# MONETARY THEORY AND POLICY

## WEEK 6-TRADE-OFFS IN MONETARY POLICY GOALS

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**WEEK 6: TRADE-OFF IN MONETARY GOALS**

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## 1.0. INTRODUCTION

The four monetary policy objectives that were mentioned in unit one above do not complement one another. Instead, they are at odds with one another. When a government works to achieve one goal, another aim retreats. One must be given up in order to obtain the other. Therefore, it is not possible to accomplish all of these goals at once. Therefore, we will analyze the conflicts or trade-offs between various aims in this unit.

## 2.0 OBJECTIVES

At the conclusion of this unit, you should be able to:

- Define and comprehend the Full Employment and Economic Growth at the conclusion of this unit.
- Recognize the connection between price stability, balance of payments, and full employment.
- Recognize the balance of payments and price stability.

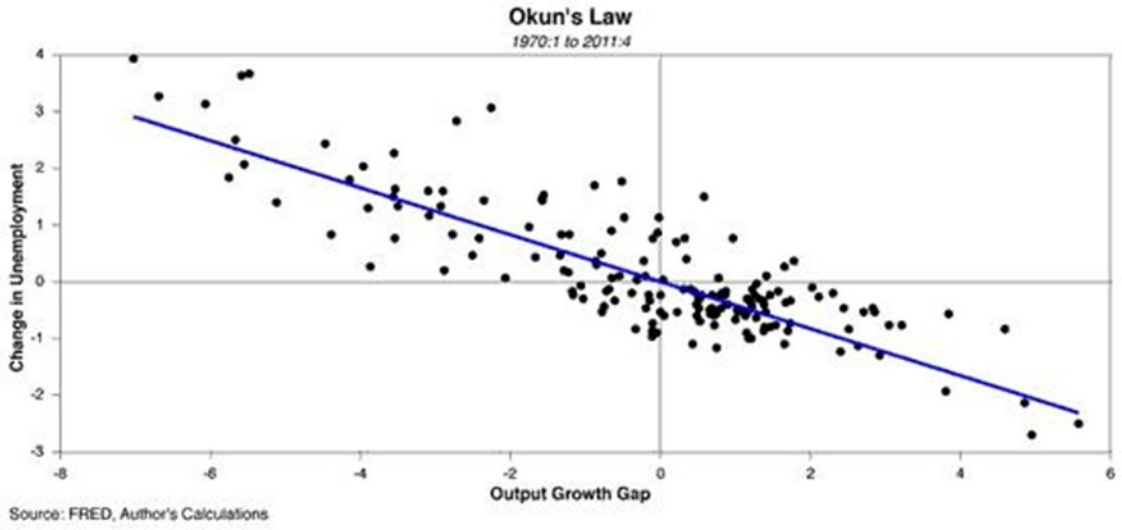
## 3.0 PRIMARY CONTENTS

### 3.1 Economic Growth and Full Employment

The majority of economists believe that full employment and economic growth do not always contradict. A 4% unemployment rate in the economy is consistent with full employment. As a result, there is a trade-off between growth and unemployment in the relationship between full employment and economic expansion. Low unemployment is related to periods of high growth, and growing unemployment is associated with periods of low growth.

Arthur Melvin Okun identified a link between fluctuations in the unemployment rate and real GNP in 1961. The phrase OKUN'S LAW has come to refer to this arrangement. According to this rule, the unemployment rate decreases by one percentage point annually for every three percentage points of real GNP growth. In a nutshell, Okun discovered that the link between the unemployment rate and the difference between real GDP growth and potential GDP growth changed over time. The association that Okun observed and discussed in his 1962 work is shown in the graph below with an Okun coefficient of -0.30.

**Figure 1: Graphical representation of Okun's Law**




Some economists, however, contend that when growth rates climb, unemployment rates rise as well. Economic expansion causes the economy's resources to be redistributed, which changes the kind and amount of labor that is required. The demand for labor is shifting from one area of the economy to another. Workers who have been trained for a particular job are replaced when there is a decline in demand for the goods produced by that industry. Employment is a result of this. This is especially true when technological advancements lead to growth that saves labor and necessitates the hiring of more competent and skilled people. Because automation causes them to lose their jobs, unskilled folks suffer the most.

### 3.2 Price stability and economic growth

The objectives of price stability and economic expansion are at odds with one another. Price increases are a natural part of the growth process. As large-scale investments increase and incomes rise, as a result, there is an increase in demand for products and services. Prices rise as a result of inflation, especially once full employment is attained. Long-term price increases will be restrained by the development of new resources, expansion, and increased production of commodities. But a mild and steady price increase will occur together with the expansion of the economy.

### 3.3. Price stability and full employment

Having full employment and price stability was one of the goals of monetary policy in 1950. However, research conducted in the 1960s by Philips, Samuelson, Solow, and others revealed a tension between the two goals. Philip curve is used to explain these observations. They contend that greater inflation can lead to full employment and that a 5- to 6-percent unemployment rate can lead to price stability. There is no tension between price stability and unemployment, according to economists. They contend that there will be price stability as long as resources are idle. Prices only begin to increase once all available resources are utilized.

