and providing investment tax credits to stimulate capital formation. While there is considerable debate over how strong the supply-side effects are in relation to the demand-side effects, such considerations may affect the choice of policies. Supply-siders tend to favor tax cuts over increases in government purchases or increases in transfer payments. President Reagan advocated tax cuts in on the basis of their supply-side effects. Coupled with increased defense spending in the early s, fiscal policy under Mr. Reagan clearly stimulated aggregate demand by increasing both consumption and investment. Falling inflation and accelerated growth are signs that supply-side factors may also have been at work during that period. Gregory Mankiw, argued that the Bush tax cuts would encourage economic growth, a supply-side argument. Finally, even when there is agreement to stimulate the economy, say through increasing government expenditures on highways, the how question remains. How should the expenditures be allocated?

Specifically, which states should the highways run through? Each member of Congress has a political stake in the outcome. These types of considerations make the implementation lag particularly long for fiscal policy. Key Takeaways Discretionary fiscal policy involves the same kind of lags as monetary policy. However, the implementation lag in fiscal policy is likely to be more pronounced, while the impact lag is likely to be less pronounced. Expansionary fiscal policy may result in the crowding out of private investment and net exports, reducing the impact of the policy. Supply-side economics stresses the use of fiscal policy to stimulate economic growth. Advocates of supply-side economics generally favor tax cuts to stimulate economic growth. Do the following hypothetical situations tend to enhance or make more difficult the use of fiscal policy as a stabilization tool? Better and more speedily available data on the state of the economy A finding that private sector investment spending is not much affected by interest rate changes A finding that the supply-side effects of a tax cut are substantial Case in Point: Crowding Out in Canada Figure Wang found that only government expenditures for capital and infrastructure crowded out private investment.

Chapter 3 : Problems and Controversies of Monetary Policy

Monetary policy seeks to promote economic stability by ensuring that the economy maximizes employment, controls long-term interest rates and maintains stable prices. The Federal Reserve holds the.

Identify the macroeconomic targets at which the Fed can aim in managing the economy, and discuss the difficulties inherent in using each of them as a target. The Fed has some obvious advantages in its conduct of monetary policy. These bodies can thus reach decisions quickly and implement them immediately. Their relative independence from the political process, together with the fact that they meet in secret, allows them to operate outside the glare of publicity that might otherwise be focused on bodies that wield such enormous power. Despite the apparent ease with which the Fed can conduct monetary policy, it still faces difficulties in its efforts to stabilize the economy. We examine some of the problems and uncertainties associated with monetary policy in this section. Lags Perhaps the greatest obstacle facing the Fed, or any other central bank, is the problem of lags. It is easy enough to show a recessionary gap on a graph and then to show how monetary policy can shift aggregate demand and close the gap. In the real world, however, it may take several months before anyone even realizes that a particular macroeconomic problem is occurring. When monetary authorities become aware of a problem, they can act quickly to inject reserves into the system or to withdraw reserves from it. Once that is done, however, it may be a year or more before the action affects aggregate demand. The delay between the time a macroeconomic problem arises and the time at which policy makers become aware of it is called a recognition lag The delay between the time a macroeconomic problem arises and the time at which policy makers become aware of it.. The â€" recession, for example, began in July It was not until late October that members of the FOMC noticed a slowing in economic activity, which prompted a stimulative monetary policy. In contrast, the most recent recession began in December , and Fed easing began in September Recognition lags stem largely from problems in collecting economic data. First, data are available only after the conclusion of a particular period. Preliminary estimates of real GDP, for example, are released about a month after the end of a quarter. Thus, a change that occurs early in a quarter will not be reflected in the data until several months later. Second, estimates of economic indicators are subject to revision. The first estimates of real GDP in the third quarter of , for example, showed it increasing. Not until several months had passed did revised estimates show that a recession had begun. And finally, different indicators can lead to different interpretations. Data on employment and retail sales might be pointing in one direction while data on housing starts and industrial production might be pointing in another. It is one thing to look back after a few years have elapsed and determine whether the economy was expanding or contracting. It is quite another to decipher changes in real GDP when one is right in the middle of events. Even in a world brimming with computer-generated data on the economy, recognition lags can be substantial. Only after policy makers recognize there is a problem can they take action to deal with it. The delay between the time at which a problem is recognized and the time at which a policy to deal with it is enacted is called the implementation lag The delay between the time at which a problem is recognized and the time at which a policy to deal with it is enacted.. For monetary policy changes, the implementation lag is quite short. The FOMC meets eight times per year, and its members may confer between meetings through conference calls. Once the FOMC determines that a policy change is in order, the required open-market operations to buy or sell federal bonds can be put into effect immediately. Policy makers at the Fed still have to contend with the impact lag The delay between the time a policy is enacted and the time that policy has its impact on the economy. The impact lag for monetary policy occurs for several reasons. First, it takes some time for the deposit multiplier process to work itself out. The Fed can inject new reserves into the economy immediately, but the deposit expansion process of bank lending will need time to have its full effect on the money supply. Interest rates are affected immediately, but the money supply grows more slowly. Second, firms need some time to respond to the monetary policy with new investment spendingâ€"if they respond at all. Third, a monetary change is likely to affect the exchange rate, but that translates into a change in net exports only after some delay. Thus, the shift in the aggregate demand curve due to initial changes in investment and in net exports occurs after some delay.

