Conflicts in monetary policy 1748

ASSIGN BUSTER

Goals of monetary policy are to " promote maximum employment, inflation (stabilizing prices), and economic growth." If economists believe it's possible to achieve all the goals at once, the goals are inconsistent. There are limitations to monetary policy.

The term " maximum employment" means that we should try to hold the unemployment rate as low as possible without pushing it below what economists call the natural rate or the full- employment rate. Pushing unemployment below that level would cause inflation to rise and thereby ruin

the other objective--stable prices, economic growth, which is our objectives in the long run.

Overall financial stability will lead to a better balance between consumption and saving that will make resources available for investment purposes, reduce

changes in the economy created by the inflation in the past, and by the reactions of savers, as well as fostering high and sustainable economic growth; and contribute towards an investor friendly environment that will attract foreign investors to the country.

Evidence has suggested that economies perform better, in terms of growth, employment and living standards, in low inflation environments than they do when inflation is persistently high. This evidence is a comparison across countries over long periods. The association between economic performance, measured by growth of output or growth of productivity, and inflation. This indicates a negative relation; that is, the higher the inflation, the lower the rate of real growth.

Evidence suggesting that low inflation promotes growth has motivated recent decisions by a number of central banks and governments, most notably

New Zealand. Canada, the United Kingdom and Sweden also have moved in recent years to establish monetary policy with official low inflation targets. Decisions to adopt a policy objective of low inflation suggest that other policy-makers are reading the evidence pertaining to inflation and growth as we are.

Consistent attempts to expand the economy beyond its potential for production will result in higher and higher inflation, while ultimately failing to produce lower average unemployment. Therefore, most economists would

argue that there are no long-term gains from consistently pursuing expansionary policies.

Monetary policy can determine the economy's average rate of inflation in the long run. And that's important for the economy, because high inflation can hinder economic growth. For example, when inflation is high, it also tends to vary a lot, and that makes people uncertain about what inflation will be in the future. That uncertainty can hinder economic growth in a couple of ways--it adds an inflation risk premium to long-term interest rates and it complicates the planning and contracting by business and labor that are so essential to capital formation. High inflation also hinders economic growth in other ways. For example, because the tax system isn't in agreement with inflation, high inflation arbitrarily helps and hurts different sectors of the economy. In addition, it makes people spend their time hedging against inflation instead of pursuing more productive activities.

Because the government can determine the economy's average rate of inflation, some commentators--and some members of Congress as well--have emphasized the need to define the goals of monetary policy in terms of price

stability, which is achievable.

One kind of conflict involves deciding which goal should take

precedence at any point in time. For example, the government needs to be

careful to avoid letting short-run temporary successes in preventing

employment losses during recessions lead to longer-run failures in

maintaining low inflation. Another kind of conflict involves the potential for

pressure from the political arena. For example, in the day-to-day course of

governing the country and making economic policy, politicians may be

tempted to put the emphasis on short-run results rather than on the longer-run

health of the economy. The government is somewhat insulated from such

pressure, however, by its independence, which allows it to achieve a more

appropriate balance between short-run and long-run objectives.

When unemployment is high the policy that should take place is inflation

should increase slightly to drive up prices in order to cause increases in

output. When unemployment is below average and nearing full employment

the policy that should take place is to slightly lower the productivity of the

workers and therefore cause a decrease in the output. This would slow the

economy down and into the ideal condition of maximum employment.

When the production is at its maximum and unemployment at a minimum the

government must raise the inflation rate in order to make sure that the

situation stays where it is. It must be sure not to raise inflation too sharply or

else everyone will be afraid to spend their money.

The belief that a 4% unemployment rate and stable prices are inconsistent

is shaped by the widely accepted " natural rate hypothesis." It argues that

monetary policy has no effect on the economy's unemployment rate, which is

often called the natural rate of unemployment. The reason is that, in the long

run, unemployment depends on so-called " real" factors--such as technology

and people's preferences for saving, risk, and work effort; these factors are

beyond the reach of monetary policy. Most current estimates place the natural

rate of unemployment in the range of 5A?-6A?%.

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