The Federal Reserve Bank of New York, 33 Liberty St, NYC.

Chapter 1

Monetary policy and fiscal policy

The basics

> **Be sure you understand and know how to use the terms in bold in the text below.**

Fiscal policy and **monetary policy** are the two **macroeconomic tools** that keep an economy humming. The objective is **stable growth** and **moderate inflation**. Fiscal policy consists in deciding on **government expenditures** and **tax revenue**. Monetary policy aims to control the **supply of money** in an economy.

Short of **balancing the budget**, a government must try to keep its **deficit** under control. In order to fund its deficit, a government issues **Treasuries**, which are **debt** instruments. When a government has difficulty **servicing its debt**, it may have to tighten its belt, that is **slash expenses.** But some governments prefer to **raise taxes**. Others will choose to attempt to boost **consumer spending** and **business investment** by combining tax cuts and high government spending, a policy known as **pump-priming. Supply-siders** believe in fiscal policies that benefit the supply, that is, businesses, whereas **demand-siders** advocate policies that benefit the demand, that is, consumers. All want an economy that is characterized by low unemployment, brisk growth and moderate inflation, such as the **Goldilocks economy** of the last decade of the 20th century in the USA.

A central bank must **adjust interest rates** in order to **keep inflation under control**. When interest rates are too high, the **cost of borrowing dampens consumer spending** and **business investment**, which are the **engines of growth**. That also makes it very expensive for a government to finance its **budget deficit**. When interest

rates are too low, there is a risk of **overinvestment** and the economy may **overheat**, leading to high inflation and a **bubble** in **asset prices**.

Some central banks are more **dovish** than others and tend to keep interest rates low, thus favoring an **expansionary monetary policy** that **boosts growth**. Other banks are more **hawkish** and will **implement** a **restrictive monetary policy**, that is, keep interest rates relatively high to make sure there are no **inflationary pressures on prices and wages**. In the case of **incipient** inflation, **hawks** advocate **pre-emptive strikes**, whereas **doves** tend to **keep interest rates unmoved**. Thus, in times of **economic boom,** the latter will tend to be **procyclical** and run the risk that an **asset bubble** will develop, while the former will adopt a **countercyclical** monetary policy and will **hike** interest rates **to nip inflation in the bud** even if that dampens **business investment** and **consumer spending**.

A tight monetary policy can curb **core inflation** (which does not include selected food and energy items), but has less effect on **headline inflation**. Eventually headline inflation **exerts upward pressure** on wages and prices and **trickles down into** core inflation.

The **Phillips curve** shows a short-term inverse relationship between unemployment and inflation. A **tight labor market** (i.e., a low unemployment rate) tends to be accompanied by high inflation.

A relationship can also be established between inflation and the **output gap**, i.e., the difference between actual and potential GDP as a per cent of potential GDP. When the factors of productions are underutilized, in other words when there is a negative output gap, there is **slack** in the economy and less inflationary pressure on prices or wages. When they are overutilized, economic resources are **under strain** and inflation rises.

Sometimes, to fight **recession** (two consecutive quarters of negative growth), central banks implement a **zero-interest-rate policy (ZIRP)**. They then must find tools to prevent **deflation**. Deflation, a fall in wages and prices, should not be confused with **disinflation** (i.e., a fall in the inflation rate). In **deflationary** environments, consumer spending and business investment tend to be postponed, which **dampens growth**. Deflation increases the **burden** of the debt and may result in a **liquidity trap** (a preference for liquidity that drives people to **hoard cash**). Deflation is all the more dangerous as central bankers do not have the possibility to adjust interest rates when they are close to zero. In order to boost growth, they may resort to an **unconventional monetary policy** known as **quantitative easing**, that is **printing money** in order to buy **financial assets**. Newly-created money is also used to **monetize** the government debt (or **inflate away the debt**).

▶ Monetary policy in the USA

The **Federal Reserve** (also known as "the **Fed**") is the central bank of the United States. Ben Bernanke became its **chairman** in 2006. The **Federal Open Market Committee (FOMC)** decides on a target for the **fed funds rate**, that is, the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight. The monetary policy is implemented through **open-market operations** (purchases and sales of U.S. Treasuries and federal agency securities). When the Fed wants to **raise** the federal funds rate, it sells government securities, and when it wants to **lower** it, it buys securities. The Fed can also influence the federal funds rate indirectly by changing the **discount rate**, the rate at which it lends reserves to banks, or altering banks' **reserve requirements**. Eight times a year, each of the twelve **Federal Reserve Banks** submits information on current economic conditions in its district. The twelve reports are summarized in what is known as "the **Beige Book.**"[1] The Beige Book is one of the bases for decisions on monetary policy.

