

COURSE TITLE: MONETARY THEORY AND POLICY

WEEK 14. ASSESMENT ANSWERS

Answer 1.

Full Employment and Economic Growth: The objectives of full employment and economic growth should be distinguished from each other. The following are the important points of distinction between the two objectives.

(a) Full employment implies exploitation of job opportunities by lifting the actual production frontier up to its maximum limits under the constraint of available resources, by developing additional resources. While economic growth means creation of more employment opportunities by raising the potentialities of production frontier

(b) Full employment is a static notion. It refers to the full utilization of existing capacity of the economy with given productive resources, technology, and production methods. Economic growth, on the other hand, is a dynamic concept. It implies an enhancement of productive resources through technological advancement, exploitation of new fields, new territories, new methods etc. It involves uplifting the country's production possibility frontier.

(c) Full employment objective is relatively a short span phenomenon. It aims at economic stabilization through the elimination of cyclical fluctuations that are faced by a advanced capitalist economy. Economic growth, on the other hand, is a long--term objective of monetary policy. Its aim is to improve the standard of living of the people, to remove poverty by increasing the level of income, output and employment in the economy. This objective is largely adopted by governments of underdeveloped countries. However, there is no reason why an advanced economy should not adopt it.

(d) In technical jargon, the full employment objective implies raising the actual output schedule of a country to its production possibility frontier with a reasonable degree of economic stability. The economic growth objective, however, implies raising the production possibility frontier itself, together with the actual output schedule. It involves structural changes.

(e) Full employment objective lays stress on the maintenance of effective demand; thus, during a depression it implies correcting the deficiency of demand and when there is inflation due to excess demand, it implies curbing it. The objective of economic growth, however, stresses on increasing the volume of the complementary resources (land, capital, etc.) essential for securing the productive employment of available labor rather than on the maintenance of effective demand as such.

Thus, policies aiming at full employment and those aiming at growth are not necessarily identical and obviously a separate set of measures may be required to serve the cause of growth. While it is broadly true that full employment stimulates growth and unemployment hinders it, in certain circumstances, the effect of full employment on costs and prices as well as on the morale of employees is liable to be very harmful to growth.

Moreover, the end of full employment is usually served by short-run measures which disregard long-term requirements. For instance, the creation of uneconomic industries for the sake of providing employment is contrary to the requirements of growth because it does not make the best possible use of the productive resources.

Answer 2

Taylor Rule is an interest rate forecasting model invented by famed economist John Taylor in 1992 and outlined in his 1993 study, "Discretion Versus Policy Rules in Practice." It suggests how central banks should change interest rates to account for inflation and other economic conditions.

The Taylor Rule suggests that the central bank should raise rates when inflation is above target or when gross domestic product (GDP) growth is too high and above potential. It also suggests that the central bank should lower rates when inflation is below the target level or when GDP growth is too slow and below potential.

The product of the Taylor Rule is three numbers: an interest rate, an inflation rate and a GDP rate, all based on an equilibrium rate to gauge the proper balance for an interest rate forecast by monetary authorities.

Taylor's rule suggests that the difference between a nominal interest rate and a real interest rate is inflation. Real interest rates account for inflation while nominal rates do not. To compare rates of inflation, one must look at the factors that drive it.

Answer 3

The target of monetary policy are money supply, availability of credit, and interest rates.

The choice of a target for monetary policy is determined by the mechanism through which money affects growth, employment and prices. Since none of the monetary authority's policy tools works directly on these policy variables, the policy makers rely on intermediate targets that they feel they can control tolerably well with the instruments at their disposal, and that are closely linked through transmission mechanism to the ultimate targets of production, employment and price level.

a) Money Supply:

So far as money supply is concerned, the central bank cannot directly control output and prices. So, it selects the growth rate of money supply as an intermediate target. In fact, it selects an "operating target" which it considers to be closely linked to its "intermediate target". Friedman suggests that the money supply should be allowed to grow steadily at the rate of 3 to 4 per cent per year for a smooth growth of the economy and to avoid inflationary and recessionary tendencies.

b) *Availability of Credit and Interest Rates:*

Availability of credit and interest rates are the other two target variables of monetary policy. Economists call them as “money market conditions” which refer to short-term interest rates and the banking system’s “free reserves” (i.e., excess reserves minus borrowed reserves).

The monetary authority can influence the short-term interest rates. It can change credit conditions and affect economic activity by rationing of credit or other means. The monetary authority influences economic activity by following an easy or expansionary monetary policy through low and/or falling short-term interest rates and a tight or contractionary monetary policy through high and/or rising short-term interest rates.