Finally, the multiplier process of an expenditure change takes time to unfold. It is only as incomes start to rise that consumption spending picks up. The problem of lags suggests that monetary policy should respond not to statistical reports of economic conditions in the recent past but to conditions expected to exist in the future. In justifying the imposition of a contractionary monetary policy early in , when the economy still had a recessionary gap, Greenspan indicated that the Fed expected a one-year impact lag. The policy initiated in was a response not to the economic conditions thought to exist at the time but to conditions expected to exist in When the Fed used contractionary policy in the middle of , it argued that it was doing so to forestall a possible increase in inflation. When the Fed began easing in September , it argued that it was doing so to forestall adverse effects to the economy of falling housing prices. In these examples, the Fed appeared to be looking forward. It must do so with information and forecasts that are far from perfect. Estimates of the length of time required for the impact lag to work itself out range from six months to two years. Worse, the length of the lag can varyâ€”when they take action, policy makers cannot know whether their choices will affect the economy within a few months or within a few years. Because of the uncertain length of the impact lag, efforts to stabilize the economy through monetary policy could be destabilizing. Suppose, for example, that the Fed responds to a recessionary gap with an expansionary policy but that by the time the policy begins to affect aggregate demand, the economy has already returned to potential GDP. The policy designed to correct a recessionary gap could create an inflationary gap. Similarly, a shift to a contractionary policy in response to an inflationary gap might not affect aggregate demand until after a self-correction process had already closed the gap. In that case, the policy could plunge the economy into a recession. Choosing Targets In attempting to manage the economy, on what macroeconomic variables should the Fed base its policies? It must have some target, or set of targets, that it wants to achieve. The choice of a target, or set of targets, is a crucial one for monetary policy. Possible targets include interest rates, money growth rates, and the price level or expected changes in the price level. Interest Rates Interest rates, particularly the federal funds rate, played a key role in recent Fed policy. The FOMC does not decide to increase or decrease the money supply. Rather, it engages in operations to nudge the federal funds rate up or down. That degree of pressure was reflected by the federal funds rate; if existing reserves were less than the amount banks wanted to hold, then the bidding for the available supply would send the federal funds rate up. If reserves were plentiful, then the federal funds rate would tend to decline. When the Fed increased the degree of pressure on reserves, it sold bonds, thus reducing the supply of reserves and increasing the federal funds rate. The Fed decreased the degree of pressure on reserves by buying bonds, thus injecting new reserves into the system and reducing the federal funds rate. The current operating procedures of the Fed focus explicitly on interest rates. At each of its eight meetings during the year, the FOMC sets a specific target or target range for the federal funds rate. When the Fed lowers the target for the federal funds rate, it buys bonds. When it raises the target for the federal funds rate, it sells bonds. Money Growth Rates Until , the Fed was required to announce to Congress at the beginning of each year its target for money growth that year and each report dutifully did so. At the same time, the Fed report would mention that its money growth targets were benchmarks based on historical relationships rather than guides for policy. As soon as the legal requirement to report targets for money growth ended, the Fed stopped doing so. Since in recent years the Fed has placed more importance on the federal funds rate, it must adjust the money supply in order to move the federal funds rate to the level it desires. As a result, the money growth targets tended to fall by the wayside, even over the last decade in which they were being reported. Instead, as data on economic conditions unfolded, the Fed made, and continues to make, adjustments in order to affect the federal funds interest rate. If so, an obvious possible target is the price level itself. The Fed could target a particular price level or a particular rate of change in the price level and adjust its policies accordingly. One difficulty with such a policy, of course, is that the Fed would be responding to past economic conditions with policies that are not likely to affect the economy for a year or more. Another difficulty is that inflation could be rising when the economy is experiencing a recessionary gap. The Fed faced a similar situation in the first half of when oil prices were again rising. If the Fed undertakes contractionary monetary policy at such times, then its efforts to reduce the inflation rate could worsen the recessionary gap. The solution proposed by Chairman Bernanke, who is an advocate of inflation rate targeting, is to focus not on the past rate of inflation or even the current rate of inflation, but on the expected rate of inflation, as revealed by various indicators, over the next year. By , the central banks of about 30 developed or developing countries had adopted specific inflation targeting. A study by economist Carl Walsh found that inflationary experiences among developed countries have been similar, regardless of whether their central banks had explicit or more flexible inflation targets. For developing countries, however, he found that inflation targeting enhanced macroeconomic performance, in terms of both lower inflation and greater overall stability. What Have We Learned? Members of the Board of Governors are appointed by the president, with confirmation by the Senate, but the year terms of office provide a considerable degree of insulation from political pressure. A president exercises greater influence in the choice of the chairman of the Board of Governors; that appointment carries a four-year term. Neither the president nor Congress has any direct say over the selection of the presidents of Federal Reserve district banks. They are chosen by their individual boards of directors with the approval of the Board of Governors. The degree of independence that central banks around the world have varies. A central bank is considered to be more independent if it is insulated from the government by such factors as longer term appointments of its governors and fewer requirements to finance government budget deficits. Studies in the s and early s showed that, in general, greater central bank independence was associated with lower average inflation and that there was no systematic relationship between central bank independence and other indicators of economic performance, such as real GDP growth or unemployment. See, for example, Alberto Alesina and Lawrence H. By the rankings used in those studies, the Fed was considered quite independent, second only to Switzerland and the German Bundesbank at the time. Perhaps as a result of such findings, a number of countries have granted greater independence to their central banks in the last decade. The charter for the European Central Bank, which began operations in , was modeled on that of the German Bundesbank.

