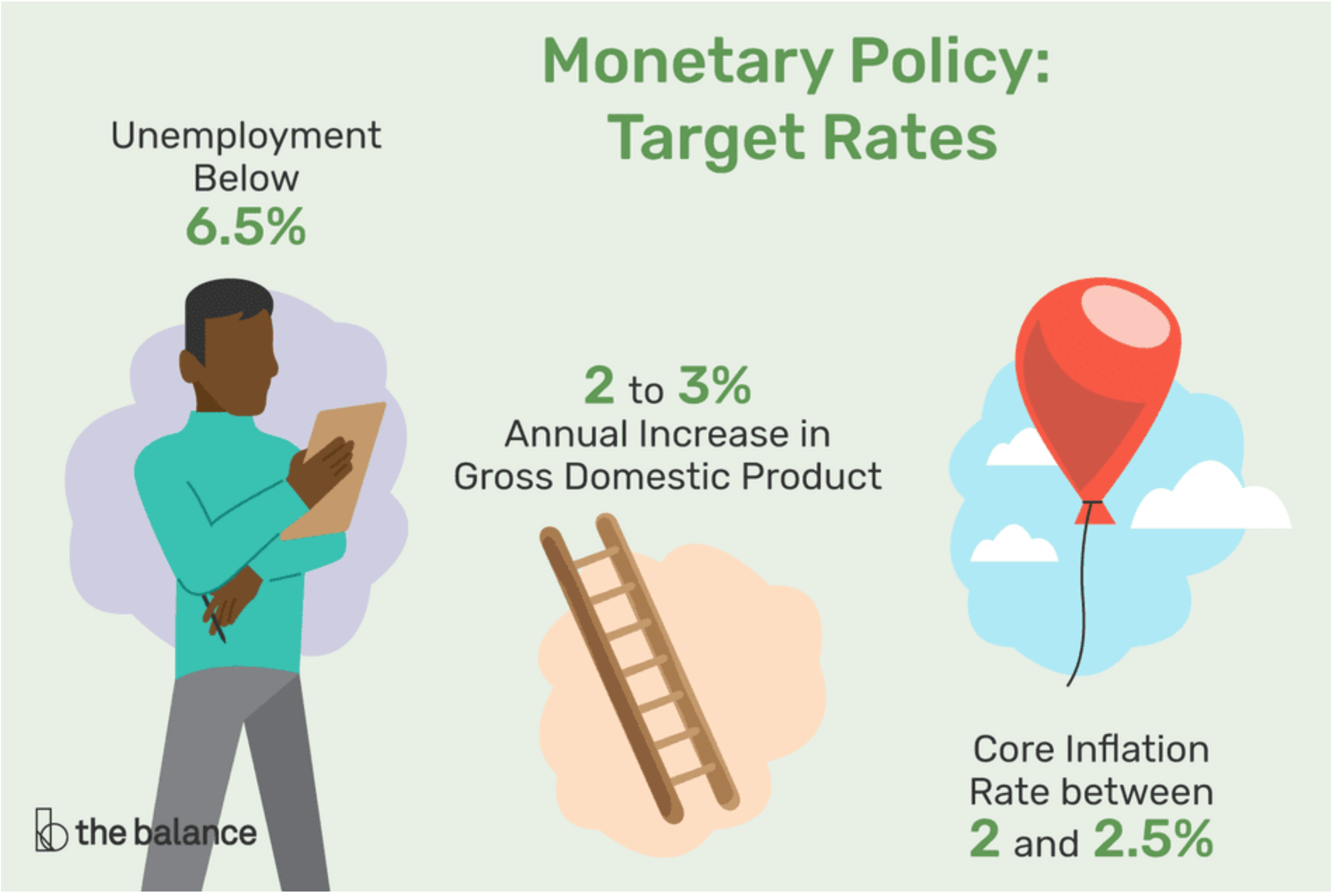
Monetary Policy Explained Including Its Objectives,Types, and Tools

Six Ways to Legally Create Money Out of Thin Air

By Kimberly Amadeo Updated July 04, 2019



Monetary policy is a central bank's actions and communications that manage the money supply. That includes credit, cash, checks, and money market mutual funds. The most important of these forms of money is credit. It includes loans, bonds, and mortgages.

