Good monetary policy research paper example

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Introduction

Aggregate demand and interest rates, along with the actual economic growth and the prospects are the benchmarks of any Federal government. In order to control the economy, government uses monetary policies to analyze essential measures.

Open Market Operation

Open Market Operations involve purchase and selling of governmental securities which helps to stabilize inflation. The Federal funds rate is equal to the interest and lending rates, according to which financial institutions charge for the loans. The Domestic Open Market Operations are guided by the Federal Open Market Committee and continuing with the aid of strengthening the efforts to support economy recovery path in a price-stabilizing context, while providing extra policy recommendations . Adjustment of the amount and structure of the Federal Reserve Balance Sheet is done to counter the pressure, especially on long-term interest rates.

Lending rate

Discount rate is the amount of money banks are charged for when loaning cash from Central Bank. Federal Reserve Bank has the mandate to change the rating to discourage/encourage banks and other financial institutions from borrowing/to borrow money. A change in the lending rate has a huge impact on the amount of money circulating in the economy. This mechanism usually describes the intentions and plans of Federal Bank towards the their monetary policy.

Fractional Reserve Banking

This is a deposit required to be kept in by every financial institution in the Federal Reserve as the minimum value . Federal Reserve gains a certain percent from such a deposit and the rest of the sum is provided for potential borrowers.

Interest Rate

The graph shows how the US economy behaved within 1969-1984 time period. Inflation had started reducing in 1969, and drastically fell to negative 3 in 1973. Money circulation in 1975 was minimal as the country experienced deflation; Federal Reserve Bank imposed a monetary measure to control and increase the money supply to the economy. Economic situation improved and inflation climbed to 3. 5 in 1981.

The economy improved and went a notch higher to an inflation rate of 3. 5 in 1981. In order to regulate the fiscal policy, Reagan attempted to decrease the growth of government spending. But he couldn’t do important changes in this issue since economic growth was somewhat slower than expected. As shown in the figure 1 below between his eras, 1981-1989, there wasn’t any affected decrease in the government spending, While he began in 1981, the government spending was at approximately 22% and it was almost at the same level in his last year 1989.

Federal Government Expenditure

Dramatic changes were made to the top marginal tax rate on individual income by lowering from 70% to 28%. Moreover, the corporate income tax was wilted from 48% to 34%. Most of the poor people were waived off the

individual income tax.

Interest rate normally changes with economic situation and financial policies of the government; expectations of banks and other financial institutions, and their borrowers on the future price changes. However, before the interest rate is determined, array of factors, including Dollar price is taken into account. Equinox is achieved when financial institutions satisfy the demands of their clients in amounts of money they prefer to lend. Interest level changes with the change of cash quantity supplied vis-à-vis the demand from the borrowers. As seen on chart below USA government debt increased from almost 38% of GDP to almost 60% of GDP after 1981.

The government has traditionally depended on the three instruments to perform monetary policy. Firstly, it can alter reserves available in the central reserve. The reserves can be in currency or deposits. These reserves put a threshold on the amounts a financial institution can hold as cash . Secondly, the federal government may take a credit. Yet, the key method is Open Market Operations (OMO), and it involves selling of securities of US Government.

Why Monetary Policy is Important

- It lowers macro financial vulnerabilities. During US economic crunch, prices of commodities went to the ceiling leaving consumers go for the basic commodities a drive that forgotten long ago. Consumptions bundles beyond the borders were cheap as compared to the countries hence paving way importation, which was then cheap.

- Enhances Central bank Accountability and autonomy. New laws gives Federation reserve primary role to look at effect price stability and enabling

Federal reserve with economical independent and adopts monetary policies as ought to in order to achieve their mandate . Monitory policy gave federation reserve the immune from choosing the monitoring operations fit to teach the institution goals.