DOWNLOAD PDF PROBLEMS IN FISCAL AND MONETARY POLICY

Chapter 4 : Whatâ€™s wrong with current US monetary policy? | World Economic Forum

In principle, fiscal and monetary policy should be easy to implement. Increases in government spending or tax cuts stimulate aggregate demand and, assuming GDP is less than potential, the economy should grow.

Some of the major limitations of fiscal policy are as follows: In view of such a situation, let us understand fully problems and limitations which are associated with a fiscal policy. During the recent times, there is not much argument about the desirability or otherwise of a discretionary fiscal policy. The burning question in this context is related with the timing of the fiscal measures. Unless the variations in taxes and public expenditure are neatly timed, the desired counter-cyclical effects can not be realized. There is generally some interval between the time when a particular action is needed and the time when a fiscal measure has its impact felt. The duration of this interval determines the extent to which a specific fiscal measure can be effective. This time interval comprises of three types of lags-recognition lag, administrative lag and operational lag. This is the interval between the time when action is needed and when it is recognized that action is needed. This lag may exist when a change in the economy and a report concerning the change do not coincide. Such a lag has a duration of 3 months. It can be reduced if the forecasting is satisfactory. This is the interval between the time when need of an action is recognized and the time when the action is actually taken. This is perhaps the most difficult lag to deal with. Even when the need of action has been recognized, the sanction from legislature and executive must take some time and that may involve about 1 to 15 months of time. In order to reduce such a lag and to minimize the legislative and executive red-taps, it is important to keep a shelf of public works in readiness. The recognition and administrative lags together determine the inside lag of the fiscal policy and its length, according to Willes, is 4 to 18 months. The time interval between when action is taken and when it has its impact on income and employment is known as the operational or the outside lag. Albert Ando and E. Brown have pointed out that the change in personal income taxes produce significant changes in disposable money income and consumption within a month or two; changes in the corporate tax structure produce changes in corporate spending in about 3 or 4 months. Willes was of the view that the outside lag of fiscal policy has a short duration of 1 to 3 months only. Ranlett, however, considers that these estimates need modification. On the basis of U. Even this estimate of outside lag of fiscal policy is much lower than that of the monetary policy. Another most serious limitation of fiscal policy is the practical difficulty of observing the coming events of economic instability. Unless they are correctly observed the amount of revenue to be raised, the amount of expenditure to be incurred or the nature and extent of budget balance to be framed cannot be suitably planned. In fact, success of fiscal measures depends on the accurate predictions of various economic activities. In its absence, it proves to be a little bit erratic. Correct Size and Nature of Fiscal Policy: The most important necessity on which the success of fiscal policy will depend is the ability of public authority to frame the correct size and nature of fiscal policy on the one hand and to foresee the correct timing of its application on the other. It is, however, too much to expect that the government would be able to correctly determine the size, nature of composition and appropriate execution-time of fiscal policy. When monetary policy is general in nature and impersonal in impact, the fiscal policy, in contrast, is selective. The