

Theories and Monetary Policy

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Abstract

Monetary policy together with fiscal policy is one of the two ways in which government authorities influence in a market economy the rhythm and direction of economic activity, with effects not only on the level and variation of gross domestic product, but on the rhythm and intensity of change the general level of prices. Efficiency of central banks to leading monetary policy result from monopoly position they hold regarding their own counterparties offer money that banks require to constitute legal reserves or settle with other commercial banks in order currency and credit to be used in daily transactions taking place in the economy

Keywords: Monetary Policy, Fiscal Policy, Central Bank, Credit Policy, Gross Domestic Product

Introduction

The classic instruments of monetary policy are: handling discount and rediscount rate, open market operations, variations allowance reserves, credit limits, bank refinancing rate. Discounting is the act by which a bank buys from its customers, sight and before the maturity, short-term debt offering them the amount charged by the document in question, excluding the interest on the length of time between the time of purchase receivable and due them (discount).

Discount rate (the relative size of the discount) depends on many factors, first, the relationship between the demand for discounting the possibility of commercial banks to meet applicants. The size of the discount rate is under the influence of charge rediscount. Rediscount operation is purchase by the central bank to commercial banks, already trading expected effects of the latter, operations performed in sight and before maturity. The value of these securities is recorded in presenting bank account, but reduced by the corresponding amount rediscount tax (legal) and duration of commercial bank lending. Rediscount fee is the interest rate that the central bank calculates in the time of rediscount bills by commercial banks (titles expected of them by their customers).

Depending on the evolution of rediscount rate, loan amount changes as well as its cost. Interest rates charged by commercial banks granted or Dynamic accommodation is rediscount

rate, which means that the central bank policy influences the cost of credit in its entirety. Discount fees are usually higher than the rediscount.

Open market operations

By means of open operations, the Central Bank buys or sells securities (government bonds, bonds, treasury bills and commercial paper) with the specific intent to alter the money stock have great power and are held by the private sector.

If the authorities have targeted reducing the supply of money, they would sell the securities that would be acquired by economic agents. Payment for these titles would involve a transfer of the clearing banks' deposits with the Central Bank to the account of the government. This will lead to a decrease in the monetary base through its effect of decreasing the deposits of the Central Bank. To maintain mandatory reserve rates, banks should reduce debt eventually introducing ever bidding that can be settled on demand, which would cause the money offer to fall.

If an expansion of the money supply, the Central Bank would buy bonds from money markets, increasing the banking reserves. Banks should consider, in these circumstances, they have excess reserves and would try properly to increase lending. A similar goal of exercising control money supply could be obtained by **changing the rate of compulsory reserves of banks**. Exactly the same effect can be obtained by a request that banks are special deposits to the Central Bank, which cannot be counted as part of their reserves.

In general, prices stability is considered as the main objective of monetary policy for the world's central banks, including National Bank of Romania. According to Benjamin Friedman (Friedman, 2000) other accepted monetary policy objectives include the trade balance equilibrium, stability of financial markets and attract foreign capital in the form of direct and portfolio investment. For monetary policy to be effective, it is necessary to have a monetary policy transmission mechanism by which the actions of the central bank to affect actions and decisions of non-financial, firms and households. One of the most important aspects of this mechanism is the need of commercial banks to hold money in the form of central bank reserve requirements, calculated as a percentage of total attracted deposits, calculation methodology and types of deposits taken into account in calculating required reserves are different from country to country.

The mechanism appears reserves as a first tool for the central bank influences the economy as a whole, acting directly on the commercial banks. Not all countries require commercial banks to build up reserves at the central bank, the exceptions being one Canada, New Zealand and Britain. Another instrument of monetary policy is system for market operations (Open Market Operations) the central bank sells or buys securities, usually in the form of bonds or treasury bills issued by the government. When a central bank buys treasury bills will pay crediting bank reserve account that is trading, account at the central bank. In this way, will increase the total volume of reserves held by the banking system and thus the monetary base. When a central bank sells treasury bills, will debit the bank's reserve account that is trading, lowering the total amount of reserves held by the banking system, ie the monetary base. The first type of operation characterizes an expansionary monetary policy (lax) and the second type a restrictive policy.