3) Enhances monetary policy adoption, having clear responsibility on stabilizing prices, every Central bank adopts Information Technology in improving their operations. IT helps a lot while predicting inflations and give allowance for adjustments for increased monetary policy. Central banks revamp their IT frameworks

4) Cooperates in improving the operational web. Central banks works better in revamping their frameworks . Policy rate is determined when the monetarist sit and decide on the appropriate short-term rate as the working target. Monetarist helps in settling on a particular rate whether policy rate or Market-based overnight interest rate . In order to attain short-term rates to policy interest rate, Federal bank normally conducts open market rates nearly to policy rate. Monetarist in Federal Reserve majorly depends on forecasting liquidity as a guide to the open market operations. Efficient means have been developed to forecast factors that may lead to liquidity imbalance, which might trigger interest rate deviation from the policy rate.

5) Helps coping with the surge in commodity and food prices, just before the financial crisis explosion, the monetarist warned of inflation. Inflationary pressures showed a combined rising of both domestic demand and accosts. With the cost-push analysis, Central banks help in harmonizing rising food and oil prices. Energy and other commodity prices had been on the rise in the world market. For instance, the various strategies that the U. S. Federal

Reserve adopted to cope with the financial crisis that stuck the U. S. in the year 2009 were far more different to those that were adopted during the 2008 crisis.

During 2008, the Federal Reserve implemented a large number of emergency lending measures. The same is indicated in the graph below:

Source: http://www. econbrowser. com/archives/2012/08/us_monetary_pol. html

There are a number of individual components which encompassed the above emergency lending of the Fed, like currency swaps, Term auction facility etc. The graph below represents the various individual components of the 2008 emergency lending of the Fed.

Source: http://www. econbrowser. com/archives/2012/08/us_monetary_pol. html

6) Manages capital inflow, Federal Reserve controls and made some adjustment on the amount of capital of finances should circulate within a country and the reserve requirement. The Federal Reserve also controls reserve needed on both foreign currency and domestic liabilities and differentiated, with a higher reserve coefficient. Besides raising reserve requirement in local currency, the Federal Reserve Bank imposes unremunerated reserve threshold on foreign borrowing and inflow portfolios. In case of the need of more reserve of local currency, monitory policy chips in and slows down cash growth.

7) Early information. Federal Reserve explains to the market participant on their decisions, policies, and goals to be achieved within a specification of

time. The prospect for economic recession and low inflation warranted an aggressive cut of policy rates. Selling foreign exchange by the Federal Reserve is reasons one being to secure liquidity aspects in foreign currency.

The Effect of not implementing a Monetary Policy

Long and variable lags, actions leveled to stimulate an economy would destabilize it. Because of the involvement of the e lags, the difficulty of predicting the effects of such activities would not allow any kind of action being taken in advance which might be correct when its effect occurred. The historical time series for money growth and cyclical turning points showing that currency lead turning points in the economy and that the timing of the connection was variable. Such reactions functions would cause Federal Reserve Bank to change the settings of their policy instrument without regard to the lags involved. Given so many lags monitory policies if not used well, will accumulates several mistakes . While the stock of cash directly related to commodities price level on average, there is much variation in the relation over a short period. Monetary changes have their effect only after a considerable lag and over a long period and that, lags are rather variable while price level could be an effective guide only if it were possible to predict, first effects of non-monetary factors on the price level for a considerable period in the future.

Federal Reserve Bank uses the interest rate is the only instrument used. This interference serves as a tool for setting rate targets in such a way that the setting is analogous to price fixing. The nominal interest rate is the price of Dollar today in terms of dollar tomorrow. Because individual welfare is reliant upon factors like the real variables, market forces fail to reduce this price

determinate. The central bank must provide nominal determinacy in way that it controls the actual and expected future creation of money. Federal reserve bank focus exclusively on regulating financial intermediation to the exclusion of money lack a rule that provides a stable nominal anchor. Virtually, without the presence of a nominal anchor in the form of constancy in projected inflation changes by the central banks to its rate target do not interpret into anticipated changes in the real interest rate. Although lenders and borrowers contract in terms of the nominal interest rate, their inflation forecast interprets the nominal rate into a real rate. Central bank interferes with the market determination of this real interest rate constitutes price fixing. An example, as consequences of maintaining a rate that is too high, the central Bank must sell bonds and existing money in order to offset the resulting excess demand in the bond market.

