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Monetary Policy and Economic Policy

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Abstract

There is widespread agreement that monetary policy matters, but there is disagreement about how it should be conducted. Behind this disagreement lie differences in theoretical understandings. The paper contrasts the New Classical, Neo-Keynesian, and Post-Keynesian frameworks, thereby surfacing the differences. The New Classical model has policy only affecting long run inflation. The Neo-Keynesian has policy impacting inflation, unemployment, and real wages. The Post-Keynesian model also impacts growth, so policy implicitly picks a quadruple. Inflation targeting is a sub-optimal policy frame because it biases decisions toward low inflation by obscuring the fact that policy also affects unemployment, real wages, and growth.

Keywords: monetary policy, inflation targeting, New Classical, Neo-Keynesian, Post-Keynesian

Introduction

Monetary Policy involves changes in the base rate of interest to influence the rate of growth of aggregate demand, the money supply and ultimately price inflation.

Monetarist economists believe that monetary policy is a more powerful weapon than fiscal policy in controlling inflation. Monetary policy also involves changes in the value of the exchange rate since fluctuations in the currency also impact on macroeconomic activity (incomes, output and prices)

Changes in short term interest rates affect the spending and savings behaviour of households and businesses over time and therefore feed through the circular flow of income and spending. The transmission mechanism of monetary policy works with variable time lags depending on the interest elasticity of demand for different goods and services – e.g. the demand for interest-sensitive consumer goods and services bought on credit or the demand for capital investment from private sector businesses. Because of the time lags involved in setting an appropriate level of short-term interest rates, the Bank of England sets nominal interest rates on the basis of hitting the inflation target over a two year forecasting horizon.

Theory

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls the supply of money, availability of money, and cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy. Monetary theory provides insight into how to craft optimal monetary policy.

Monetary policy rests on the relationship between the rates of interest in an economy, that is the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. Where currency is under a monopoly of issuance, or where there is a regulated system of issuing currency through banks which are tied to a central bank, the monetary authority has the ability to alter the money supply and thus influence the interest rate (to achieve policy goals).

It is important for policymakers to make credible announcements. If private agents (consumers and firms) believe that policymakers are committed to lowering inflation, they will anticipate future prices to be lower than otherwise (how those expectations are formed is an entirely different matter; compare for instance rational expectations with adaptive expectations). If an employee expects prices to be high in the future, he or she will draw up a wage contract with a high wage to match these prices. Hence, the expectation of lower wages is reflected in wage-setting behavior between employees and employers (lower wages since prices are expected to be lower) and since wages are in fact lower there is no demand pull inflation because employees are receiving a smaller wage and there is no cost push inflation because employers are paying out less in wages.

To achieve this low level of inflation, policymakers must have *credible* announcements; that is, private agents must believe that these announcements will reflect actual future policy. If an announcement about low-level inflation targets is made but not believed by private agents, wage-setting will anticipate high-level inflation and so wages will be higher and inflation will rise. A high wage will increase a consumer's demand (demand pull inflation) and a firm's costs (cost push inflation), so inflation rises. Hence, if a policymaker's announcements regarding monetary policy are not credible, policy will not have the desired effect.

If policymakers believe that private agents anticipate low inflation, they have an incentive to adopt an expansionist monetary policy (where the marginal benefit of increasing economic output outweighs the marginal cost of inflation); however, assuming private agents have rational expectations, they know that policymakers have this incentive. Hence, private agents know that if they anticipate low inflation, an

expansionist policy will be adopted that causes a rise in inflation. Consequently, (unless policymakers can make their announcement of low inflation *credible*), private agents expect high inflation. This anticipation is fulfilled through adaptive expectation (wage-setting behavior); so, there is higher inflation (without the benefit of increased output). Hence, unless credible announcements can be made, expansionary monetary policy will fail.

Announcements can be made credible in various ways. One is to establish an independent central bank with low inflation targets (but no output targets). Hence, private agents know that inflation will be low because it is set by an independent body. Central banks can be given incentives to meet targets (for example, larger budgets, a wage bonus for the head of the bank) to increase their reputation and signal a strong commitment to a policy goal. Reputation is an important element in monetary policy implementation. But the idea of reputation should not be confused with commitment.