The third basic tool of monetary policy is the mechanism of refinancing credits from the central bank. This mechanism plays an important role primarily in countries that do not require provisioning by commercial banks to the bank account issue. Refinancing loans often appear in the form of discounting or Lombard loan (the pledge of securities). Discount rate

(undergoing rediscount operations) is considered as a limit (floor) for the interest rates in the economy.

Since these instruments are primarily intended to preserve or restore economic balance, their use is done differently, depending on the state of the national economy finds its cyclical evolution. Broadly defined monetary policy rules as "directions prescribed for certain actions or behaviors". As a result, monetary policy rules can be described as "prescribed guide for conduct of monetary policy" (Woodford et. all, 1998). Both in literature and in practice, a distinction is made between two fundamental types of rules: rules for instruments ("instrument rules") and target rules or aiming ("target rules" or "targeting rules").

Type instrument rules presented instruments of monetary policy rules as a function of predetermined variables and forward-looking. After Svensson, where monetary policy tools are presented as a function of predetermined variables, we are dealing with explicit rules. If monetary policy tools are presented as a function of forward-looking variables, monetary policy rule is considered the default (shown as a condition of equilibrium).

Monetary policy rules are considered effective if they lead to the minimization of a weighted amounts of variance inflation and GDP variation around target levels. Both target levels are set and the weight assigned by the authority has been delegated the management of monetary policy. An effective rule is one that minimizes this sum for a certain value of the two weights. Equivalently, an effective rule puts the economy in a given point on the border of variation of inflation and GDP.

Inflation targeting regime can be defined as a monetary policy framework is based on the adoption of a monetary policy rule that predictions about the future inflation play a central role. Since monetary policy has no effect on inflation with some delay (literature and practice shows that it can vary between nine months and two years), inflation targeting is actually a projected inflation targeting (Svensson, 1998). The inflation forecasts are dependent on the central bank's vision on the transmission mechanism of monetary policy, the current state of the economy and the planned path of the instrument. The rationale behind the adoption of an inflation targeting regime is that, under certain conditions, price stabilization is equivalent to the stabilization of output around its natural - this refers to the level of output that would prevail if there were no rigid nominal order in the economy (Blanchard, 2003).

As shown by IMF (*Fernandez-Ansola, 2008*) catalyst of economic growth is domestic demand that remains strong both in terms of consumption and in terms of investments. Domestic demand is driven by wage growth and credit expansion. Sooner or later, however, the evolution of the European Union will have consequences and internally. Romanian economy can not grow forever in the annual growth rates of 8%. As a result, economic growth, however, is not a healthy one because it relies on inflation fueled by wage increases and budget deficits, and higher prices of raw materials and utilities prices, credit expansion rate and population decline. The fact that imports are valued in dollars and the currency appreciated significantly against the dollar helped maintain control over inflation. But it is not enough to achieve an acceptable rate of inflation. If we look at the figures, we find that tradable prices include import prices expressed in dollars also rises significantly above the inflation target.

The flexibility of fiscal policy should be primarily the result of good management costs; in this current spending (especially public sector wage bill) become an important part of the budget. The general consolidated budget becomes very inflexible. Another aspect that does

not help is that the Government will create a serious problem if allocate additional revenues resulting from economic growth above trend for recurring expenses. The situation may arise when the declining economy would require that surplus. An important source of revenue surplus budget was the result of growth above trend and inflation well above forecasts. Neither growth nor inflation reduction can not be sustained without major actions are taken to counteract. Therefore, given that inflation is well above target and the economy overheats, it would have been better if this important surplus revenue would be saved in order to make investments in infrastructure.

Overheating is a common effect of uncontrolled and listed the causes that harm the company's image of economic growth. Which emphasizes overheating is economic growth, which in turn is driven by inflation and investments that support expanding consumption. But fueling economic growth and wage pressures in the various production sectors and credit expansion not slowing down at a rate noticeably.

Transmission mechanism of monetary policy

The mechanism by which changes in demand and supply of money affects global demand is called transmission mechanism.