During financial stress, funds flow from illiquid debts instruments into the demand the signal to noise ratio is very low for monitory aggregates . Nothing in fact, however, bears on the validity of the monetarist hypothesis that monetary control and a rule that follows the price system to work are inseparable concepts.

The attempt by the central banks to engineer a negative output gap in order to reduce either the prices of the asset or inflation can be an essential circumstance for recession without also being a sufficient condition. The central banks may operate regularly with an activist rule in which it manipulates Philips curve trade-offs but periodically is unlucky. The monitories hypothesis, however is that in order to evade the economy from destabilizing, the central bank should follow a non-activist rule.

Artificial Economy

Its main feature includes an open economy where optimal behavior of consumers leads to equilibrium transition paths of endogenously determined variables. Some of these variables, for instance the aggregate, supply the economy, behave in a forward manner that takes into consideration staggered pricing mechanism. It also generates inflation inertia and recessionary disinflation in the economy that allow the monetary policy interventions as well as the exogenous stochastic process. This will produce equilibrium and results to real effects in the short run.

On Household

There is a continuum of household making sequence of decisions during each period. It makes its consumptions decisions and its capital accumulations decisions and decides on how many units of capital services to supply . The ability to purchase securities whose payoff is contingent upon whether it can re-optimize or not. Household finally decides how much of its financial asset to hold with a financial intermediary in the form of deposits and how much to hold in the form of liquid cash. Since the uncertainty faced by the household over whether it can re-optimize its wages is idiosyncratic in nature, household work different amounts and earn different wage rate. Loan Market Clearing and the resource constraint, Household absorbs an increase in the money supply, this is because the demand for money supplied. As in standard limited participation model, the drop in interest rate because of the subset of agents must absorb the full amount of an increase in the money supply. Unlike those models, here household absorb the cash. The decline in the interest rate reduces marginal cost. This in turn helps the

model generate an inertia response of inflation to appositive monetary policy shock.

Natural Disasters

In August 2005, US was hit by Katrina which caused unprecedented damage to property worth an estimate $150 billion making it a disaster of its kind. As a result, economy’s activities are disrupted immediately after the wrath . Domestic production fell by 0. 4 percent margin in the third quarter of 2005. The degree of disaster caused Federal Open Market Committee to postpone 25% increase in federal funds rate.

Natural disasters may destroy an economic, effecting productive capital stock, disaster production, which we model as transitory negative technology shock.

Considering two crucial characteristics of a natural disaster like a Hurricane and Katrina. Disaster destroys an economic all relevant share of the economy‘ s productive capital stock, disaster too disrupts temporarily production, which we model as transitory negative technology shock. Since natural disaster is an infrequent event, the disaster shock model as two –state marks of switching process. The negative shocks to the capital stock and to technologically specified S functions of the two –state disaster variable. To compensate for lost productivity and a lower capital stock, then on-price adjustment firms must upsurge their labor to maintain the levels of production. Conversely, Price–adjustments firms reduce their labor demand as output falls. As a result, employment increases in the sticky price model and sticky prices and wage, but decreases in the flexible model

Conclusions

Monitory policies meant to controls the amount of money on the hands of the public. The policies formulated and implemented by Federal Reserve; the Federal Reserve banks oblige the forces of supply and demand by raising and lowering interest rates as per the Federal Reserve requirements . Federal Reserve has three major mechanism of controlling and manipulate sing amount of cash in the public hands. The federal can buy and sell securities, which will increase cash circulation, and the reverse is true, using open market operation helps in a short period interests rates and the federal cash rate, dictates the interbank lending rate and the lending rate by the Federal Reserve Bank.

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