CONSIDERATIONS REGARDING THE CONCEPT OF MONETARY POLICY

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Abstract: This paper aims to make a conceptual analysis of the monetary policy notion by reviewing the literature regarding the concept of monetary policy, as well as, by highlighting the way in which monetary policy opinions have changed in time. Further, we presented the transmission mechanism of monetary policy together with the most important channels through which central banks, by using various monetary policy instruments, can affect the dynamics of aggregate demand and prices in the economy. The paper ends by reviewing the main objectives of central banks and their evolution in time.

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Key words: monetary policy, central banks, inflation targeting, monetary targeting

1. INTRODUCTION

Through time, the objectives, as well as the monetary policy behavior of central bank have changed considerably. Starting from the idea that central banks need to pay special attention to stabilizing growth, continuing with the argument that the role of the central banks should have been to provide sufficient liquidity in order to re-launch the economic activity, as well as the new monetary policy which gave more importance to price stability, nowadays, central banks have come to have different objectives, depending on the level of country/union development or global circumstances. However, currently, price stability is the dominant objective in terms of monetary policies promoted by central banks.

Among the main objectives of contemporary central banks can be mentioned: ensuring long-term growth of monetary aggregates and debt, in accordance with the increasing in long-term production potential, as well as achieving a high degree of employment as is the case of Federal Reserve System of the United States of America, or maintaining price stability, objective of European Central Bank. As far as the main objective of National Bank of Romania goes, this is to ensure and maintain price stability.

This paper aims to create an overall picture of monetary policy by presenting the main definitions granted over time in terms of monetary policy starting from the monetarist theory, continuing with the theories promoted by New Classical or New Keynesian approaches and concluding with the contemporary discussions that pay particular attention to the inflation targeting as the main objective of central bank.

2. CONTENT

In general, the economic policy addresses all the strategies adopted by a state and, in particular, by a government, in economic terms, in order to achieve their objectives. Most of the time, at macroeconomic level, governments are concerned about ensuring the equilibrium for a number of indicators, including: employment rate, economic growth, price stability or balance of payments equilibrium. Even if would be ideal to ensure a simultaneous realization of all these objectives, in practice, given the complexity of economy as well as its exposure to international influences, these objectives are impossible to achieve simultaneously.

In time, several researchers have tried to give a definition for the economic policy, and the majority of them have seen it as a tool through which authorities interfere with economic activity.

The economic science is the underlying theoretical basis of the economic policy and it studies the way in which society uses limited resources to produce valuable goods for its members (Samuelson, 2000).

Cerna, S. (2014) believes that economic policy consists in all the interventions made by authorities in the economic activity. These interventions are forms of state sovereignty manifestation in this essential area of social life, mainly in production and distribution of goods and services.

In the same paper, Cerna (2014) has highlighted the three phases of economic policy:

- the government formulates a diagnostic for the economic situation; in this regard, authorities should take into account the evolution and level of the most relevant and important economic indicators such as GDP growth rate, unemployment rate, inflation rate, and so on;
- starting from this diagnostic, the state defines its priorities. Indeed, the economic policy can only follow certain objectives (usually, reducing unemployment rate, relaunching economic growth, reducing inflation), while other objectives must necessarily be overlooked for some time, or even neglected;
- further, the government has to choose the right instruments in order to achieve its fixed objectives.

Nowadays, the government can interfere in the economy through two types of economic policies: monetary policy and fiscal policy. These two types of policies are considered to be the only economic policies that are compatible with both the laws of market economy and the principles of democratic governance.

Fiscal policy targets the government spending and fiscal instruments used in order to influence economic conditions, including goods and services demand, economic growth, employment rate or inflation rate.

On the other side, monetary policy consists in the elaboration and implementation process of an action plan formulated by a central bank, monetary council or other national competent monetary authority in order to control the money supply existent in the economy. Likewise, monetary policy manages the money supply, as well as the interest rate, in order to achieve macroeconomic objectives (by controlling consumption, inflation, growth or liquidity). These objectives are achieved through several actions such as changes made in terms of interest rates, by selling or purchasing government bonds, regulating the exchange rate or by changing the rate of minimum reserves that commercial banks are required to maintain.

Originally, the notion of *monetary policy* involved the central bank's actions to influence and / or to target a measure on the amount of money in the economy. Most of the time, monetary policy definitions have focused more on the purchasing power of money.

A definition, viewed from the point of view of political decision-makers, was that monetary policy refers to the central bank's actions to influence short-term interest rates or foreign exchange rates.

This was not the only vision of monetary policy at that time. The 1960s brought with them the appearance of monetarism, as a result of Friedman and Schwartz (1963), Friedman and Meiselman (1963) and Andersen and Jordan (1968) works.

There were several opinions among monetarists. The first and primordial among them argued that inflation was a monetary phenomenon and that central banks had to be held accountable for maintaining price stability. Monetarists claimed that central banks should have controlled money supply and not focus on short-term nominal interest rate targeting, in order to achieve their long-term inflation objectives. The underlying argument behind the increasement in the monetary volume was that, in a money-based economy, the volume of money could ensure a nominal anchor for the system.