While a central bank might have a favorable reputation due to good performance in conducting monetary policy, the same central bank might not have chosen any particular form of commitment (such as targeting a certain range for inflation). Reputation plays a crucial role in determining how much would markets believe the announcement of a particular commitment to a policy goal but both concepts should not be assimilated. Also, note that under rational expectations, it is not necessary for the policymaker to have established its reputation through past policy actions; as an example, the reputation of the head of the central bank might be derived entirely from his or her ideology, professional background, public statements, etc.

In fact it has been argued that to prevent some pathologies related to the time inconsistency of monetary policy implementation (in particular excessive inflation), the head of a central bank should have a larger distaste for inflation than the rest of the economy on average. Hence the reputation of a particular central bank is not necessarily tied to past performance, but rather to particular institutional arrangements that the markets can use to form inflation expectations.

Despite the frequent discussion of credibility as it relates to monetary policy, the exact meaning of credibility is rarely defined. Such lack of clarity can serve to lead policy away from what is believed to be the most beneficial. For example, capability to serve the public interest is one definition of credibility often associated with central banks. The reliability with which a central bank keeps its promises is also a common definition. While everyone most likely agrees a central bank should not lie to the public, wide disagreement exists on how a central bank can best serve the public interest. Therefore, lack of definition can lead people to believe they are supporting one particular policy of credibility when they are really supporting another.

History of monetary policy

Monetary policy is primarily associated with interest rate and credit. For many centuries there were only two forms of monetary policy: Decisions about coinage; Decisions to print paper money to create credit. Interest rates, while now thought of as part of monetary authority, were not generally coordinated with the other forms of monetary policy during this time. Monetary policy was seen as an executive decision, and was generally in the hands of the authority with seigniorage, or the power to coin. With the advent of larger trading networks came the ability to set the price between gold and silver, and the price of the local currency to foreign currencies. This official price could be enforced by law, even if it varied from the market price.

Paper money called "jiaozi" originated from promissory notes in 7th century China. Jiaozi did not replace metallic currency, and were used alongside the copper coins. The successive Yuan Dynasty was the first government to use paper currency as the predominant circulating medium. In the later course of the dynasty, facing massive shortages of specie to fund war and their rule in China, they began printing paper money without restrictions, resulting in hyperinflation.

With the creation of the Bank of England in 1694, which acquired the responsibility to print notes and back them with gold, the idea of monetary policy as independent of executive action began to be established. The goal of monetary policy was to maintain the value of the coinage, print notes which would trade at par to specie, and prevent coins from leaving circulation. The establishment of central banks by industrializing nations was associated then with the desire to maintain the nation's peg to the gold standard, and to trade in a narrow band with other gold-backed currencies. To accomplish this end, central banks as part of the gold standard began setting the interest rates that they charged, both their own borrowers, and other banks who required liquidity. The maintenance of a gold standard required almost monthly adjustments of interest rates.

During the 1870-1920 period, the industrialized nations set up central banking systems, with one of the last being the Federal Reserve in 1913. By this point the role of the central bank as the "lender of last resort" was understood. It was also increasingly understood that interest rates had an effect on the entire economy, in no small part because of the marginal revolution in economics, which demonstrated how people would change a decision based on a change in the economic trade-offs.

Monetarist macroeconomists have sometimes advocated simply increasing the monetary supply at a low, constant rate, as the best way of maintaining low inflation and stable output growth. However, when U.S. Federal Reserve Chairman Paul Volcker tried this policy, starting in October 1979, it was found to be impractical, because of the highly unstable relationship between monetary aggregates and other macroeconomic variables.

Even Milton Friedman acknowledged that money supply targeting was less successful than he had hoped, in an interview with the Financial Times on June 7, 2003. Therefore, monetary decisions today take into account a wider range of factors, such as:

- short term interest rates;
- long term interest rates;
- velocity of money through the economy;
- exchange rates;
- credit quality;
- bonds and equities (corporate ownership and debt);
- government versus private sector spending/savings;
- international capital flows of money on large scales;
- financial derivatives such as options, swaps, futures contracts, etc.