former permits the market mechanism to operate smoothly. A particular set of fiscal measures may have an excessively harsh impact upon certain sectors, while leaving others almost unaffected. Inadequacy of Fiscal Measures: In anti-depression fiscal policy, the expansion of public spending and reduction on taxes are always important elements. The question arises naturally, whether a specific variation in public spending or taxes will bear the desired results or not. In case the injections or withdrawals from the circular flow are more or less than what are required, the system will fail to move in the desired direction. This results in exaggeration of instability in the economy. Adverse Effect on Redistribution of Income: It is felt that fiscal policy measures redistribute income, the actual effect will be uncertain. If income is redistributed in favour of the low-income classes whose marginal propensity to consume is high, the effect will be increase in total demand. But the fiscal action will be contractionary if larger part of the additional income goes to people having higher marginal propensity to save. The compensatory fiscal policies of the government may discourage private investment, since the private entrepreneurs have to face a competition from public enterprises in securing labour, raw materials and finances. Moreover, increased involvement of the government in economic activity at the onset of recession strengthens the pessimistic expectations of the private entrepreneurs. The expansion of public spending may be associated with a curtailment of private spending. Consequently, the fiscal measures may be self-offsetting. Reduction in National Income: Balanced budget multiplier as a fiscal weapon can be gainfully applied during depression is conditioned by the fact of marginal propensity to spend of the recipients of public expenditure being larger than or, at least, equal to that of the taxpayers. In case it becomes smaller than the taxpayers, the fiscal programmes under balanced budget will bring about reduction in the national income. The purpose of fiscal policy will be defeated if the policy can not maintain a rising supply level of work effort. The money national income will rise with increase in productive efficiency and increased supply of work effort. But if the tax measures are stringent and too high, they will certainly affect the incentive to work. This is an important limitation of fiscal policy. Adverse Effect on debt Management: The use of fiscal instruments during unemployment and depression is often associated with the subsequent problem of debt management. Because deficit budgeting is the normal fiscal cure, public debt is made for financing it. And if the process of recovery from depression is long, the creation of budget deficit year after year will create a huge problem of debt repayment and debt management. Large deficit programmes financed by borrowings bring about adverse psychological reactions. Rumours of government bankruptcy discourage investors and often flight of capital takes place. The creation of additional income through compensatory fiscal measures is not easily possible in underdeveloped countries as in advanced economies. This is mainly because a stagnating agricultural sector dominates the largest part of their economy where marginal propensity to consume is so high that most of the additional income is consumed and the marketable surplus is the least. Administrative Problems in Democratic Countries: In a democracy fiscal policy measures must be a time-consuming process. Legislative actions, administrative tasks and the executive process are often delayed and the original estimates of revenue earnings and government expenditures often become irrelevant. The operational lag relating to fiscal measures results in a considerable erosion of effect and the gap between expected achievement and the real attainment often becomes vast.