The transmission mechanism operates in three stages:

- first is related to the equilibrium interest rate, currency and interest rate will change if the balance between money demand and money supply (inelastic) is affected by a change in either the money supply or money demand (a growth of money demand with money supply unchanged, will increase interest rates, a decline in the demand for money will cause a decrease in the interest rate).
- the second is related to the correlation between interest rates and investment spending, investments respond to changes in real interest rates: a decrease in the real interest rate makes borrowing cheaper and generate new capital expenditure under an inflation expected zero, so real and nominal interest rates are equal. Negative relationship between investment and the real interest rate is called the investment demand function.
- money supply growth leads to a decrease in interest rates and an increase in investment spending. A decrease in the money supply leads to an increase in interest rates and a decline in investment spending.
- the third is related to the correlation between investment spending and aggregate demand. A change in the money supply, by causing a change in investment spending and thus a shift of the aggregate expenditure, aggregate demand curve moves. Transmission mechanism connecting monetary forces and real expenditure. This mechanism works based on a change in money demand or money supply and rising to a change in bond prices and interest rates, respectively, to changes in investment spending and, ultimately, to a shift of the demand curve aggregates.

Operations specific to this channel transmission mechanism can be analyzed in terms of the definition of aggregate demand (consumer spending + investment + government spending + net exports).

In the short term, an expansionary monetary policy moves LM^1 curve to the right, which lowers the interest rate corresponding to a situation of balance, while fiscal policy

¹ Curve LM represents combinations of national income and the interest rate corresponding to a given exogenous money deals and a given price level, which are consistent with the need

expansion IS^2 curve moves to the right, which increases the interest rate corresponding to a point equilibrium. The remaining differences result from the fact that the first result in an increase in investment, while the latter has the effect of reducing them.

Extension made in the case of the short-term to the long term is the same as for both changes in fiscal policy and monetary policy. In the long term there may be some implications that the government allow a budget deficit. If expansionary monetary policy will return to the same level of real balance all real variables unchanged. Fiscal policy expansion involved a permanent increase in government spending that replaces or eliminates real investment spending, calling, in this respect to an increase in interest rates.

Choices about the types of monetary policy can not be analyzed independently of the institutional context, closely linked to the exchange rate regime (regime gold standard, fixed exchange rate regime, the regime rate flexible exchange). Monetary policy must be properly flexible and amend to suit specific environment in which they operate.

With kings gold standard, there is no need for the government to engage in monetary policy. Money supply³ is determined by the interaction of international flows of gold and the domestic banking system. Interest rates are determined by market forces existing international markets for loans and deposits.

Fixed exchange rate regimes involves the use of foreign currency held by the government to buy and sell foreign currency to local currency in order to influence the exchange rate.

Under a floating exchange rate, monetary policy is responsible for determining the value of domestic currency, expressed as relative to domestic prices and to the value of foreign exchange rate.

Monetary policy has been the subject of fierce controversy since the early '70s, due to the finding that only under floating rate regimes exhibit authorities discretionary

to achieve balance by achieving equality between money demand and money supply. This curve shows a locus of combinations of national income and the interest rate was in line with money market equilibrium. An increase in the money supply moves the LM curve to the right, while a decrease in the money supply moves the LM curve to the left.

² Curve IS introduces the relationship between the interest rate and the equilibrium level of national income which aggregate expenditure required equals national income current and output, ie the injections equal withdrawals (saving S + taxes T + import IM = Investment I + government spending G+ export X) ; IS curve has a negative slope; IS curve is the locus of equilibrium interest rates and income levels are consistent with the national balance between desired spending and national output for given values of all other expenses exogenous government spending, exports.

³ Money supply and money multiplier

$$M = (b + 1) : (b + x) \times H$$

where M is the money stock

H monetary base, cash or money based high power

b proportion of cash to bank deposits chosen by public

x share of bank reserves.

This relationship is known as the money multiplier as the term $(b + 1) : (b + x)$ must be greater than one, as long as x is less.

intervention, while the fixed exchange regime and the gold standard constraint of convertibility severely restricts the actions of the authorities.