A small but vocal group of people advocate for a return to the gold standard (the elimination of the dollar's fiat currency status and even of the Federal Reserve Bank). Their argument is basically that monetary policy is fraught with risk and these risks will result in drastic harm to the populace should monetary policy fail. Others see another problem with our current monetary policy. The problem for them is not that our money has nothing physical to define its value, but that fractional reserve lending of that money as a debt to the recipient, rather than a credit, causes all but a small proportion of society (including all governments) to be perpetually in debt.

In fact, many economists disagree with returning to a gold standard. They argue that doing so would drastically limit the money supply, and throw away 100 years of advancement in monetary policy. The sometimes complex financial transactions that make big business (especially international business) easier and safer would be much more difficult if not impossible. Moreover, shifting risk to different people/companies that specialize in monitoring and using risk can turn any financial risk into a known dollar amount and therefore make business predictable and more profitable for everyone involved. Some have claimed that these arguments lost credibility in the global financial crisis of 2008-2009.

Trends in central banking

The central bank influences interest rates by expanding or contracting the monetary base, which consists of currency in circulation and banks' reserves on deposit at the central bank. The primary way that the central bank can affect the monetary base is by open market operations or sales and purchases of second hand government debt, or by changing the reserve requirements. If the central bank wishes to lower interest rates, it purchases government debt, thereby increasing the amount of cash in circulation or crediting banks' reserve accounts. Alternatively, it can lower the interest rate on discounts or overdrafts (loans to banks secured by suitable collateral, specified by the

central bank). If the interest rate on such transactions is sufficiently low, commercial banks can borrow from the central bank to meet reserve requirements and use the additional liquidity to expand their balance sheets, increasing the credit available to the economy. Lowering reserve requirements has a similar effect, freeing up funds for banks to increase loans or buy other profitable assets.

A central bank can only operate a truly independent monetary policy when the exchange rate is floating. If the exchange rate is pegged or managed in any way, the central bank will have to purchase or sell foreign exchange. These transactions in foreign exchange will have an effect on the monetary base analogous to open market purchases and sales of government debt; if the central bank buys foreign exchange, the monetary base expands, and vice versa. But even in the case of a pure floating exchange rate, central banks and monetary authorities can at best "lean against the wind" in a world where capital is mobile.

Accordingly, the management of the exchange rate will influence domestic monetary conditions. To maintain its monetary policy target, the central bank will have to sterilize or offset its foreign exchange operations. For example, if a central bank buys foreign exchange (to counteract appreciation of the exchange rate), base money will increase. Therefore, to sterilize that increase, the central bank must also sell government debt to contract the monetary base by an equal amount. It follows that turbulent activity in foreign exchange markets can cause a central bank to lose control of domestic monetary policy when it is also managing the exchange rate.

In the 1980s, many economists began to believe that making a nation's central bank independent of the rest of executive government is the best way to ensure an optimal monetary policy, and those central banks which did not have independence began to gain it. This is to avoid overt manipulation of the tools of monetary policies to effect political goals, such as re-electing the current government. Independence typically means that the members of the committee which conducts monetary policy have long, fixed terms. Obviously, this is a somewhat limited independence.

In the 1990s, central banks began adopting formal, public inflation targets with the goal of making the outcomes, if not the process, of monetary policy more transparent. In other words, a central bank may have an inflation target of 2% for a given year, and if inflation turns out to be 5%, then the central bank will typically have to submit an explanation.

The Bank of England exemplifies both these trends. It became independent of government through the Bank of England Act 1998 and adopted an inflation target of 2.5% RPI (now 2% of CPI).

The debate rages on about whether monetary policy can smooth business cycles or not. A central conjecture of Keynesian economics is that the central bank can stimulate aggregate demand in the short run, because a significant number of prices in the economy are fixed in the short run and firms will produce as many goods and services as are demanded (in the long run, however, money is neutral, as in the neoclassical model). There is also the Austrian school of economics, which includes Friedrich von Hayek and Ludwig von Mises's arguments, but most economists fall into either the Keynesian.