▶ Monetary policy in the euro area

Mario Draghi became the **president** of the **European Central Bank (ECB)** in 2011. The ECB implements a **one-size-fits-all** monetary policy in the **euro area** (also known as "the **eurozone**"). The euro area includes the 17 **member states** of the **European Union (EU)** that have adopted the **euro** (Austria, Belgium, Cyprus, Estonia, Germany, Greece, Ireland, France, Italy, Luxembourg, Malta, The Netherlands, Portugal, Slovakia, Slovenia, Spain, Finland).[2] These states **have relinquished sovereignty** in terms of monetary policy. In the euro area, the key interest rate is the refinancing rate (**refi rate**), i.e., the minimum interest rate that banks must pay when they borrow money from the ECB.

▶ Monetary policy in the UK

The **Monetary Policy Committee** (**MPC**) of the **Bank of England** sets the official interest rate (known as **Bank Rate**) at which it lends to financial institutions.

1. http://www.federalreserve.gov/monetarypolicy/beigebook/.
2. Latvia will adopt the euro as of 1 January 2014.

Subject-related terminology

When fighting inflation is the priority	When boosting growth is the priority
monetary tightening	monetary loosening
to curb inflation/ to keep inflation under control/ to keep a lid on inflation/ to keep inflation in check/ to stem inflation	to boost growth/ to stimulate growth/ to pump-prime the economy
to prevent the economy from overheating	to ward off recession
to tighten the monetary policy/ to hike key interest rates/ to raise key interest rates	to loosen the monetary policy/ to ease the monetary policy/ to cut key interest rates/ to lower key interest rates
a rise/a hike in interest rates	a drop/a cut in interest rates
an interest rate rise	an interest rate cut
to raise the cost of borrowing	to lower the cost of borrowing
a tight/restrictive monetary (or fiscal) policy	an accomodative/loose/lax/ expansionary monetary (or fiscal) policy
In the case of incipient inflation	
a pre-emptive interest rate hike	benign neglect
to raise interest rates pre-emptively	to let an asset price bubble develop
to nip inflation in the bud	to keep interest rates on hold

When the monetary policy is too loose	When the monetary policy is too tight
a low cost of borrowing	a high cost of borrowing
unchecked/runaway/rampant/double-digit inflation/hyperinflation	slack/sluggish/lackluster/ faltering/ailing growth
The economy overheats.	The economy grows at a snail's pace/ slackens.
to stoke/to fuel inflation to cause the economy to overheat to create inflationary pressures on wages and prices to trigger a wage-price inflationary spiral	to dampen growth to stifle growth

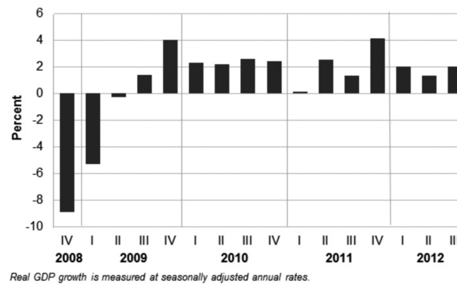
to create a bubble	to dent/to dampen consumer spending and business investment
to expand	to shed/to trim/to slash (jobs/expenses)
a rise in (confidence, sales, investment…)	a slide in, a slump in (confidence/ sales/investment…)
runaway growth	low GDP/negative GDP
expansion irrational exuberance	recession/depression a double-dip/a W-shaped recession/ an L-shaped recession

When the fiscal policy is loose	When the fiscal policy is tight
a profligate/spendthrift government	a thrifty government
government profligacy	government belt-tightening
to go on a spending spree	to tighten one's belt/ to tighten the purses' strings/ to cut expenses drastically/ to pinch pennies
to waste money on	to save on
to run a budget deficit	to run a budget surplus
a widening budget deficit	a narrowing budget deficit
an expanding government debt	a shrinking government debt

The perfect economy	The worst economy
subdued/moderate inflation	runaway inflation, deflation or stagflation
brisk/high/fast growth	negative growth
a buoyant economy	a deeply-depressed economy
low unemployment/few jobless claims	high unemployment/jobless claims
a narrow budget deficit or a budget surplus	a wide budget deficit
a low debt overhang	a high debt overhang

The Economic Cycle
Quarterly Growth in the U.S. 2008-2012

Quarter-to-Quarter Growth in Real GDP



U.S. Bureau of Economic Analysis

Q4 2008: GDP **hit a low**. GDP **bottomed out**. 2008 was a period of **economic bust.**

Q1 2009: After two consecutive quarters of **negative growth**, the US economy was in **recession**.