Monetary policy increases liquidity to create economic growth. It reduces liquidity to prevent inflation. Central banks use interest rates, bank reserve requirements, and the amount of government bonds that banks must hold. All these tools affect how much banks can lend. The volume of loans affects the money supply.

Three Objectives of Monetary Policy

Central banks have three monetary policy objectives. The most import is to manage inflation. The secondary objective is to reduce unemployment, but only after controlling inflation. The third objective is to promote moderate long-term interest rates.

The U.S. Federal Reserve, like many other central banks, has specific targets
for these objectives. It wants the core inflation rate to be between 2% and 2.5%. It seeks an unemployment rate below 6.5%. Beyond that, it prefers a natural rate of unemployment of between 4.7% and 5.8%. The Fed's overall goal is healthy economic growth. That's a 2% to 3% annual increase in the nation's gross domestic product.

Types of Monetary Policy

Central banks use contractionary monetary policy to reduce inflation. They reduce the money supply by restricting the amount of money banks can lend. The banks charge a higher interest rate, making loans more expensive. Fewer businesses and individuals borrow, slowing growth.

Central banks use expansionary monetary policy to lower unemployment and avoid recession. They increase liquidity by giving banks more money to lend. Banks lower interest rates, making loans cheaper. Businesses borrow more to buy equipment, hire employees, and expand their operations. Individuals borrow more to buy more homes, cars, and appliances. That increases demand and spurs economic growth.

Monetary Policy Versus Fiscal Policy

Ideally, monetary policy should work hand-in-glove with the national government's fiscal policy. It rarely works this way. Government leaders get re-elected for reducing taxes or increasing spending. As a result, they adopt expansionary fiscal policy. To avoid inflation in this situation, the Fed is forced to use restrictive monetary policy.

For example, during the Great Recession, Republicans in Congress became concerned about the U.S. debt. It exceeded the benchmark debt-to-GDP ratio of 100%. As a result, fiscal policy became contractionary just when it needed to be expansionary. To compensate, the Fed injected massive amounts of money into the economy with quantitative easing.

Monetary Policy Tools

All central banks have three tools of monetary policy in common. First, they all use open market operations. They buy and sell government bonds and other securities from member banks. This changes the reserve amount the banks have on hand. A higher reserve means banks can lend less. That's contractionary policy. In the United States, the Fed sells Treasurys to member banks.

The second tool is the reserve requirement. The central banks tell their members how much of their money they must have on reserve each night. If it weren't for the reserve requirement, banks would lend 100% of deposits. Not everyone needs all their money each day, so it is safe for the banks to lend most of it out. That way, they have enough cash on hand to meet most demands for redemption.

When a central bank wants to restrict liquidity, it raises the reserve requirement. That gives banks less money to lend. When it wants to expand liquidity, it lowers the requirement. That gives members banks more money to lend. Central banks rarely change the reserve requirement because it requires a lot of paperwork for the members.

The Fed requires that banks keep 10% of deposits on reserve.

The third tool is the discount rate. That's how it much a central banks charges members to borrow funds from its discount window. It raises the discount rate to discourage banks from borrowing. That reduces liquidity and slows the economy. It lowers the discount rate to encourage borrowing. That increases liquidity and boosts growth.

In the United States, the Federal Open Market Committee sets the discount rate a half-point higher than the fed funds rate. The Fed prefers banks to borrow from each other.

Most central banks have many more tools. They work together to manage bank reserves.

For example, the Fed has two other major tools. Its most well-known is the fed funds rate. This is the interest rate that banks charge each other to store their excess cash overnight. The target for this rate is set at the FOMC meetings. The fed funds rate impacts all other interest rates, including bank loan rates and mortgage rates.

The Fed, as well as many other central banks, also uses inflation targeting. It clearly sets expectations that the banks want some inflation. The Fed’s inflation goal is 2% for the core inflation rate. That encourages people to stock up now since they know prices are rising later. It stimulates demand and economic growth.

When inflation is lower than the core, the Fed is likely to lower the fed funds rate. When inflation is at the target or above, the Fed will raise its rate.

The Federal Reserve created many new tools to deal with the 2008 financial crisis. These included the Commercial Paper Funding Facility and the Term Auction Lending Facility. It stopped using most of them once the crisis ended.