Developing countries

Developing countries may have problems establishing an effective operating monetary policy. The primary difficulty is that few developing

primary difficulty is that few developing countries have deep markets in government debt. The matter is further complicated by the difficulties in forecasting money demand and fiscal pressure to levy the inflation tax by expanding the monetary base rapidly. In general, the central banks in many developing countries have poor records in managing monetary policy. This is often because the monetary authority in a developing country is not independent of government, so good monetary policy takes a backseat to the political desires of the government or are used to pursue other non-monetary goals. For this and other reasons, developing countries that want to establish credible monetary policy may institute a currency board or adopt dollarization. Such forms of monetary institutions thus essentially tie the hands of the government from interference and, it is hoped, that such policies will import the monetary policy of the anchor nation.

Recent attempts at liberalizing and reforming financial markets (particularly the recapitalization of banks and other financial institutions in Nigeria and elsewhere) are gradually providing the latitude required to implement monetary policy frameworks by the relevant central banks.

Types of monetary policy

In practice, to implement any type of monetary policy the main tool used is modifying the amount of base money in circulation. The monetary authority does this by buying or selling financial assets (usually government obligations). These open market operations change either the amount of money or its liquidity (if less liquid forms of money are bought or sold). The multiplier effect of fractional reserve banking amplifies the effects of these actions.

Constant market transactions by the monetary authority modify the supply of currency and this impacts other market variables such as short term interest rates and the exchange rate.

The distinction between the various types of monetary policy lies primarily with the set of instruments and target variables that are used by the monetary authority to achieve their goals.

Monetary Policy:	Target Variable:	Market	Long Term Objective:
Inflation Targeting	Interest rate on overnight debt		A given rate of change in the CPI
Price Level Targeting	Interest rate on overnight debt		A specific CPI number
Monetary Aggregates	The growth in money supply		A given rate of change in the CPI
Fixed Exchange Rate	The spot price of the currency		The spot price of the currency
Gold Standard	The spot price of gold		Low inflation as measured by the gold price
Mixed Policy	Usually interest rates		Usually unemployment + CPI change

The different types of policy are also called **monetary regimes**, in parallel to exchange rate regimes. A fixed exchange rate is also an exchange rate regime; The Gold standard results in a relatively fixed regime towards the currency of other countries on the gold standard and a floating regime towards those that are not. Targeting inflation, the price level or other monetary aggregates implies floating exchange rate unless the management of the relevant foreign currencies is tracking exactly the same variables (such as a harmonized consumer price index).

Inflation targeting

Under this policy approach the target is to keep inflation, under a particular definition such as Consumer Price Index, within a desired range.

The inflation target is achieved through periodic adjustments to the Central Bank interest rate target. The interest rate used is generally the interbank rate at which banks lend to each other overnight for cash flow purposes. Depending on the country this particular interest rate might be called the cash rate or something similar.

The interest rate target is maintained for a specific duration using open market operations. Typically the duration that the interest rate target is kept constant will vary between months and years. This interest rate target is usually reviewed on a monthly or quarterly basis by a policy committee.

Changes to the interest rate target are made in response to various market indicators in an attempt to forecast economic trends and in so doing keep the market on track towards achieving the defined inflation target. For example, one simple method of inflation targeting called the Taylor rule adjusts the interest rate in response to changes in the inflation rate and the output gap. The rule was proposed by John B. Taylor of Stanford University.

The inflation targeting approach to monetary policy approach was pioneered in New Zealand. It is currently used in Australia, Brazil, Canada, Chile, Colombia, the Eurozone, New Zealand, Norway, Iceland, Philippines, Poland, Sweden, South Africa, Turkey, and the United Kingdom.

