

# **RESEARCH ARTICLE**

# MONEY POLICY IMPLEMENTATION: ISSUES AND PARADOXES

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# Manuscript Info

## Abstract

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..... Monetary policy is conducted through transmission channels which are by definition channels through which monetary variables influence real economic variables, notably the liquidity effect, which is shown by the repercussions of a change in the money supply on global demand, and the interest rate effect, which has an impact on the cost of capital, thus affecting the spending behaviour of agents through income effects and their choice of assets through substitution effects. To the extent that price and exchange rate expectations modulate the economic and financial behaviour of agents, monetary policy also tries to influence these variables via announcement effects. The effectiveness of these effects remains conditioned by the credibility of monetary policy and the confidence of agents in this policy. This paper attempts to explain the objectives of monetary policy and their paradoxical management. The main internal objective of monetary policy is the fight against inflation through demand and inflation through income. Subsequently, the external objective of exchange rate stability. Monetary policy may, therefore, be faced with a dilemma, in that the emergence of conflicts between internal and external objectives calls for contradictory and transitional measures.

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# Introduction:-

In order to conduct monetary policy, the mechanisms by which monetary variables influence economic variables must be made explicit. Knowledge of these "transmission channels" and the determination of the economic policy objectives on which monetary policy can effectively act make it possible to choose the most appropriate modalities for achieving these objectives.

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Monetary authorities can act either by direct authoritarian control of monetary variables (credit, foreign exchange, interest rates, etc.), or by intervention in the financial markets with the aim of influencing both the money creation behaviour of credit institutions (the supply of money) and the behaviour of non-financial agents in terms of financing and holding cash balances: a dual action on the supply of and demand for money. The choice of monetary variables to be modulated and the instruments to be used to achieve this will evolve with the structure of the national and international financial and monetary system, as shown by the French example of the 1980s.

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This article has several objectives. To begin with, it aims to explain the transmission channels of monetary policy and their respective influences on the economic and financial behaviour and expectations of agents via monetary variables. Secondly, we will attempt to analyse the internal and external objectives of monetary policy by explaining the approaches to be taken which rely on the previously explained transmission channels. Then, in fine, we will look at the relative limits of these approaches, trying to address the conflicts between the internal and external objectives that hinder the proper conduct of monetary policy. And to which, the monetary authorities, envisage transitional solutions of instruments to remedy these divergences.

#### Fundaments and objectives of monetary policy:

Theoretical studies and the development of econometric models as a basis for economic policy implementation have led to a better understanding of the channels through which monetary variables influence "real" variables, including global demand and output, so that monetary authorities can try to influence the general objectives of internal (price) and external (exchange) stability, the level of activity and employment, growth and economic development through these "channels". Monetary policy alone, however, cannot achieve all these objectives at the same time: activity, employment, growth and development are rather the responsibility of budgetary and structural policies, even in the achievement of the objectives for which it has particular responsibility - prices and exchange rates - and it needs to be supplemented by other actions such as income policy, e.g. in the case of prices.

#### Monetary policy transmission channels:

It is possible to operate on the behaviour of spending, production and investment of agents by using two monetary variables: the quantity of money in circulation and the interest rate. Price levels and exchange rates also exert an important influence, but their control by the monetary authorities is more uncertain. Finally, the public authorities can try to influence agents' behaviour by influencing their expectations regarding the evolution of all these monetary variables: the announcement effect.

## Quantitative action and the liquidity effect:

Money can, exert an influence through its quantity as a means of payment fuelling global demand. An increase in the stock of money in circulation can conceivably allow the beneficiary agents to increase their expenditure. Thus, exporters who have received large amounts of foreign currency, government officials or suppliers who have received payments, financed by advances from the Central Bank, enterprises who have obtained bank credits, all of which are sources of money creation, will be able to increase their consumption and investments.