Q3 2009: GDP **bounced back into positive territory**. There was an economic **upturn/ upswing**.

From Q4 2008 to Q4 2009, GDP **trended upwards**.

Q4 2009: The economy **boomed**, then GDP **peaked/hit a high**.

Q1 2010: There was a **reversal in trend**. GDP **trended downwards**.

From Q1 to Q4 2010, **there was steady growth**.

Q1 2011: There was a **downswing/a downturn**.

Q2 2011: GDP **bounced back** to drop again in Q1 2012.

Mostly GDP **see-sawed** from Q2 2009 to Q3 2012.

Source: Bureau of Economic Analysis, US Department of Commerce, http://www.bea.gov/newsreleases/national/gdp/gdp_glance.htm

Exercises

1 ***Fill in the blanks with the proper terms.***

1. A budget deficit is the difference between tax ……… and government ……… .
2. If the economy grows too fast, it may create ……… pressures and the central bank will have to ……… the monetary policy.
3. When access to credit is too easy, there is a real estate ……… .
4. The dot-com bubble ……… in 2000-2001.
5. The lower the key interest rate, the higher the risk of ……… .
6. In times of recession, a government may resort to pump-priming, that is, fiscal and monetary ……… .
7. Fiscal ……… implies higher government ……… and tax ……… Monetary ……… implies lower ……… ……… .
8. After the 2008 financial meltdown, western central banks adopted a ……… monetary policy in order to boost consumer ……… and business ……… .
9. When an economy operates below capacity, there is a wide negative ……… ……… .
10. High unemployment causes a ……… in consumer confidence.
11. Recession is usually defined as two consecutive ……… of negative GDP.
12. The higher the rate of unemployment, the ……… the inflation rate tends to be.
13. Whenever there is ……… in the economy, that is, the economy operates well below capacity, the risk of inflation is minimal.
14. When the factors of production are under ………, the risk of inflation is high.
15. Doves will give priority to growth, while ……… will favor the fight against inflation.

2 ***Test your knowledge.***

1. When do monetary authorities cut key interest rates?
2. What do monetary authorities do when they are worried about rising inflation?
3. To what extent is deflation worse than inflation?
4. What are the main engines of economic growth? Why are they affected by interest rate moves?
5. What type of monetary policy do hawks advocate? What type of monetary policy do doves advocate?
6. When do monetary authorities decide on quantitative easing?
7. To what extent do EU member states have sovereignty in terms of monetary policy?
8. What is a double dip?
9. According to the Phillips curve, there is a trade-off between the unemployment rate and the inflation rate. Explain why the two are related.
10. What does a wide negative output gap indicate?
11. Explain what a countercyclical monetary policy entails in times of recession.

3 ***Fill in the blanks with one of the following: good/bad/worse/better/the worst/ the best.***

1. Unemployment is ……… than it was in 2008.
2. In spite of low interest rates, inflation is not as ……… as anticipated.
3. One of ……… signs of economy recovery is a buoyant building sector.
4. Deflation is ……… than inflation as central bankers have less experience dealing with.
5. 2001 was ……… year for internet start-ups.
6. The economic recovery is not as ……… as the government claims it is.

4 ***Fill in the blanks with either "to rise (rose, risen)" or "to raise" in the proper tense and form.***

1. No central banker should be blamed for ……… interest rates pre-emptively.
2. Key interest rates should ……… in the U.S. to bolster the dollar.
3. If a central bank waits for inflation to shoot up before it ……… interest rates, the economy will overheat.
4. Inflation seems to ……… in the EU. If it ……… further, the ECB ……… interest rates.
5. Because of the US slowdown, before 2004 the federal funds rate ……… (+ not) for years.
6. In August 2006, the Fed stopped ……… the fed funds rate.
7. The Fed ……… the federal funds rate whenever there is a risk of inflation.
8. If the Bank of England ……… interest rates, it would dampen consumer spending.

5 ***Fill in the blanks with either "to lose (lost, lost)" or "to loosen" in the proper tense and form.***

1. With a zero-interest rate policy, a central bank ……… its capacity to boost growth by ……… the monetary policy.
2. If monetary authorities are too dovish, they ……… credibility.
3. In September 2007, the Fed started ……… the monetary policy.
4. Central banks must not ……… focus and should give priority to price stability.
5. Pump-priming implies ……… both fiscal and monetary policies.

6 ***Based on the table below describe the changes in the federal funds rate between 2003 and 2008. Use the verbs "to cut", to hike", "to raise", "to rise", "to peak", "to bottom (out)," and/or the adjectives "high" or low" in their comparative or superlative forms.*** *(e.g., Between December 2007 and December 2008, the intended fed funds rate was cut by 4 percent.)*