Price level targeting

Price level targeting is similar to inflation targeting except that CPI growth in one year over or under the long term price level target is offset in subsequent years such that a targeted price-level is reached over time, e.g. five years, giving more certainty about future price increases to consumers. Under inflation targeting what happened in the immediate past years is not taken into account or adjusted for in the current and future years.

Monetary aggregates

In the 1980s, several countries used an approach based on a constant growth in the money supply. This approach was refined to include different classes of money and credit (M0, M1 etc.). In the USA this approach to monetary policy was discontinued with the selection of Alan Greenspan as Fed Chairman.

This approach is also sometimes called monetarism.

While most monetary policy focuses on a price signal of one form or another, this approach is focused on monetary quantities.

Fixed exchange rate

This policy is based on maintaining a fixed exchange rate with a foreign currency. There are varying degrees of fixed exchange rates, which can be ranked in relation to how rigid the fixed exchange rate is with the anchor nation.

Under a system of fiat fixed rates, the local government or monetary authority declares a fixed exchange rate but does not actively buy or sell currency to maintain the rate. Instead, the rate is enforced by non-convertibility measures (e.g. capital controls,

import/export licenses, etc.). In this case there is a black market exchange rate where the currency trades at its market/unofficial rate.

Under a system of fixed-convertibility, currency is bought and sold by the central bank or monetary authority on a daily basis to achieve the target exchange rate. This target rate may be a fixed level or a fixed band within which the exchange rate may fluctuate until the monetary authority intervenes to buy or sell as necessary to maintain the exchange rate within the band. (In this case, the fixed exchange rate with a fixed level can be seen as a special case of the fixed exchange rate with bands where the bands are set to zero.)

Under a system of fixed exchange rates maintained by a currency board every unit of local currency must be backed by a unit of foreign currency (correcting for the exchange rate). This ensures that the local monetary base does not inflate without being backed by hard currency and eliminates any worries about a run on the local currency by those wishing to convert the local currency to the hard (anchor) currency.

Under dollarization, foreign currency (usually the US dollar, hence the term "dollarization") is used freely as the medium of exchange either exclusively or in parallel with local currency. This outcome can come about because the local population has lost all faith in the local currency, or it may also be a policy of the government (usually to rein in inflation and import credible monetary policy).

These policies often abdicate monetary policy to the foreign monetary authority or government as monetary policy in the pegging nation must align with monetary policy in the anchor nation to maintain the exchange rate. The degree to which local monetary policy becomes dependent on the anchor nation depends on factors such as capital mobility, openness, credit channels and other economic factors.

Gold standard

The gold standard is a system in which the price of the national currency is measured in units of gold bars and is kept constant by the daily buying and selling of base currency to other countries and nationals. (i.e. open market operations, cf. above). The selling of gold is very important for economic growth and stability.

The gold standard might be regarded as a special case of the "Fixed Exchange Rate" policy. And the gold price might be regarded as a special type of "Commodity Price Index".

Today this type of monetary policy is not used anywhere in the world, although a form of gold standard was used widely across the world between the mid-19th century

through 1971. Its major advantages were simplicity and transparency. (*See also*: Bretton Woods system)

The major disadvantage of a gold standard is that it induces deflation, which occurs whenever economies grow faster than the gold supply. When an economy grows faster than its money supply, the same amount of money is used to execute a larger number of transactions. The only way to make this possible is to lower the nominal cost of each transaction, which means that prices of goods and services fall, and each unit of money increases in value. Deflation can cause economic problems, for instance, it tends to increase the ratio of debts to assets over time. As an example, the monthly cost of a fixed-rate home mortgage stays the same, but the dollar value of the house goes down, and the value of the dollars required to pay the mortgage goes up. William Jennings Bryan rose to national prominence when he built his historic (though unsuccessful) 1896 presidential campaign around the argument that deflation caused by the gold standard made it harder for everyday citizens to start new businesses, expand their farms, or build new homes.