Although the liquidity effect measures the repercussions of a change in the money supply on global demand, the impact may be more or less important depending on the cash behaviour of agents. Assuming an increase in the money stock of six billion, aggregate demand may increase by the same amount if the recipients immediately spend these additional funds in full, but they may also, for reasons of precaution or speculation, keep them in "idle" cash balances and, in this case, the impact on aggregate demand will not occur or will occur only partially. If we think that the proportion of cash in relation to their income or wealth that agents wish to hold is relatively stable, we can hope that by varying the money supply we will have a significant effect on aggregate demand because the induced phenomena of hoarding (or dehoarding) will be non-existent or weak. On the other hand, if we believe that cash collection behaviour is highly variable, i.e. that the speed of money circulation is unstable, we cannot rely on this "quantitative" policy to increase or decrease demand.

On precisely here, two main theoretical currents oppose each other: monetarists believe in a direct liquidity effect on global demand: an increase in the money supply translates into increased spending on goods, services or securities (investments), while a decrease translates into a decrease in spending. This liquidity effect mainly affects prices and imports, although a "transitory" effect may occur on the level of national activity. For the Keynesians, the degree of liquidity of an agent is not a direct factor in his spending behaviour, which is a function of his income; income and cash do not necessarily coincide. It is particularly for companies that the liquidity effect is uncertain: their investments depend more on their profits than on the state of their cash flow. A change in the money supply will only have an indirect effect, through changes in interest rates that it will provoke. The role of money as a financing and investment instrument is underlined, complementing that of a payment instrument.

## Action through interest rates:

Varying interest rates affect expenses financed by borrowing (cost of capital), as well as having a more general influence on the level and structure of demand, since interest rate changes affect the distribution of income, the value of assets, particularly financial assets, and the comparative return on different types of assets. The elasticity of interest (ratio of the relative variation of the loan to the relative variation of the interest rate) varies according to the agents and the purpose of the financing. Businesses have always been relatively sensitive to interest rates for inventory financing. The financing of their capital expenditure has become so due to a high level of indebtedness, which has led to a volume of financial charges that is all the heavier, as it is difficult to pass on in prices in a context of international competition. Private individuals are less sensitive with regard to their current expenses, insofar as their indebtedness is still limited. On the other hand, the importance of financial charges linked to the purchase of housing explains their greater sensitivity in this area.

Note that slowing down inflation increases the interest elasticity of all agents by increasing the real burden of repayments and interest, as borrowers cannot rely on rising prices and income to alleviate their debt. The declared intention of the monetary authorities to fight inflation (announcement effect), can in this respect curb the expenditure of agents financed by borrowing.

Apart from this "cost of capital" effect, changes in interest rates can modify the spending behaviour of agents through socalled "income" and "wealth" effects, and modify the choice of assets through "substitution effects".

The fall or rise in interest rates changes the distribution of income between lenders and borrowers. Indeed, this income effect affects the structure of aggregate demand, depending on the propensities to consume and invest of the agents in question. If lenders are predominantly individuals and borrowers are predominantly businesses, an increase in interest rates may reduce investment and provide an incentive to increase consumption.

Changes in rates also alter the value of agents' wealth, particularly its component of long-term fixed-rate debt securities. For example, a fall in interest rates increases the value of previously issued bonds, generating substantial capital gains. These have prompted the beneficiary agents to increase their expenditure outside of any increase in their current income: this is known as a wealth or asset effect. Conversely, rising interest rates depress the price of previously issued securities, impoverishing holders and may induce them to reduce their spending. Changes in prices and the exchange rate may also, by modifying the real value of agents' assets, lead to positive or negative "wealth effects".

It is worth noting that the income effect and the wealth effect work in opposite directions: the rise in interest rates increases the income of new lenders or of those who own variable-rate debt, but decreases the value of the financial wealth of holders of fixed-income securities issued before the rise. The conclusions regarding the effect on aggregate demand are therefore uncertain.

The change in the yield on financial assets caused by a change in interest rates may encourage agents to substitute financial investments for the purchase of real assets or vice versa. Therefore, the increase in yields, particularly on long-term securities, in the face of a slowdown in rents encourages households to buy securities rather than rental housing. Similarly, the high returns (income and capital gains) on investments in national and international capital markets in the face of corporate profitability has led companies to buy securities rather than make capital goods investments. As a result, demand in the construction and capital goods sectors was depressed as a result of these substitutions in response to rising stock returns. Substitution effects also exist between long-term financial assets "The stock market crisis has led to a significant swelling of the liquid assets that agents have been holding at risk. substituted for the securities in their portfolio. These arbitrages carried out by all agents ensure the transmission of interest rate changes to all capital markets

Substitution effects in the financial sphere can favour or, on the contrary, hinder the implementation of monetary policy.price and exchange rate developments are the key role of anticipations:

Although these are objectives of monetary policy and as such will be analysed in the following section, price and exchange rate developments need to be addressed here as they can strongly influence the effects described above.