### 3.4. Balance of Payment and Full Employment

Between balance of payments and full employment, there is a significant policy problem. A balance of payments deficit is always correlated with full employment. Actually, maintaining either internal or external balance is the issue. A program of cutting spending will lower imports if there is a balance of payments imbalance, but it would increase unemployment in the nation. If the government increases total spending in an effort to boost employment, this will increase demand for imports and throw the balance of payments out of balance. This tension can only be averted, if briefly, when the government adopts expenditure-switching policies like devaluation.

### 3.5 Price Stability and Payment Balance

The goals of price stability and balance of payments of a nation don't appear to contradict with one another. In order to discourage imports and boost exports and achieve balance of payments equilibrium, monetary policy attempts to manage inflation. However, there seems to be a tension between these two goals if the government attempts to reduce unemployment while allowing some inflation inside the economy. Because a rise in prices will deter exports and stimulate imports, an imbalance in the balance of payments will result. However, if costs also increase at the same rate in other nations throughout the world, this might not happen.

## 4.0 STABILIZATION POLICY

Stabilization policy refers to a strategy implemented by the government of a nation to ensure that the economy is steady, this policy reduces price fluctuations in an economy through the implementation of certain measures and monitoring the economic cycle. Given that the economy rises and falls, governments implement fiscal policy or monetary policy to keep the economy in check. Stabilization policy is a remedy that central banks or governments use to prevent irregular and unpredictable changes in price which affects the gross domestic product (GDP) and output of an economy. Stabilization policy is often used as both an economic and discretionary policy that keeps the economy in a healthy state. Rises and falls occur in an economy, this might occur naturally or due to unnatural causes. Several factors, including inflation and deflation upturn the economy and it is the duty of governments and central banks to keep the economy steady. Stabilization policy is one of the economic policies that the government uses to maintain a good level of economic growth and prevent surges and erratic price movements in the economy. As the name implies, stabilization policy helps to stabilize the economy through effective control of aggregate demand and supply in an economy, healthy price levels and adequate monitoring of trading in the economy.

### The Origin of Stabilization Policy

John Maynard Keynes was the first economist who introduced the stabilization policy as a key process to stop or prevent erratic movements and surges in the

prices of goods in an economy. Central to the stabilization policy is the control of aggregate demand in an economy. Sudden changes in price can affect many aspects of an economy, including employment rate, money supply, and others. There are many instances where stabilization policies can be deployed or used by governments and central banks. During financial shock or economic crisis, stabilization policy can be used as a recovery mechanism to get the economy stabilized. The policies can also be implemented to prevent surge or erratic deflation and inflationary movements in an economy.

**Stabilization Policy Expansionary Monetary Policy**

Expansionary monetary policy is when a central bank uses its tools to stimulate the economy. That increases the money supply, lowers interest rates, and increases demand. It boosts economic growth. It lowers the value of the currency, thereby decreasing the exchange rate.

**Stabilization Policy Expansionary Monetary Policy**

Contractionary monetary policy is driven by increases in the various base interest rates controlled by modern central banks or other means producing growth in the money supply. The goal is to reduce inflation by limiting the amount of active money circulating in the economy. It also aims to quell unsustainable speculation and capital investment that previous expansionary policies may have triggered.

**The Future of Stabilization Policy**

Generally, fiscal and monetary policies will continuously be used by central banks and governments of nations that keep the economy in a healthy state. Stabilization policy as a key fiscal policy will be needed even in the future. Given the continuous

demand that governments maintain good economic growth and stable price levels, stabilization policy will remain a vital economic tool.

## 5.0 POLICY LAGS

In the process of monetary authorities working to stabilize the policy objectives lags occur. *Time lags* occur between the onset of an economic problem and the full impact of the policy intended to correct the problem. Policy lags can reduce the effectiveness of business-cycle stabilization policies and can even destabilize the economy. Policy lags, especially inside lags, are often different for monetary policy than for fiscal policy.

Policy lags arise because government actions are not instantaneous. The use of any stabilization policy encounters time lags between the onset of an economic problem, such as a business-cycle contraction or the onset of inflation, and the full impact of the policy designed to correct the problem. For example, should a business-cycle contraction hit the economy on January 1st, stabilization policy cannot correct the problem by January 2nd. The use of any stabilization policy, especially fiscal policy and monetary policy, takes time to work through the system.

Policy lags are commonly divided into two broad categories-

*1.Inside lag* -they occur when getting the policy activated, and

2. *Outside lag* – refers to the subsequent impact of the policy.

**Inside lags**

The three specific inside lags are-

(i) Recognition lag,

(ii) Decision lag, and

(iii) Implementation lag.

**1. Outside lags**

The one specific outside lag is termed *impact lag*.

Inside Lag

Inside lag is the time it takes between the actual onset of a problem and the launching of the corrective action by government. The wheels of government often spin slowly and deliberately.

Three types of inside lag occur.