In the view of monetarists, inflation control was not the only concern of monetary authorities. They saw monetary policy as having significant effects on short-term fluctuations in real output (Andersen & Jordan, 1968; Andersen & Carlson, 1970), but not affecting long-term growth. Indeed, many monetarists (Milton Friedman & Schwartz, 1963; Brunner & Meltzer, 1968; Meltzer, 1995) thought that monetary policy was responsible for worsening cyclical fluctuations in real output.

Milton Friedman (1969) has made the difference between lending policy and monetary policy: in his opinion, lending policy involves the goals set by monetary authorities in terms of interest rates, lending conditions, and so on, while monetary policy refers to the effects of monetary authorities' actions regarding money supply.

Kent R.P. (1966) defined monetary policy as the management of expansion and contraction in existing money supply with the explicit purpose of achieving a specific objective, such as full employment.

Along with the appearance of *the rational expectations revolution*, macroeconomics also faced *the proposal of inefficient policies*, according to the macroeconomic theory promoted by the New Classical school of thought (Sargent and Wallace, 1975). The initial interpretation of this paradigm was that, in any macroeconomic model, assuming rational expectations would make monetary policy inefficiency to influence real output, both in short and long term. Therefore, there was no part for monetary policy in stabilizing production.

Subsequent studies (Fischer, 1977; Calvo, 1983; Taylor, 1993) have shown that the interaction between the expectation hypothesis and the wage and/or perfectly flexible pricing hypothesis have generated *the proposal of inefficient policies*. This perspective was the result of the New Keynesian school of thought.

With the extensive use of the New Keynesian models, monetary principles regarding how monetary policy affects the economic activity have become widespread both in academic and banking circles, even though most academics and central bankers would have quit such a monetarist label. The money has largely disappeared from the discussions on monetary policy strategies.

In contemporary literature, models and discussions about monetary policy pay particular attention to the role of inflation targeting within policy rules promoted by central banks.

Taylor's Rule (J. Taylor, 1993), which highlights a systematic relationship between short-term interest rate targeting and the deviations from inflation targets as well as the real output from a *potential output* measure have become the rule for analyzing the impact of monetary policy.

Broadly speaking, monetary policy can be defined as the deliberate effort of a central bank made to influence the economic activity by modifying money supply, lending opportunities or interest rates, in order to achieve several objectives.

In a narrow sense, monetary policy could be identified with the policy of central banks in respect of the appropriate use of credit control measures to influence financial flows in order to ensure harmony in terms of employment, production, inflation, balance of payments, and so on.

According to Einzig P. (1954), monetary policy represents the attitude of political authorities towards the monetary system in its community. In other words, a country's government can decide whether to take certain measures in order to achieve a series of economic targets, or to refrain from taking such action. In the first case it is an active monetary policy, while the second one can be classified as a passive monetary policy.

Monetary policy depends on the relationships between interest rates in an economy, which is the price at which money can be borrowed, and the total money supply. Monetary policy uses a variety of instruments to control one or both variables so they can influence results such as growth, inflation, exchange rates or unemployment.

Regarding the types of monetary policy used by the central banks, two such policies were identified, as it follows:

- expansionary monetary policy;
- restrictive monetary policy.

The expansionary monetary policy is characterized by an increase in the existent money supply, while through the restrictive monetary policy government reduces the amount of money. Both types of monetary policy have a great impact on aggregate demand. A central bank can choose to use an expansionary monetary policy strategy to boost the growth of aggregate demand. Tight monetary policy is used especially to reduce inflation by reducing demand in money supply which, in turn, lead to a lower aggregate demand.

As far as the effects of expansionary monetary policy are concerned, they can be:

- short-term: by decreasing interest rates, there will be recorded increases in terms of economic agents' expenses, especially regarding investment, consumption and government spending. This will lead to an increase in aggregate demand, production and employment rate, but, at the same time, there will also be increases in terms of prices;
- long-term: the only increase will be recorded regarding price level, the other real variables will not be affected.

As effects of restrictive monetary policy, the following can be highlighted:

- short-term: with the decrease of the interest rate, the other variables will decrease as well (consumption, investment, government spending, aggregate demand, employment rate);
- long-term: by adopting a restrictive monetary policy, there will be recorder a decrease in price levels.

Unlike monetary policy, the monetary policy transmission mechanism focuses on the effects that these decisions have on economic activity and inflation, by using transmission channels.

Kuttner and Mosser (2002) considered that the transmission mechanism between money market and real market is the most important factor that influences the efficiency of monetary policy in economy and the changes made in a country's money market affect the real sector through different channels.

The monetary policy transmission mechanism has a complex character and it consists of two large segments:

- the first segment reflects the impact of monetary policy decisions on financial variables (financial market's interest rates, price of financial assets, exchange rate, and so on);
- the second segment highlights the impact of changing financial variables on the real economy.

