Monetary policy wages, markets and income

Finance

ASSIGN BUSTER

As asserted by Woodruff, the real interest rate is defined as the interest rate minus the rate of inflation in the economy. Viewing it in another way, interest rate, specifically the nominal interest rate, is the real interest rate plus the inflation. The nominal interest rate is what is actually applied to my mortgage or loan application. With this, it becomes evident that an increase in inflation brings about an increase in interest rate. As such, should I perceive that inflation is relative during a particular period, then I may defer my decision to apply for a loan or mortgage until inflation has been curbed as expected by economic agencies. This would generally lessen my cost of borrowing given the resulting lower interest rate.

Relative to inflation, Woodruff also noted that leading inflation indicators should be watched. These key reports include those on the unemployment rate, employment cost index (ECI), GDP, consumer price index (CPI), and producer price index (PPI).

The employment reports of the Department of Labor are deemed as the " harbinger of inflation." This is because of the perceived inverse relationship between inflation and unemployment rate, meaning with a lower unemployment rate-an uptick in inflation is expected. On the other hand, the ECI may also be monitored since it indicates if employers have increased wages. Given the direct relationship between wages and inflation, an increase in wages results in an increase in inflation.

Apart from these, the CPI, PPI, and GDP may also be worth considering. The CPI and PPI show the price level of goods and services purchased by

consumers and wholesalers. In this regard, they may be deemed as the main inflation indicators. Similarly, the GDP, although a harder indicator to analyze, may signal whether there is a change in inflation given the economic growth rate. This means that, generally, economists view that if the economy grows too fast, inflation would increase, and so would the interest rate.

2. How would Federal Reserve policy affect your decision to make such a purchase

The Federal Reserve (Fed) being the primary monetary body that controls the supply of money in the economy plays a crucial role in my decision. This is because, with its mandates, the Fed directly affects the interest rate regime. It may undertake either expansionary or contractionary policies to curb inflation, control interest rate, and the growth of the economy. (Samuelson & Nordhaus)

For instance, if the government deems that the economy needs stimulation in order to produce more jobs for the untapped labor force, then the Fed may undertake expansionary monetary policies including the purchase of credit instruments in the open market (e. g. treasury bills), lowering the discount rate (the interest rate that bank is charged for short-term borrowings from Fed through the discount window) as well as the reserve requirement. These monetary actions have a direct bearing on the interest rate. This is because when the Fed purchases securities in the open market, the price of securities is jacked up, thus, they become a more attractive investment over saving in a bank or other investments that require bank borrowing so interest rate

decreases.

In the same way, a lower discount rate essentially entails lower interest rates for borrowing and lending. Similarly, lower reserve requirement leaves banks with more cash which they could invest in other projects like purchasing of bonds and other credit securities. This, in turn, causes the price of these alternative investments to rise and reduces the interest rate. (Samuelson & Nordhaus)

The reverse process applies to contractionary monetary policy.
In view of the above, prior to making my major financing decision, I would be better equipped to make the optimal choice by looking at the direction taken by the Fed since its actions indicate what the interest rate regime would be.