

Background

What is the role of monetary policy in business cycles?

ECONOMIC STIMULUS
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Q. What is the role of monetary policy in business cycles?

A. Economists view monetary policy as the first line of defense against economic slowdowns—the Federal Reserve can act faster than the president or Congress, and it is better equipped to judge the appropriate timing and magnitude of economic stimulus.

Monetary policy—adjustments to interest rates and the money supply—can play an important role in combatting economic slowdowns. Such adjustments can be made quickly, and monetary authorities devote considerable resources to monitoring and analyzing the economy. Monetary policy can offset a downturn because lower interest rates reduce consumers' cost of borrowing to buy big-ticket items such as cars or houses. For firms, monetary policy can also reduce the cost of investment. For that reason, lower interest rates can increase spending by both households and firms, boosting the economy.

The Federal Reserve can adjust monetary policy more quickly than the president and Congress can adjust fiscal policy. Because most contractions in economic activity last for only a few quarters, a prompt policy response is crucial. Yet fiscal policy in practice responds slowly to changes in economic conditions: it takes time first to enact a stimulus bill and then to implement it, and time for the spending increases or tax reductions to reach consumers' pockets. As a result, the effect of fiscal stimulus on household and business spending may come too late.

Whether and how much stimulus is needed depends on present economic conditions, on projections of future conditions, and on possible risks to both economic activity and inflation. Forecasting economic conditions—or even determining the current state of the economy—is inherently difficult, given limitations in the data available and in economists' understanding of the world. But the Federal Reserve's large and sophisticated team of analysts is better positioned to accomplish this task than any other agency of the federal government. In addition, the Federal Reserve staff carries out this work independent of political considerations.

The potential of monetary policy to combat extreme events is limited, however, because its primary tool is the short-run interest rate, and that rate can't fall below zero. That means that in a particularly severe downturn such as the recent Great Recession, the Federal Reserve will reduce the short-run interest rate to zero, after which the Fed can employ only less effective and well-understood policies such as asset purchases. Under those conditions, fiscal policy may complement monetary policy in boosting the economy.

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Further Reading

Bernanke, Ben S. 2015. "[How the Fed Saved the Economy.](#)" *Wall Street Journal*, October 4.

Elmendorf, Douglas W., and Jason Furman. 2008. "[If, When, How: A Primer on Fiscal Stimulus.](#)" Washington, DC: Brookings.

Elmendorf, Douglas W., and David Reifschneider. 2002. "[Short Run Effects of Fiscal Policy with Forward-Looking Financial Markets.](#)" *National Tax Journal* 55(3): 357–86.

Labonte, Marc. 2015. "[Monetary Policy and the Federal Reserve: Current Policy and Issues for Congress.](#)" Washington, DC: Congressional Research Service.