Policy of various nations

- Australia - Inflation targeting
- Brazil - Inflation targeting
- Canada - Inflation targeting
- Chile - Inflation targeting
- China - Monetary targeting and targets a currency basket
- Colombia - Inflation targeting
- Eurozone - Inflation targeting
- Hong Kong - Currency board (fixed to US dollar)
- India - Multiple indicator approach
- New Zealand - Inflation targeting
- Norway - Inflation targeting
- Singapore - Exchange rate targeting
- South Africa - Inflation targeting
- Switzerland - Inflation targeting^[16]
- Turkey - Inflation targeting
- United Kingdom - Inflation targeting, alongside secondary targets on 'output and employment'.
- United States - Mixed policy (and since the 1980s it is well described by the "Taylor rule," which maintains that the Fed funds rate responds to shocks in inflation and output)

Monetary policy tools

Monetary base

Monetary policy can be implemented by changing the size of the monetary base. This *directly* changes the total amount of money circulating in the economy. A central bank can use open market operations to change the monetary base. The central bank would buy/sell bonds in exchange for hard currency. When the central bank disburses/collects this hard currency payment, it alters the amount of currency in the economy, thus altering the monetary base.

Reserve requirements

The monetary authority exerts regulatory control over banks. Monetary policy can be implemented by changing the proportion of total assets that banks must hold in reserve with the central bank. Banks only maintain a small portion of their assets as cash available for immediate withdrawal; the rest is invested in illiquid assets like mortgages and loans. By changing the proportion of total assets to be held as liquid cash, the Federal Reserve changes the availability of loanable funds. This acts as a change in the money supply. Central banks typically do not change the reserve requirements often because it creates very volatile changes in the money supply due to the lending multiplier.

Discount window lending

Discount window lending is where the commercial banks, and other depository institutions, are able to borrow reserves from the Central Bank at a discount rate. This rate is usually set below short term market rates (T-bills). This enables the institutions to vary credit conditions (i.e., the amount of money they have to loan out), thereby affecting the money supply. It is of note that the Discount Window is the only instrument which the Central Banks do not have total control over.

By affecting the money supply, it is theorized, that monetary policy can establish ranges for inflation, unemployment, interest rates, and economic growth. A stable financial environment is created in which savings and investment can occur, allowing for the growth of the economy as a whole.

Interest rates

The contraction of the monetary supply can be achieved *indirectly* by increasing the nominal interest rates. Monetary authorities in different nations have differing levels of control of economy-wide interest rates. In the United States, the Federal Reserve can set the discount rate, as well as achieve the desired Federal funds rate by open market

operations. This rate has significant effect on other market interest rates, but there is no perfect relationship. In the United States open market operations are a relatively small part of the total volume in the bond market. One cannot set independent targets for both the monetary base and the interest rate because they are both modified by a single tool — open market operations; one must choose which one to control.

In other nations, the monetary authority may be able to mandate specific interest rates on loans, savings accounts or other financial assets. By raising the interest rate(s) under its control, a monetary authority can contract the money supply, because higher interest rates encourage savings and discourage borrowing. Both of these effects reduce the size of the money supply.

Currency board

A currency board is a monetary arrangement that pegs the monetary base of one country to another, the anchor nation. As such, it essentially operates as a hard fixed exchange rate, whereby local currency in circulation is backed by foreign currency from the anchor nation at a fixed rate. Thus, to grow the local monetary base an equivalent amount of foreign currency must be held in reserves with the currency board. This limits the possibility for the local monetary authority to inflate or pursue other objectives. The principal rationales behind a currency board are threefold:

1. To import monetary credibility of the anchor nation;
2. To maintain a fixed exchange rate with the anchor nation;
3. To establish credibility with the exchange rate (the currency board arrangement is the hardest form of fixed exchange rates outside of dollarization).

In theory, it is possible that a country may peg the local currency to more than one foreign currency; although, in practice this has never happened (and it would be a more complicated to run than a simple single-currency currency board). A gold standard is a special case of a currency board where the value of the national currency is linked to the value of gold instead of a foreign currency.

