What is monetary policy?

Monetary policy is how central banks manage liquidity to create economic growth. Liquidity is how much there is in the money supply. That includes credit, cash, checks and money market mutual funds. The most important of these is credit. It includes loans, bonds and mortgages.

Monetary policy consists of the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates. Monetary policy is maintained through actions such as modifying the interest rate, buying or selling government bonds, and changing the amount of money banks are required to keep in the vault (bank reserves).

Tools of monetary policy

Central banks have three main monetary policy tools: open market operations, the discount rate and the reserve requirement. Most central banks also have a lot more tools at their disposal. Here's what the three primary tools are and how they work together to sustain healthy economic growth.

1. Open Market Operations

Open market operations are when central banks buy or sell securities. These are bought from or sold to the country's private banks.

When the central bank buys securities, it adds cash to the banks' reserves. That gives them more money to lend. When the central bank sells the securities, it places them on the banks' balance sheets and reduces its cash holdings. The bank now has less to lend. A central bank buys securities when it wants expansionary monetary policy. It sells them when it executes contra-dictionary.

2. Reserve Requirement

The reserve requirement refers to the money banks must keep on hand overnight. They can either keep the reserve in their vaults or at the central bank. A low reserve requirement allows banks to lend more of their deposits.

It's expansionary because it creates credit.

A high reserve requirement is contra-dictionary. It gives banks less money to loan. It's especially hard for small banks since they don't have as much to lend in the first place. That's why most central banks don't impose a reserve requirement on small banks.

Central banks rarely change the reserve requirement because it's expensive and disruptive for member banks to modify their procedures.

3. Discount Rate

The discount rate is the third tool. It's the rate that central banks charge its members to borrow at its discount window. Since the rate is high, banks only use this if they can't borrow funds from other banks.

There is also a stigma attached. The financial community assumes that any bank that uses the discount window is in trouble. Only a desperate bank that's been rejected by others would use the discount window.

How It Works

Central bank tools work by increasing or decreasing total liquidity. That's the amount of capital available to invest or lend. It's also money and credit that consumers spend. It's technically more than the money supply. That only consists of M1 (currency and check deposits) and M2 (money market funds, CDs and savings accounts). Therefore, when people say that central bank tools affect the money supply, they are understating the impact.

Objectives of monetary policy:

The monetary policy in developed economies has to serve the function of stabilization and maintaining proper equilibrium in the economic system. But in case of underdeveloped countries, the monetary policy has to be more dynamic so as to meet the requirements of an expanding economy by creating suitable conditions for economic progress. It is now widely recognized that monetary policy can be a powerful tool of economic transformation.

i. Neutrality of money
ii. Stability of exchange rates
iii. Price stability
iv. Full Employment
v. Equilibrium in the balance of payments
vi. Economic Growth

1. Neutrality of Money:

Monetary authority should aim at neutrality of money in the economy. Any monetary change is the root cause of all economic fluctuations. According to neutralists, the monetary change causes distortion and disturbances in the proper operation of the economic system of the country.

They are of the confirmed view that if somehow neutral monetary policy is followed, there will be no cyclical fluctuations, no trade cycle, no inflation and no deflation in the economy. Under this system, money is kept stable by the monetary authority. Thus the main aim of the monetary authority is not to deviate from the neutrality of money. It means that quantity of money should be perfectly stable. It is not expected to influence or discourage consumption and production in the economy.

2. Exchange Stability:

Exchange stability was the traditional objective of monetary authority. This was the main objective under Gold Standard among different countries. When there was disequilibrium in the balance of payments of the country, it was automatically corrected by movements. It must be noted that if there is instability in the exchange rates, it would result in outflow or inflow of gold resulting in unfavorable balance of payments. Therefore, stable exchange rates play a key role in international trade. Thus, it is clear from this fact that: the main objective of monetary policy is to maintain stability in the external equilibrium of the country. In other words, they should try to eliminate those adverse forces which tend to bring instability in exchange rates.

3. Price Stability:

Price stability is considered the most genuine objective of monetary policy. Stable prices repose public confidence because cyclical fluctuations are totally eliminated.

It promotes business activity and ensures equitable distribution of income and wealth. As a consequence, there is general wave of prosperity and welfare in the community. Price stability also impedes economic progress as there is no incentive left with the business community to increase production of qualitative goods.

It discourages exports and encourages imports. But it is admitted that price stability does not mean 'price rigidity' or price stagnation'. A mild increase in the price level provides a tonic for economic growth. It keeps all virtues of a stable price.

4. Full Employment:

During world depression, the problem of unemployment had increased rapidly. It was regarded as socially dangerous, economically wasteful and morally deplorable. Thus, full employment assumed as the main goal of monetary policy. In recent times, it is argued that the achievement of full employment automatically includes prices and exchange stability.

However, with the publication of Keynes' General Theory of Employment, Interest and Money in 1936, the objective of full employment gained full support as the chief objective of monetary policy. Keynes equation of income, $Y = C + I$ throws light as to how full employment can be secured with monetary policy. He argues that to increase income, output and employment, it is necessary to increase consumption expenditure and investment expenditure simultaneously. This indirectly solves the problem of unemployment in the economy. Since the consumption function is more or less stable in the short period, the monetary policy should aim at raising investment expenditure.

As monetary policy is the government policy regarding currency and credit, in this way, government measures of currency and credit can easily overcome the problem of trade fluctuations in the economy. On the other side, when the economy is facing the problem of depression and unemployment, private investment can be stimulated by adopting 'cheap money policy' by the monetary authority.

Monetary policy can be designed to meet with the problem of under employment and disguised unemployment and by further creating new opportunities for employment. The most suitable and favorable monetary policy should be followed to promote full-employment through increased investment, which in turn having multiplier and acceleration effects.

After achieving the objective of full-employment, monetary policy should aim at exchange and price stability. In short, the policy of full employment has the far-reaching beneficial effects.

5. Economic Growth:

In recent years, economic growth is the basic issue to be discussed among economists and statesmen throughout the world. In other words, it means utilization of all the productive natural, human and capital resources in such a manner as to ensure a sustained increase in national and per capita income over time.

Therefore, monetary policy promotes sustained and continuous economic growth by maintaining equilibrium between the total demand for money and total production capacity and further creating favorable conditions for saving and investment. For bringing equality between demand and supply, flexible monetary policy is the best course.

In other words, monetary authority should follow an easy or tight monetary policy to suit the requirements of growth. Again, monetary policy in a growing economy, has to satisfy the growing demand for money. Thus, it is the responsibility of the monetary authority to circulate the proper quantity and quality of money.

6. Equilibrium in the Balance of Payments:

Equilibrium in the balance of payments is another objective of monetary policy which emerged significant in the post war years. This is simply due to the problem of international liquidity on account of the growth of world trade at a faster speed than the world liquidity.

It was felt that increasing of deficit in the balance of payments reduces, the ability of an economy to achieve other objectives. As a result, many less developed countries have to curtail their imports which adversely affect development activities. Therefore, monetary authority makes efforts that equilibrium should be maintained in the balance of payments.