UNIVERSITY OF THE PEOPLE

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Introduction

Monetary policy refers to the actions taken by a nation's central bank to influence economic growth, unemployment, inflation, and other macroeconomic variables (Wright & Quadrini, 2009). Central banks have several tools at their disposal to impact money supply, interest rates and exchange rates. However, there are constraints and trade-offs that can make simultaneously targeting multiple objectives challenging or even impossible at times.

1. Why the simultaneous targeting of the money supply and interest rates is sometimes impossible to achieve?

Central banks sometimes face conflicts between targeting money supply growth and interest rates. “The larger the money supply the more access we have to funds that go into the economy, which lowers market interest rates.” (Ross, 2021) conversely, a decrease in money supply typically causes market interest rates to rise. Setting interest rates requires buying or selling government bonds to impact market rates, which also affects the money supply. So, if the bank has an inflation target implying a certain money supply increase, changing rates to stabilize growth could make hitting the money target impossible. This problem arose for the Federal Reserve in 1979-1982 when high interest rates were needed to control inflation but conflicted with money supply targets.

2. How do central banks intervene in foreign exchange markets?

“The success of foreign exchange intervention depends on how the central bank sterilizes the impact of its interventions, as well as general macroeconomic policies set by the government.” (Chen, 2021). Central banks intervene in foreign exchange markets to influence the value of the domestic currency. This is done by buying and selling reserves of foreign currencies to impact supply and demand. ***For example***, if a strong currency is hurting exports, the central bank may sell its dollar reserves to increase the dollar supply, depreciating the domestic currency. Intervention helps manage volatility or prevent large misalignments between currencies. But market forces ultimately determine long-run exchange rate values based on trade flows, inflation differentials, interest rates and investor capital flows.

3. Explain the determinants of exchange rates in the long run?

The main determinants of long-run exchange rates are relative price levels between countries based on inflation, and the competitiveness of exports and imports which impacts trade balances. The Purchasing Power Parity theory holds that exchange rates should equalize the prices of common goods across countries when converted into a common currency. Meanwhile, the International Fisher Effect says differences in real interest rates dictated by monetary policy also impact currency values through capital flows. So, in the long term, relative inflation rates and competitiveness reflected in trade balances drive currency values more than central bank intervention can override.

Example

Japan's central bank has tried keeping the yen weak for decades to support exports. But fundamentals like low inflation and consistent trade surpluses have kept driving the yen's underlying value higher, limiting the effectiveness of intervention over long periods.

Conclusion

In summary, central banks have a variety of policy tools to influence economic conditions and currency values, including money supply, interest rates and foreign exchange market intervention. However, targeting multiple objectives can pose conflicts while market fundamentals constrain long-run exchange rate manipulation. Understanding these limitations and trade-offs is important for crafting effective monetary policy.

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