The currency board in question will no longer issue fiat money but instead will only issue a set number of units of local currency for each unit of foreign currency it has in its vault. The surplus on the balance of payments of that country is reflected by higher deposits local banks hold at the central bank as well as (initially) higher deposits of the (net) exporting firms at their local banks. The growth of the domestic money supply can now be coupled to the additional deposits of the banks at the central bank that equals additional hard foreign exchange reserves in the hands of the central bank. The virtue of this system is that questions of currency stability no longer apply. The drawbacks are that the country no longer has the ability to set monetary policy according to other domestic considerations, and that the fixed exchange rate will, to a large extent, also fix

a country's terms of trade, irrespective of economic differences between it and its trading partners.

Hong Kong operates a currency board, as does Bulgaria. Estonia established a currency board pegged to the Deutschmark in 1992 after gaining independence, and this policy is seen as a mainstay of that country's subsequent economic success (see Economy of Estonia for a detailed description of the Estonian currency board). Argentina abandoned its currency board in January 2002 after a severe recession. This emphasized the fact that currency boards are not irrevocable, and hence may be abandoned in the face of speculation by foreign exchange traders. Following the signing of the Dayton Peace Agreement in 1995, Bosnia and Herzegovina established a currency board pegged to the Deutschmark (since 2002 replaced by the Euro).

Currency boards have advantages for *small, open* economies that would find independent monetary policy difficult to sustain. They can also form a credible commitment to low inflation.

Unconventional monetary policy at the zero bound

Other forms of monetary policy, particularly used when interest rates are at or near 0% and there are concerns about deflation or deflation is occurring, are referred to as **unconventional monetary policy**. These include credit easing, quantitative easing, and signaling. In credit easing, a central bank purchases private sector assets, in order to improve liquidity and improve access to credit. Signaling can be used to lower market expectations for future interest rates. For example, during the credit crisis of 2008, the US Federal Reserve indicated rates would be low for an “extended period”, and the Bank of Canada made a “conditional commitment” to keep rates at the lower bound of 25 basis points (0.25%) until the end of the second quarter of 2010.

ECONOMIC POLICY

Economic policy refers to the actions that governments take in the economic field. It covers the systems for setting interest rates and government budget as well as the labour market, national ownership, and many other areas of government interventions into the economy.

Such policies are often influenced by international institutions like the International Monetary Fund or World Bank as well as political beliefs and the consequent policies of parties.

Types of economic policy

Almost any aspect of government has an economic aspect and so many terms are used. A few examples of types of economic policy include:

- Macroeconomic stabilization policy tries to keep the money supply growing, but not so quick that it results in excessive inflation.
- Trade policy refers to tariffs, trade agreements and the international institutions that govern them.
- Policies designed to create Economic growth
 - Policies related to development economics,
- Redistribution of income, property, or wealth
- Regulation
- Anti-trust
- Industrial policy
- Technology-based Economic Development Policy

Macroeconomic stabilization policy

Stabilization policy attempts to stimulate an economy out of recession or constrain the money supply to prevent excessive inflation.

- Fiscal policy, often tied to Keynesian economics, uses government spending and taxes to guide the economy.
 - Fiscal stance: The size of the deficit
 - Tax policy: The taxes used to collect government income.
 - Government spending on just about any area of government
- Monetary policy controls the value of currency by lowering the supply of money to control inflation and raising it to stimulate economic growth. It is concerned with the amount of money in circulation and, consequently, interest rates and inflation.
 - Interest rates, if set by the Government
 - Income policies and price controls that aim at imposing non-monetary controls on inflation
 - Reserve requirements which affect the money multiplier

Tools and goals

Policy is generally directed to achieve particular objectives, like targets for inflation, unemployment, or economic growth. Sometimes other objectives, like military spending or nationalization are important.

These are referred to as the **policy goals**: the outcomes which the economic policy aims to achieve.

To achieve these goals, governments use **policy tools** which are under the control of the government. These generally include the interest rate and money supply, tax and government spending, tariffs, exchange rates, labour market regulations, and many other aspects of government.

Selecting tools and goals

Government and central banks are limited in the number of goals they can achieve in the short term. For instance, there may be pressure on the government to reduce inflation, reduce unemployment, and reduce interest rates while maintaining currency stability. If all of these are selected as goals for the short term, then policy is likely to be incoherent, because a normal consequence of reducing inflation and maintaining currency stability is increasing unemployment and increasing interest rates.

