Monetary Policy and Its Role in Macroeconomic Stability

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Abstract

My paper aims at presenting a brief synthesis of the conceptual approaches of monetary policy, as well as considerations at European and national level. Besides, the monetary policy tools and their influences on the economic context are also part of the presentation.

Keywords: monetary policy, inflation, price stability, monetary policy instruments

Introduction

In dealing with macroeconomic policies, we should distinguish between the active role of the macroeconomic policies – related to reaching some macroeconomic targets, and the role of politics as an automatic macroeconomic stability trigger.

Monetary policy influences the level of nominal interest rates, the currency and the average rate of inflation in the economy. The relationship between inflation and interest rates is an example of a policy rule. A monetary policy rule describes the way in which the Central Bank adjusts the policy as a reaction to economic circumstances. Inflation is one of the main factors that determine the reaction of the Central Bank, but it reacts to changes of unemployment rate and GDP, too. To be able to stabilize the economy, the Central Bank should change the nominal interest rate in a greater measure than it proceeds with inflation. Thus, monetary policy is the main factor determined by inflation.¹

Inflation targeting aims at stabilizing economy by the means of anti cyclical policies and diminishment of economic fluctuations.

Considering the monetary aspect, the objectives of the central banks are to protect payment system of the economy and prevent from deflation. Avoiding a deflation implies the stabilization of MV (maintaining the monetary level M, under the terms of decrease in speed of monetary expansion V).

Theories on monetary mass

Monetary market plays a more and more important role, mainly due to the role that currency occupies in the contemporary economy.

The analysis on the monetary stocks administration shows that monetary issue is ascending income function and descending function to the level of interest rate. Empirical studies confirm the idea that the demand for currency is a function of income and interest rate.

An anticipation of increase in price diminishes the monetary mass stock and leads to an even higher speed of currency circulation. The mechanisms of the monetary market are complex; through gradual modification of interest rate, the currency demand is balances with currency offer.

Starting with 1950, Milton Friedman, brings again to audience’s attention classic quantity theory, adjusting it the economic circumstances of the 20th century, under a new formula “new quantity theory of money”.

Classic quantity theory on money is based on the model $M \times v = P \times Y$.

Static quantity theory on money refers to the fact that money circulations speed is invariable, total production is constant, and the modification of the monetary mass is directly proportional to the general price level.

Fischer Equation $M \times v' = P \times T$, takes into consideration the fact that monetary mass is considered only a payment instrument and, in this vein, the money demand is calculated in relation with the volume of money transactions.

Cambridge Equation $M = k \times P \times Y$, takes into consideration the fact that the monetary mass is a payment instrument through the volume of transactions and a cash instrument, as well.

The essential difference between the classic quantity theory and the quantity theory reformulated by the representatives of the School of Chicago consists of the fact that the monetary balance is taken into consideration on long-term as well as on short-term. Monetary policy, through monetary mass, reestablishes the balance of the economic activity by modifying volumes of money.

As for the mechanism of transmission, the monetary policy influences the aggregate demand. The change of the level of money offer results into the modification of interest rates, and implicitly of the aggregate demand.
In regard to monetary policy, we have to consider the level of real cash, namely “the possibility of a cash trap, under the circumstances of a low rate, stands for a notion that is grounded on the great economist J.M. Keynes’s theory. Yet, this is contrary to the fact that Keynes admits he did not know anything on such a situation had ever happened.”

Liquidity preference theory design by J.M. Keynes analyses the factors that determine the rate of interest as macroeconomic stability trigger. The rate of interest is adjusted to balance money demand and offer.

Expansionary monetary policy determines the decrease of interest rate, economic growth and price level increase. As for the restrictive monetary policy, when the rate of interest increases, the price level and real production decrease, new restrictions on loans are impose, compulsory bank reserves are increased, and monetary mass is more rigorously controlled.

Macroeconomic stability policies aimed at combating short-term economic fluctuations. Monetary policy operates through the instruments of exchange rate and interest rate to be able to change the level of aggregate expenditure. Model aggregate-request – aggregate offer is the macroeconomic tool for setting inflation rate and price-level. The negative curve inclination of aggregate demand is determined by the aggregate influence of the exchange rate effect, interest rate effect and the effect of wealth.

Considerations on monetary policy at European level

According to art. 127 of The Treaty of the Functioning of the European Union”, the main goal of the European System of Central Bank (...) is to maintain price stability”.

Price stability is both a goal in itself, as well as a means for monetary policy, as it contributes to achieving a sustainable growth and macroeconomic stability. The three elements of consensus concerning price stability are:

- Price stability refers to the aggregate level of prices measured by indicators.
- Price stability is achieved when money keep their value in time or the erosion speed of buying power slows down.
- The concept on monetary stability overlaps price stability.

This is the fundamental disposition of the chapter related to monetary policy laid down in The Treaty of the Functioning of the European Union.

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The monetary policy of the European Central Bank will contribute to the maintenance of price stability over the medium term, in the context of higher inflation and problems on financial markets.

Acting in such a way that ECB's monetary policy should meet this objective, the Treaty reflects modern economic thinking in terms of the role, scope and limits of monetary policy and the institutional and organizational structure of the activity of the Central Bank in the framework of Economic and Monetary Union.

Economic and Monetary Union stands for the process by which economic and monetary policies of the E.U. Member States harmonize to introduce euro unique currency.

A monetary policy oriented to maintain price stability over the long term will contribute fully to improving economic outlook and to ensure social welfare.

Achieving a single monetary policy requires to define the instruments and procedures that are used. Monetary policy tools are: the tools of monetary policy in accordance with the regulations in force, which are: money market operations, standing facilities granted to credit institutions and minimum compulsory reserves.

Considerations on monetary policy in Romania

In this context, the National Bank of Romania has the basic objective of ensuring and maintaining price stability, the main task being the monetary policy.

Preserving the prudent conduct of monetary policy, aiming to firmly anchoring medium-term inflationist forecasts, was motivated, in this period, by higher volatility of the exchange rate of the Romanian currency and the dynamics of prices, ready to exert adverse effects on current evolution and the short term inflation perspective.

In 2011, the context related to the implementation of the monetary policy benefit from a process of fiscal consolidation and structural reforms in accordance with the objectives of the economic programme provided for the agreements with the E.U., FMI and World Bank, but also the impact of the positive offer shock generated by the agricultural production.4

In the third quarter 2012, NBR5 has kept the monetary policy interest rate at 5.25% and kept in force levels of mandatory minimum reserve rates applicable to liabilities in lei and in foreign currency of credit instruments.

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Monetary policy of NBR has firmly focused to achieve the laid down inflation targeting as well as to ensure price stability over the medium term, which represents the main contribution that monetary policy can make to assure the ground for sustainable economic growth.

At the same time, NBR will continue to use the tools of monetary policy from the perspective of monetary transmission improvement, as well as of the sustainable recovery of lending activity.

Conclusion

The viability and effectiveness of a monetary policy configuration remain conditioned by structural reforms and fiscal consolidation measures, along with an intensification of the process of E.U. funds absorption, according to the commitments laid down in the agreements concluded with the E.U., the IMF and other international financial institutions, which are essential for maintaining inflation at low levels as well as for a sustainable economy in Romania.

References