Intermediate Targets:

Money supply and interest rate are intermediate targets of monetary policy. In fact, they are competing targets. The central bank can either aim at a certain rate of increase in the money supply or at a certain level of interest rate. It cannot adopt both the targets at the same time.

The money supply target means loss of control over the interest rate, while the interest rate target means loss of control over the money supply

Of the two targets relating to money supply and interest rate, the monetarists prefer a monetary target for various reasons. First, the money supply is measurable, while there are a variety of interest rates. It is, therefore, difficult to adjust nominal interest rates to real interest rates. Second, the money supply linkage with nominal GNP is more direct and predictable than the interest linkage with nominal GNP.

Market Yield on Equity

Tobin suggests the market yield on equity as a target variable for monetary policy. According to him, the monetary authority should try to equate this yield with the real return expected from investment in physical capital. When the real rate of return on equity rises, the value of existing capital equipment falls which

discourages the purchase of new capital equipment. Contrariwise, investment is encouraged when the cost of production of new capital is less than its market value.

Thus, the valuation of investment goods relative to their cost is the proper target of monetary policy. This target is superior to other targets because the market value of equity capital can be observed easily and an index of market value can be compared with a price index of investment goods.

Despite this, it is difficult to compare the value of existing assets with those of newly produced assets. Moreover, it is not possible to link investments with changes in stock market prices. So, it is not advisable to adopt market yield on equity as the sole target of monetary policy.

Conclusion:

Of the various targets of monetary policy, it is advisable for the monetary authority not to rely on any single target. It should select the targets according to the prevailing economic and financial conditions. The interest rate is more suitable during the short run. But in the long run, the credit availability and the money supply should be relied upon by the monetary authority.

Answer 4

The central banks of a country are normally mandated to achieve certain goals such as price stability, high growth, low unemployment. But the central banks do not directly control these variables. Rather they have set of instruments such as open-market operations, setting bank rate etc. which they can use to achieve these objectives.

The problem of a central bank is compounded by the fact that its instruments do not directly affect these goals. These instruments affect variables such as money supply and interest rates, which then affect goal variables with lag. In addition, these lags may be uncertain. A distinction is made among (i) goals (or objectives), (ii) targets

(or intermediate targets), (iii) indicators (or operational targets), and (iv) instruments (or tools) in the conduct of monetary policy. Target and indicator variables lie between goal and instrument variables. Target variables such as money supply and interest rates have a direct and predictable impact on the goal variables and can be quickly and more easily observed. By observing these variables, a central bank can determine whether its policies are having desired effect or not. However, even these target variables are not directly affected by the central bank instruments. These instruments affect target variables through another set of variables called indicators. These indicators such as monetary base and short run interest rates are more responsive to instruments. The conduct of monetary policy can be represented schematically as follows:

Instruments → Indicators → Targets → Goals

Goals or Objectives

1. High Employment
2. Economic Growth
3. Price Stability
4. Interest-Rate Stability
5. Stability of Financial Markets
6. Stability in Foreign Exchange Markets

Targets or Intermediate Targets

1. Monetary Aggregates (M1, M2, M3 etc.)
2. Short Run and Long Run Interest Rates

Indicators or Operational Targets

1. Monetary Base or High-Powered Money
2. Short Run Interest Rate (Rate on Treasury Bill, Overnight Rate)

Instruments or Tools

1. Open Market Operations
2. Reserve Requirements
3. Operating Band for the Overnight Rate
4. Bank Rate

Different countries and regimes will give different weight to all these goals. Different goals may get different emphasis in different countries and times

Answer 5

The use of interest rates and credit availability as target variables are beset with several difficulties:

1. No doubt interest rates and the supply of credit influence spending, but it cannot be predicted with definiteness about the size and timing of the effects of any change in them.
2. So far as interest rates are concerned, it is the real interest rate that matters and not the nominal interest rate.

It is possible to control and observe the movements in the nominal interest rate and not in the real interest rate because it is difficult to measure the expected rate of price inflation. When the monetary authority raises the nominal interest rate, the real interest rate will also rise, other things being equal. But this does not happen always because when money interest rates are raised, the expectations of price inflation are growing. Under such circumstances, a rise in the nominal interest rate may be associated with a fall in the expected real rate. Thus the nominal interest rate is not a good target of monetary policy.

3. The use of credit availability as a monetary target is not helpful in monetary policy. Suppose there is a reduction in the availability of credit, it may be offset by credit flows through NBFIs. Moreover, it is difficult to predict the amount of reduction/increase in the availability of credit.