DOWNLOAD PDF PROBLEMS IN FISCAL AND MONETARY POLICY

Chapter 5 : Problems of Monetary and Fiscal Policies in Nigeria

Economic policy-makers are said to have two kinds of tools to influence a country's economy: fiscal and monetary. Fiscal policy relates to government spending and revenue collection. For example, when demand is low in the economy, the government can step in and increase its spending to stimulate.

Fiscal policy involves the government changing the levels of taxation and government spending in order to influence Aggregate Demand AD and the level of economic activity. Fiscal policy is often used in conjunction with monetary policy. In fact, governments often prefer monetary policy for stabilising the economy. Therefore the government will increase spending G and cut taxes T. Lower taxes will increase consumers spending because they have more disposable income C This will tend to worsen the government budget deficit, and the government will need to increase borrowing. Higher taxes will reduce consumer spending C Tight fiscal policy will tend to cause an improvement in the government budget deficit. Diagram showing the effect of tight fiscal policy UK fiscal policy UK Budget deficit In , the government pursued expansionary fiscal policy. This caused a big rise in government borrowing Government borrowing also rose because of the recession leading to lower tax revenue When the new coalition government came into power in May , they argued the deficit was too high and then announced plans to reduce government borrowing. This involved spending limits. These austerity measures were a factor in causing lower economic growth in and Terms relating to fiscal policy Fiscal Stance: This refers to whether the government is increasing AD or decreasing AD, e. This involves maintaining a steady rate of economic growth through using fiscal policy. However, this has proved quite difficult to achieve precisely. Automatic fiscal stabilisers â€" If the economy is growing, people will automatically pay more taxes VAT and Income tax and the Government will spend less on unemployment benefits. The increased T and lower G will act as a check on AD. But, in a recession, the opposite will occur with tax revenue falling but increased government spending on benefits, this will help increase AD Discretionary fiscal stabilisers â€" This is a deliberate attempt by the government to affect AD and stabilise the economy, e. When an increase in injections causes a bigger final increase in Real GDP. Injections J â€" This is an increase of expenditure in the circular flow, it includes govt spending G , Exports X and Investment I Withdrawals W â€" This is leakages from the circular flow This is household income that is not spent on the circular flow. To increase government spending will take time. It could take several months for a government decision to filter through into the economy and actually affect AD. By then it may be too late. Some economists argue that expansionary fiscal policy higher government spending will not increase AD because the higher government spending will crowd out the private sector. This is because the government have to borrow from the private sector who will then have lower funds for private investment. Government spending is inefficient. Free market economists argue that higher government spending will tend to be wasted on inefficient spending projects. Also, it can then be difficult to reduce spending in the future because interest groups put political pressure on maintaining stimulus spending as permanent. Under certain conditions, expansionary fiscal policy can lead to higher bond yields, increasing the cost of debt repayments. Criticisms of Fiscal Policy â€" More detail on criticisms of fiscal policy Evaluation of fiscal policy The success of fiscal policy will depend on several factors, such as It depends on the size of the multiplier. If the multiplier effect is large, then changes in government spending will have a bigger effect on overall demand. It depends on the state of the economy. Fiscal policy is most effective in a deep recession where monetary policy is insufficient to boost demand. In a deep recession liquidity trap. Higher government spending will not cause crowding out because the private sector saving has increased substantially. Liquidity trap and fiscal policy â€" why fiscal policy is more important during a liquidity trap. It depends on other factors in the economy. For example, if the government pursue expansionary fiscal policy, but interest rates rise, and the global economy is in a recession, it may be insufficient to boost demand. If there is concern over the state of government finances, the government may not be able to borrow to finance fiscal policy. Countries in the Eurozone experienced this problem in the recession. Brief history of fiscal policy Keynes advocated the use of fiscal policy as a way to stimulate economies during the great depression. Fiscal Policy was particularly used in the 50s and 60s to stabilise economic cycles. Fiscal policy became more prominent during the great depression of US fiscal policy Further Reading on Fiscal Policy Deflationary Fiscal Policy â€" impact on the economy of raising taxes and cutting spending. The difference between monetary and fiscal policy â€" Monetary policy has a similar aim to fiscal policy but involves changing interest rates and other monetary policies.