Monetary policy objectives are to maintain a currency with a stable value and minimizing impacts on the real economy.

The techniques of monetary control

In the postwar period, monetary control was exercised through both direct controls, specific limits as bank loans (temporarily abandoned in 1971 under reforms known as the Competition and Credit Control), or exchange controls, which delimited the domestic monetary system from the world.

Quantitative limits, known as the corset were Refresh in 1973, in a slightly different form, but all controls were abandoned in 1980. Bodice a limit liquidity growth rate generating bank and a limit to the growth rate of loans. Exchange controls were abandoned in 1979. Once abolished foreign exchange controls, banks were free to do anything business abroad, which led to the abandonment of quantitative ceilings domestic affairs.

The expansion of deposits to your account will stop when all the cash in is kept in banks as reserves. Based on fractional reserves, cash injections cause an expansion of the money supply. For each u.m. brought cash into the banking system, banks will be proportional demand deposits, ie currency of account. In general, the multiplier currency account is defined as the volume of new deposits and new reserves ($M_M = D / R = 1 / r$) where D = deposits, R = reserves, r = rate reserves, M_M = money multiplier

Monetary control by banking institutions

Typically, monetary control is indirect, the banking institutions. Main bank liquidity are deposits and the main activities are related to the credits. Monetary aggregates as an expression of the money supply, bank deposits containing as major components (cash).

The assets of the banking sector can be divided into two parts:

1. loans to the public sector - are controlled by two instruments.
 - 1.1. The first tool involves the use of fiscal policy to maintain control borrowing by the government. The amount that the public sector can borrow each year is known as the loan request by the public sector, also called loan application. This tool takes into account the removal of the need for government borrowing in general and thus any need government loan from the banking system.
 - 1.2. The second tool is an appropriate policy for sales of securities. By financing demand for loans through sales of long-term government securities, government authorities can obtain loans that will not result in an increase in the money supply. These securities sold to allow non-banking private sector to achieve the purpose of obtaining loans for government, independent of the banking system. A form of financing the budget deficit, which directly increases the money supply occurs when the central bank buys government securities (treasury bills) issued recently. In exchange tezaur bills, the government receives a credit in his account at the Central Bank, which then transfers it to the private sector via checks or other bills. Owners of checks credited as the banking system (called monetization of government flow).
2. loans to the private sector - are controlled by interest rates. Central Bank determines the interest rate at which you purchase (redeem) bonds which are offered by discount houses. This fixes the approximate interest rate on short-term money markets. The interest rates at which banks grant loans and receive deposits and money markets can sell determine

rates of deposits and loans market different bank base rate (the rate that a bank makes it official for most loans).

If the central bank pursues a monetary policy contraction, it will increase interest rates. Banks will increase accordingly, base rates, with a direct effect on the cost of the loan, its upside, which will reduce demand for loans (*ceteris paribus*). This policy will lead to weaker economic activity through the mechanism of transmission. A restriction of lending will lead to a restriction of deposits, namely the money supply.

Conclusions

A monetary policy contraction loan supply curve moves to the left, thus increasing lending rates and reducing the amount of loan required. An easing of monetary policy loan supply curve moves to the right, lowering loan rates and increasing the amount of loans requested. A significant reduction of the amount borrowed in a reduction of deposits and money supply. An increase in the amounts borrowed implies an increase in deposits and the money supply.

Monetarists concerning monetary control as a necessary and sufficient condition of checking inflation, appreciating the importance of changes in the money supply as a determinant of inflation on. For monetarists, inflation control targets and minimizing monetary shocks to the economy are achieved by establishing and maintaining a growth rate of money supply. The monetarists opting for economic policy rules, not be at the discretion of government authorities.

If money demand is unstable, the interest rate insulates the real economy from the effects of these disturbances, while fixing the money supply does not lead to such a result. The interest rate is the best policy to stabilize national income when money demand is unstable, but fixing the money supply is preferable if instability is rooted in actual costs. Monetary policy can be improved in the future by taking also consider certain indicators to assess money transaction services. Monetary policy may be able to exert some influence in the sense of expansion and contraction of the economy, but it operates with delay.

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