

How Does Monetary Policy Affect Economic Growth?

The central bank tries to maintain price stability through controlling the level of money supply. Thus, monetary policy plays a stabilizing role in influencing economic growth through a number of channels. However, the scope of such a role may be limited by the concurrent pursuit of other primary objectives of monetary policy, the nature of monetary policy transmission mechanism, and by other factors, including the uncertainty facing policy makers and the stance of economic policies. In addition, the concurrent target of intermediate goals may have implications on the attainment of the ultimate objective of achieving sustainable growth.

The contribution that monetary policy makes to sustainable growth is the maintenance of price stability. Since sustained increase in price levels is adjudged substantially to be a monetary phenomenon, monetary policy uses its tools to effectively check money supply with a view to maintaining price stability in the medium to long term. Theory and empirical evidence in the literature suggest that sustainable long term growth is associated with lower price levels. In other words, high inflation is damaging to long-run economic performance and welfare. Monetary policy has far reaching impact on financing conditions in the economy, not just the costs, but also the availability of credit, banks' willingness to assume specific risks, etc. It also influences expectations about the future direction of economic activity and inflation, thus affecting the prices of goods, asset prices, exchange rates as well as consumption and investment.

A monetary policy decision that cuts interest rate, for example, lowers the cost of borrowing, resulting in higher investment activity and the purchase of consumer durables. The expectation that economic activity will strengthen may also prompt banks to ease lending policy, which in turn enables business and households to boost spending. In a low interest-rate regime, stocks become more attractive to buy, raising households' financial assets. This may also contribute to higher consumer spending, and makes companies' investment projects more attractive. Low interest rates also tend to cause currency to depreciate because the demand for domestic goods rises when imported goods become more expensive. The combination of these factors raises output and employment as well as investment and consumer spending.