**(i) Recognition Lag**

Before any policy action can be pursued, the existence of the actual problem must be identified. It takes time to collect and analyze economic data. Unemployment and inflation data are usually available only a month or so after the fact. That is, the unemployment rate for January is usually available in February. Production

and income data are reported quarterly and have an even longer lag. Gross production data for January, February, and March is seldom available until May. Once data are obtained, it must be analyzed and evaluated to ensure that it reflects the onset of an actual problem, such as a business-cycle contraction. This often requires several months of data to document an actual trend and determine that it is not just a temporary statistical aberration.

### (ii) Decision Lag

Once government policy makers have identified the problem, they need to decide on a suitable course of action, then pass whatever legislation, laws, or administrative rules are necessary. Often this requires an act of Congress, signed into law by the President. Congress is bound to debate the appropriate policy, make amendments, and promote particular political interests along the way. For example, if a business-cycle contraction is identified, Congress is likely to debate over an expansionary fiscal policy use of increased government spending or decreased taxes. But will the spending go for purchases or transfer payments? If it goes for purchases, then what types of goods or services are purchased? If taxes are decreased, which taxes are cut and who receives the extra income? These decisions could take days, weeks, or months.

### (iii) Implementation Lag

After a particular policy has been selected, steps then need to be taken to implement the policy. For any change in spending, the appropriate government

agencies need to be contacted. Often, this involves a change in budget appropriations. The affected agencies then need to make changes in their spending. The act of spending is not instantaneous. Most agencies require competitive bids to identify product suppliers before they can make the expenditures. Even the employment, then subsequent payment, of additional workers takes time. The implementation of fiscal and monetary policy is also likely to take weeks if not months.

Inside lags are likely to take several months. A best-case scenario involves at least two months. One month to recognize the problem and another month to select and implement the appropriation policy. A more likely scenario is three to six months of inside lags.

**2. Outside Lags**

The outside lag is the time it takes after a policy is selected and implemented by appropriate government entities to be effective and achieve the desired change in the economy. The effectiveness of results of a policy action are not instantaneous. The principal outside lag is termed the impact lag.

**Impact Lag**

This lag is the time it takes any change initiated by a government policy to impact the producers and consumers in the economy. A key part of the impact lag is the multiplier. An initial change in government spending, taxes, the money supply, interest rates must work through the economy, triggering changes in production and income, which induces changes in consumption, which causes more changes

in production and income, which induces further changes in consumption. Each "round" of changes (consumption expenditures on production that are induced income) is likely to take a month or two. Several rounds are needed (six to ten or more) before the bulk of this impact is realized. An impact lag of one to two years is not uncommon.

**Monetary versus Fiscal Policy time lags**

Both monetary and fiscal policy encounter time lags. The outside, impact lag for each is very much the same. Once the policies are activated, then the economy works through several rounds of production, income, and consumption before results are realized.

However, the story is a little different for inside lags. While the recognition lag is much the same regardless of the policy used, the decision and implementation lags tend to be different for monetary versus fiscal policy.

*Monetary Policy*: The decision lag for monetary policy tends to be relatively short. Monetary policy decisions are made by the monetary authorities through the monetary policy committees .For example, the Federal Open Market Committee of the Federal Reserve System, a small group consisting of 12 members and an relatively powerful chairman. Monetary policy is their primary task. This committee meets every six weeks or sooner if needed usually comes to a policy decision when faced with a business-cycle problem with very little delay.

The implementation lag is also relatively short. Policy decisions are implemented by a special branch of the Federal Reserve System devoted to this task. Once a

policy action is identified, then the implementation steps are begun almost immediately (often by the end of the day). And because monetary policy works through financial markets (which tend to operate quickly), implementation is completed in short order.

*Fiscal Policy*: The decision lag for fiscal policy tends to be relatively long. Fiscal policy decisions are made by government through an act of parliament. Because Congress or parliament represents diverse interests, finding a fiscal policy that is acceptable to a majority can take time. And hopefully this decision is acceptable to the President, as well. If not, then the decision making process continues, and the decision lag continues.

The implementation lag also tends to be relatively long. Any changes in government spending or taxes need to work through the government agencies and bureaucracies before than are implemented. Bureaucracies, by their very nature, are slow to act as they make sure that necessary rules and procedures are followed. But this tends to lengthen the time needed to implement fiscal policy.

**Destabilizing Policies**

The goal of stabilization policies is to stabilize the business cycle, to counter contractions and expansions. However, policy lags can actually make stabilization policies destabilizing. That is, they can worsen the ups and downs of the business cycle.

For example, if the impact of expansionary fiscal policy is not seen for a year or more after the onset of a business-cycle contraction, then the stimulation might

occur during the ensuing expansion, which can then overstimulate the economy and cause inflation.

Alternatively, the impact of contractionary monetary policy designed to reduce inflation created during an expansion might not occur until the onset of an subsequent contraction. In both cases, the resulting policy is not counter-cyclical, but pro-cyclical. The policies reinforce and thus destabilize the business cycle.

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