Chapter 6 : Monetary and fiscal policy (video) | Khan Academy

Fiscal and Monetary Policy: Opportunities and Problems by WILLIAM E. GIBSON William E. Gibson is a Senior Staff Economist for the Council of Economic Advisers, He.

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.

DOWNLOAD PDF PROBLEMS IN FISCAL AND MONETARY POLICY

Chapter 7 : The Limitations of Fiscal and Monetary Policy | Bizfluent

Between monetary and fiscal policy, the former is generally viewed as having the largest impact on the economy, while fiscal policy is seen as being the less efficient way to influence growth trends. How Monetary and Fiscal Policy Interact to Affect the Economy.

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 s 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 theses 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.

DOWNLOAD PDF PROBLEMS IN FISCAL AND MONETARY POLICY

Chapter 8 : Current fiscal and monetary policy issues in the euro area

There is a lag in fiscal policy as it filters into the economy, and monetary policy has shown its effectiveness in slowing down an economy that is heating up at a faster than desired, but it has.

Explore the latest strategic trends, research and analysis This article is published in collaboration with VoxEU. Monetary policy operates in an uncertain environment with long and variable lags. Different macroeconomists and policy advisers can reasonably have different views about what would be the most appropriate monetary policy strategy at any moment in time and differ on their views on the appropriate policy setting. This is often cited to justify different views about the stance of monetary policy. There is little disagreement, however, that monetary policy works best when it is systematic and avoids short-sighted, seat-of-the-pants discretionary decision making that places undue importance on perceived short-term gains and ignores larger long-term costs. The Federal Reserve, like other central banks, has been granted operational independence to protect against political pressures that constitute one source of unsystematic short-sighted policy. The risks are well understood. However, Federal Reserve policymakers retain immense discretionary power and, as the history of the Federal Reserve suggests, Federal Reserve policymakers have often used that power inappropriately, adopting policies that placed excessive emphasis on perceived short-term gains. The Great Inflation serves as an important example. For over a decade, the Federal Reserve pursued inappropriately-expansionary monetary policy focusing on short-term gains on employment and growth. The excessive focus on employment gains resulted in greater economic instability, higher inflation and lower growth. For a generation following the Great Inflation, under the leadership of Paul Volcker and Alan Greenspan, the Federal Reserve followed a more systematic policy approach based on the premise that the best way the Federal Reserve could contribute to long-term sustainable employment and growth was by protecting price stability over the long- term. The Great Moderation, a period of low inflation and greater economic stability reflected in large part the systematic nature of monetary policy. Post Crisis Following the crisis, the Federal Reserve has followed a different approach. In the past few years, the Federal Reserve has once again started placing undue emphasis on short-term employment. The sustained reduction in the rate of unemployment appears to have become the guiding principle of monetary policy. And this year, six years after the end of the recession, and despite larger declines in the unemployment rate than projected by the policymakers themselves, the Fed has been unable to even begin the process of policy normalisation. A short-termist mentality is the antithesis of systematic monetary policy. The fear of liftoff exhibited in Fed decisions suggests a return to the unsystematic, short-term oriented policy approach pursued before the Great moderation. This should be a cause of great concern. Since the start of the crisis in , core measures of inflation have been moving roughly sideways. This can justify the maintenance of somewhat accommodative monetary conditions. The issue is whether this can be used to justify the continuation