e-Resources Module-XII

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PROBLEMS OF MONETARY POLICY MAKING

Monetary authority invariably faces numerous problems in the conduct of monetary policy both at the stage of formulation as well as implementation. First of all, there could be conflicts between various goals of monetary policy as suggested by Jan Tinbergen condition. Moreover, there could be conflicts between monetary authority and fiscal authority as also between past, present and future monetary policy makers. These conflicts not only relate to the "trade-offs" between various policy objectives, but could also emerge on account of differences in the underlying macroeconomic model adopted by different policy makers. Further, the choice of a suitable "intermediate target" and preferred "instruments of monetary control" poses yet another challenge for the monetary authority. This is more so in view of the possibility of "instrument instability" arising out of policy instruments having sustained influence on the chosen intermediate target variable over considerably long periods. Another significant problem confronted by monetary authority is one of lags in monetary policy that might take the form of "implementation lags" and "effectiveness lags".

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In the conduct of monetary policy, the monetary authority typically faces numerous problems. Some of these problems arise at the stage of policy formulation whereas others are encountered at the stage of implementation. In fact, the starting point of monetary policy is to set its aims, objectives or goals and problems start coming up in making this decision itself. For, owing to the "opportunity cost" of different resources and the operation of "no free lunch principle", there may exist "trade-offs" between various policy goals.

That is to say, there may exist *conflicts between various policy goals* which could compel the monetary authority to decide as to which policy objective has to be given precedence and which

one shall be given up and to what extent. For example, the Jan Tinbergen condition suggests that due to the non-availability of sufficient number of "independent" policy instruments at the disposal of monetary authority, the price and output targets cannot be simultaneously achieved in an economy. This clearly implies that if the monetary authority wants to control inflation, it will have to tolerate a lower generation of national product and if it wishes to focus on output generation, it will have to allow for a higher rate of inflation in the economy.

Further, such "trade-offs" and policy conflicts may not exist among various aims & objectives of monetary policy alone, but could very well be witnessed among various policy makers too. For instance, the monetary authority may like to give priority to price control but the fiscal authority *viz.*, Government may instead be interested in according preference to the policy objective of output generation *i.e.*, ensuring a high growth rate of national product. Evidently, if the Central Bank as the monetary authority in the concerned economy is not fully autonomous, then such differences of opinion or *conflicts between the monetary and fiscal policy makers* could pose a serious hinderance in the conduct of monetary policy.

Not only different types of policy makers, but even different policy makers of the same type could hold different opinions on such issues over time. In other words, apart from conflicting with the views of contemporary fiscal authority, *the views of present monetary authority may differ from those of past and future monetary authorities* in the economy under consideration. To the extent it happens, maintaining "consistency" in policy making will become difficult thereby posing yet another serious problem in the functioning of monetary policy.

Such conflicts among different policy makers are not only confined to the choice of objectives and goals of monetary policy, but also extend to the entire "policy stance" covering in its ambit the adoption of suitable instruments of monetary control as well. For, any policy decision in this regard is conditional on the underlying "macroeconomic model" and different policy makers, whether contemporary or over time, may be following different macroeconomic models. As no economic model is ever perfect and there always exists a possibility of the *underlying macroeconomic model itself being inaccurate*, there is always a danger that the policy prescriptions of the monetary authority may turn out to be totally wrong as they were based on the "correct" interpretation of the "incorrect" model. This obviously is one of the major problems of monetary policy making in any economy.

Once the policy goals are somehow settled in this manner, they must then be quantified and converted into time-bound targets otherwise at a very general level, the aims and objectives

can only give a direction to the monetary policy but are of very little help for all practical purposes. Even policy targets may not be directly achievable with the policy instruments available to the monetary authority and thus it is imperative to choose a suitable "intermediate target" that could act as a link between original *i.e.*, final targets of monetary policy on the one hand and instruments of monetary control on the other. The choice of a suitable intermediate target, however, poses as yet another major problem in the formulation and conduct of monetary policy in the economy as there are no "unequivocal" ways of making this choice and everything crucially hinges on the precise nature and structural attributes of the economy under consideration.

Likewise, while formulating its monetary policy, the monetary authority must decide whether it wishes to employ "direct" instruments involving quantitative restrictions and an element of statutory compulsion or instead market-friendly price-based "indirect" instruments of monetary control in the economy.

When it comes to the implementation stage, "lags of monetary policy" have become the order of the day which in turn can be considered as a serious problem faced by monetary authority. More specifically, there can be "implementation lags" in the form of *information lags*, *recognition lags* and *legislative lags* on the one hand and "effectiveness lags" on the other. No matter which form these policy lags take, they invariably lead to a deviation of factual reality from underlying expectations in as much as the anticipated results do not fructify at the right time due to delays on one count or the other.

But by far, one of the most pressing problems confronted while implementing monetary policy is one of "instrument instability" which is actually a problem arising out of the choice of inappropriate "intermediate target" of monetary policy and thus cannot be solved merely by changing the policy instrument. To be specific, the problem of *instrument instability* comes into being when changes in instruments of monetary control continue to exert persistent influence on the variable chosen as the "intermediate target" over a considerably long period of time.

For example, let us assume that the monetary authority chooses price stability on a *quarterly basis* as the intermediate target of monetary policy in an economy. Given that the entire year is divided into four Quarters (Qs) of 3 months each *viz.*, Q1, Q2, Q3 and Q4 respectively, let us further assume that at the beginning of the first quarter Q1, the rate of growth of prices *i.e.*, the inflation rate is observed to be higher than the targeted level.

In view of this, the monetary authority will obviously adopt a "hawkish" stance by following a restrictive monetary policy say trying to lower money supply through the raising of statutory Cash Reserve Requirement (CRR) so as to contain the inflationary price rise and let us assume that it succeeds in bringing back the general price to the targeted level by the end of first quarter. But if policy instruments tend to have sustained and persistent impact on the "intermediate target" variable say over a period of 12 months, then the dampening influence of hawkish stance of quarter Q1 on the price level will continue during the second Quarter Q2 too, so much so that by the beginning of third quarter *viz.*, Q3, the prices may actually fall below the "intermediate target" level.

In the light of this development, the monetary authority will try to increase price during Q3 by adopting a "dovish" stance and lowering the CRR. But as the impact of "hawkish" or restrictive monetary policy followed during Q1 is still continuing during Q3, it will have a dampening effect on the price level. In case the two "opposite" effects following from the "hawkish" stance of Q1 and "dovish" stance of Q3 do not offset or cancel each other, the net impact on prices will become "unpredictable" to such an extent that the monetary authority will be clueless as to whether it shall follow a *restrictive* or instead an *expansionary* monetary policy during the fourth quarter *viz.*, Q4. This is a clear-cut manifestation of "instrument instability" as the monetary authority can no longer decide conclusively as to what shall be the direction in which the instruments of monetary control shall be altered.

Replacing one policy instrument by another is not going to resolve this issue since so long as the "intermediate target" chosen continues to be affected persistently by any policy instrument over a sustained period of time, the problem of "instrument instability" is bound to arise. One possible solution to this problem could be to *lengthen* the period from a quarter to a year over which *price stability* is to be achieved.

For, the sustained effect of policy instrument on the intermediate target variable *viz.*, price, which is the root cause of the problem of instrument instability, is likely to disappear beyond 12 months or 1 year. However, a final solution to the problem of *instrument instability* could be to altogether replace price by some other variable such as money supply or rate of interest as the *intermediate target* of monetary policy so that changes in policy instruments do not affect the targeted variable over a number of future periods.