Monetary policy transmission mechanism represents the totality of channels through which the central bank, by using a various set of monetary policy instruments, can influence the dynamics of aggregate demand and prices in economy.

Among the channels (or specific mechanisms) used by the transmission of monetary policy identified by literature, economic practice has particularly highlighted the importance of the following:

- the interest rate channel;
- the credit channel;
- the exchange rate channel;
- the inflation expectation channel.

In order to achieve their objectives, central banks are using a range of operational tools and procedures. According to Bario (1996), there is a wide variety in choosing the monetary instruments, procedures and strategies by a central bank. This statement raises the question of whether there is a relationship between these aspects of monetary policy and whether a specify choice of instruments and procedures may affects the ability of a central bank to achieve its operational objectives.

Prudential instruments involving banking system are essential within the instruments used to develop monetary policies which aim an economic stability. These are the most used tools in implementing micro-prudential and macro-prudential policies. "Macro-prudential policy seeks to ensure the strength of individual financial institutions, while macro-prudential policy seeks to focus on systemic risks in the financial system as a whole." (Cerutti, Correa, Fiorentino, & Segalla, 2016, p. 4)

The monetary policy instruments used by central banks to achieve their objectives can be grouped into two main categories, as it follows:

- indirect monetary policy instruments (market targeting), used by central banks in the relationship with non-financial agents and other market-oriented banks (Eijffinger & Haan, 2000). These tools are making possible controlling the cost and quantity of money;

- direct monetary policy instruments (as a result of the measures taken by monetary authorities) - used to influence financial agents (users and coin holders): credit classification, administrative fixation of interest rates, exchange rate control (Dardac & Vascu, 2002).

Regarding the main objectives of central banks, they have evolved considerably in time: starting with the reconciliation of joining the Golden Standard with maintaining financial stability, a specific objective for the first central bank, and achieving price stability, the most common objective of banks modern facilities.

In general, central banks have three main objectives, functions or roles:

- to maintain price stability;
- to maintain financial stability;
- local government finance in times of crisis, but without the abuse of this power.

Of course, the importance of each objective has changed in time, for example, the local government finance in times of crises function has increased in wartime and has become less important in peacetime.

In theory, the main objective of monetary policy, which has been found for the vast majority of central banks, is to maintain the purchasing power of the national currency, both externally and internally.

Regarding the ultimate goal of most of central banks, it is to maintain a low and stable inflation rate. Thus, banks are trying to control the inflation directly, by modifying interest rates or by modifying the amount of monetary aggregates.

The objectives of monetary policy may vary from one country to another and even in the same country, from one time to another. They also change according to the dominant needs and conditions in the economic system

Among the most important monetary policy objectives promoted by central banks are included:

- monetary neutrality - according to which the amount of money in the economy must be kept perfectly stable by the monetary authorities, this neutrality may not influencing or ignoring the consumption and production of the economy;
- stability of exchange rates - considered as a traditional objective of the monetary authorities, being practiced especially during the period of application of the Golden Standard;
- price stability - is the most common objective of monetary policy promoted by contemporary central banks and it implies that price fluctuations bring uncertainty and instability to the economy, and the increases or decreases in prices should not be very healthy in terms of economic prosperity because they produce unnecessary losses to some of the market participants and undue gains to others;
- employment - it has become a main object of monetary policy, especially after the great world economic crisis that took place between 1929-1933, when the unemployment problem grew rapidly;
- economic growth - defined as a steady increase in per capita real incomes, the economic growth objective has become particularly important as full employment can not be achieved without an increase in economic growth;
- balance of payments equilibrium - an objective mainly developed after the Second World War, the Balance of Payments balance is of particular importance because an increase in the balance of payments deficit may adversely affect the state's development activity.

3. CONCLUSIONS

This paper aimed to make a conceptual analysis of the monetary policy notion by reviewing the literature regarding the concept of monetary policy, as well as, by highlighting the way in which monetary policy opinions have changed in. In this regard, we have come to the conclusion that monetary policy is a part of economic policy through which monetary policy strategies are developed and implemented in order to achieve macroeconomic objectives such as price stability, consumption control, inflation control or ensuring sustainable economic growth

A key component of monetary policy is related to its transmission mechanism. The transmission mechanism of monetary policy consists in the channels through which central banks can influence the dynamics of aggregate demand and prices in economy. After analyzing the literature, we came to the conclusion that among the transmission channels of the monetary policy, the most important are: the interest rate channel practiced by financial institutions, the exchange rate channel, the credit channel, the financial development channel, the channel of the economic agents' expectations regarding inflation, as well as the price channel.

In order to achieve their objectives, central banks use a range of operational tools and procedures. Monetary policy instruments can have: indirect action, market-oriented, currency-controlled, or direct action which are used to influence economic agents (exchange rate control, changes in interest rate). It was also attempted to briefly present the monetary policy objectives that central banks had in time, concluding the fact that among the factors that led to changes in central bank monetary policy priorities can be mentioned: the phenomenon of globalization, financial innovation and the considerable development in the field of non-banking financial intermediation.

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