Demand-side vs. supply-side tools

This dilemma can in part be resolved by using microeconomic, supply-side policy to help adjust markets. For instance, unemployment could potentially be reduced by altering laws relating to trade unions or unemployment insurance, as well as by macroeconomic (demand-side) factors like interest rates.

Discretionary policy vs policy rules

For much of the 20th century, governments adopted discretionary policies like demand management designed to correct the business cycle. These typically used fiscal and monetary policy to adjust inflation, output and unemployment.

However, following the stagflation of the 1970s, policymakers began to be attracted to policy rules.

A discretionary policy is supported because it allows policymakers to respond quickly to events. However, discretionary policy can be subject to dynamic inconsistency: a government may say it intends to raise interest rates indefinitely to bring inflation under control, but then relax its stance later. This makes policy non-credible and ultimately ineffective.

A rule-based policy can be more credible, because it is more transparent and easier to anticipate. Examples of rule-based policies are fixed exchange rates, interest rate rules, the stability and growth pact and the Golden Rule. Some policy rules can be imposed by external bodies, for instance the Exchange Rate Mechanism for currency.

A compromise between strict discretionary and strict rule-based policy is to grant discretionary power to an independent body. For instance, the Federal Reserve Bank, European Central Bank, Bank of England and Reserve Bank of Australia all set interest rates without government interference, but do not adopt rules.

Another type of non-discretionary policy is a set of policies which are imposed by an international body. This can occur (for example) as a result of intervention by the International Monetary Fund.

Economic policy through history

The first economic problem was how to gain the resources it needed to be able to perform the functions of an early government: the military, roads and other projects like building the Pyramids.

Early governments generally relied on tax in kind and forced labour for their economic resources. However, with the development of money came the first policy choice. A government could raise money through taxing its citizens. However, it could now also debase the coinage and so increase the money supply.

Early civilizations also made decisions about whether to permit and how to tax trade. Some early civilizations, such as Ptolemaic Egypt adopted a **closed currency policy** whereby foreign merchants had to exchange their coin for local money. This effectively levied a very high tariff on foreign trade.

By the early modern age, more policy choices had been developed. There was considerable debate about mercantilism and other restrictive trade practices like the Navigation Acts, as trade policy became associated with both national wealth and with foreign and colonial policy.

Throughout the 19th Century, monetary standards became an important issue. Gold and silver were in supply in different proportions. Which metal was adopted influenced the wealth of different groups in society.

The first fiscal policy

With the accumulation of private capital in the Renaissance, states developed methods of financing deficits without debasing their coin. The development of capital markets meant that a government could borrow money to finance war or expansion while causing less economic hardship.

This was the beginning of modern fiscal policy.

The same markets made it easy for private entities to raise bonds or sell shares to fund private initiatives.

Business cycles

The business cycle became a predominant issue in the 19th century, as it became clear that industrial output, employment, and profit behaved in a cyclical manner. One of the first proposed policy solutions to the problem came with the work of Keynes, who proposed that fiscal policy could be used actively to ward off depressions, recessions and slumps. The Austrian school argues that central banks create the business cycle.

Summary and Conclusion

As countries move toward market-based policies, it is important for them to have effective competition policy. The cornerstones of competition policy include a statute, enforcement agency, and adjudicating body. Although there are basic principles that are useful to follow when designing new competition policy, the specific context of each economy should be taken into account when preparing a policy. Simply copying an approach used elsewhere will not guarantee effectiveness.

Establishing this basic framework is the first step in implementing competition policy. Once it is in place, adequate funding and appropriate enforcement choices are essential to protect the competitive forces on which a market economy is based.

The lessons we have learned from helping some developing countries implement their competition policies, as well as the antitrust laws and policies of the United States and other mature market economies, are useful references for designing an effective competition policy for China. The successful implementation of such a policy will prove crucial to the success of China's ongoing market reform.

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