of the unprecedented accommodation the Fed has engineered not only during the recession, but since then. The short-term real interest rate has remained significantly negative for many years, much longer than in any recession in the past several decades. In addition, the expansion of the balance sheet has added to this accommodation what may be the equivalent of a few hundred basis points of additional easing. What about the real economy? The Fed was correct in responding aggressively to the downturn in In my view, the Fed deserves credit for that policy easing. The problem at present is that the Fed has been unable, unwilling or reluctant to begin the process of normalisation. The economy recovered from the Great Recession long ago and labour markets are not far from normal. For those who measure slack in terms of deviations of the unemployment rate from measures of the natural rate of unemployment, the economy is very close and perhaps beyond full employment, depending on the estimates. The unemployment rate is at 5. The latest survey reports the central tendency as 4. There is disappointment that real GDP growth has been subdued, that productivity is lower than what was hoped. However, given the rapid improvement in employment markets, this appears to reflect lower trend productivity and lower potential output growth. We may all wish for better trend productivity and should lobby for better fiscal and structural policies to encourage higher long-term productivity and growth but higher trend productivity is not something the Fed can deliver. The best way the

Fed can contribute to long-term growth is by following a systematic policy that defends price stability over the medium and long term. With the economy close to full employment, the currently massive degree of policy accommodation cannot be justified. The process of policy normalisation should have started long ago. Liftoff is notthe end of accommodative conditions. Liftoff was needed to prevent an overheating in labour markets that would threaten longer term stability. Why would systematic policy need to begin the process of normalisation before inflation concerns become immediate? The Fed should retain a somewhat accommodative stance given that inflation is somewhat below its target. However, this cannot be used as an excuse to retain the massive accommodation that was engineered to fight the recession years ago. Monetary policy operates with long and variable lags. According to some Fed models, the maximum effect is around two years after a policy action. The Fed has been adding accommodation with quantitative easing up until less than a year ago, which will continue to stimulate the economy and push inflation upward well into Policy needs to be pre-emptive. The degree of policy accommodation should be reduced to avoid an overheated economy which would surely destabilise inflation and make a recession more likely for a more detailed exposition, see Orphanides Concluding remarks The costs of further delay in normalising policy will not be felt in the next year or two. The success of the Fed under Paul Volcker and Alan Greenspan in anchoring inflation expectations serves as a shield. Given the long lags in the monetary policy process, even major mistakes at present are unlikely to have large destabilising effects on price stability in the next year or two. Short-sighted policies always shift costs into the future. The need for a somewhat accommodative policy cannot be used to defend the current non-systematic policy and excessive emphasis on short-term employment gains. First and foremost, the Fed should take a long view and return to a systematic policy approach that preserves and defends price stability. As Paul Volcker and Alan Greenspan kept reminding us over a generation while cleaning up the mess that short-sighted policies created before their chairmanships, this is best way monetary policy can contribute to enhancing growth and employment in the long run. Publication does not imply endorsement of views by the World Economic Forum.

Chapter 9 : A Look At Fiscal And Monetary Policy | Investopedia

Fiscal and Monetary Policy Practice Problems Name _____ 1. What is the Fed (Federal Reserve Board)'s main tool for controlling interest rates and the money supply in the economy?