To begin, price and exchange rate changes can alter the real value of the stock of money in circulation and interest rates and, more generally, the real value of total income, yields and wealth. Hence, the fall in prices or the simple slowing of inflation that takes place increases the purchasing power of money holdings and the value of financial assets in general, leading to the following effects

"However, it is not clear how much "Real Cash" and "Wealth" can increase demand. On the other hand, this same price drop has the effect of modifying the distribution of income to the detriment of borrowers who see the relative weight of their financial charges increase (Fischer effect), and more broadly it influences the comparative yields of assets

inducing substitution effects. In the same way, a change in exchange rates modifies the wealth, cost of capital and substitution effects to the extent that the assets held, invested or borrowed include foreign currencies.

Forecasts of prices and exchange rates have an important influence on the economic and financial behaviour of agents. Thus, one of the means of action of monetary policy is to try to influence these expectations by means of announcement effects, i.e. signals which may consist either in setting a growth rate for the money supply or in interventions on the financial markets with a view to orienting rates. These measures must be widely publicised so that all agents know that the monetary authorities intend either to curb inflation and keep the exchange rate stable or to revive economic activity. Clearly, the effects of "announcing" will only be effective if the policy implemented is credible and if agents believe in its success, otherwise expectations and behaviour will not be changed.

#### Monetary policy objectives:

A separation is made between the final and intermediate objectives of monetary policy. The intermediate objectives are the monetary variables that can be controlled by the authorities and are tied to the final objectives in a sufficiently stable and predictable manner.

#### Main internal objective: fighting inflation:

Internal equilibrium aims to prevent both insufficient financing and high interest rates from hampering economic activity and employment, or conversely, excessive monetary abundance fuelling internal demand and an inadequate structure of interest rates disrupting financial mechanisms from leading to inflation.

A policy to stimulate economic activity can be based on the liquidity effect of more money creation and lower interest rates favouring borrowing, but the results of this type of policy are not guaranteed. In the first place, the liquidity effect may be neutralised by the swelling of (idle) cash balances due to economic uncertainty or speculation. This is the hypothesis of the famous Keynesian "liquidity trap".

Furthermore, a drop in interest rates does not automatically have a positive effect on activity if the economic actors' economic expectations are bad. Thus, a company will only increase its production capacity (investment) if its prospects of selling profits are sufficient. An abundant cash flow may only result in speculative investments, as was the case in the stock market crisis. Consequently, in order to achieve the objectives of expansion, growth, economic development, fiscal and budgetary policies accompanied by structural actions will be implemented.

Indeed, the main goal of monetary policy is in fact the other component of the internal equilibrium : price stability and, more precisely, the reduction of the inflationary gap in relation to the main partners. Whether or not monetary variables are used effectively to achieve this objective will depend on the source of inflation. Inflation is characterised by a more or less rapid rise in price levels, a cumulative process accompanied by a change in the structure of prices and incomes. Depending on the origin of the increase, a distinction is made between inflation through demand and inflation through income.

Demand-driven inflation is characterized by a situation in which the rigidity of national production does not allow for increases in demand to be met. It is a hypothesis of the quantitative and qualitative theory of money. The inelasticity of output is mainly a function of real variables. The reason is the quantitative or qualitative insufficiency of equipment (technology) or labour (qualification), either in the overall framework or in one or more branches, which then constitutes "bottlenecks" slowing down the whole of activity.

Insufficient investment generates a rigidity of supply in certain sectors. In such a situation, any increase in demand will result in a fall in prices (and imports). Increased demand may be created by money creation resulting from overly broad bank financing, or it may be the result of substitution effects, or of wealth creation resulting from interest rate changes such as the fall in rates that have generated capital gains on fixed-income debt securities.

## Three channels for monetary action to fight inflation through demand:

- 1. Braking down monetary creation will weigh on domestic demand (liquidity effect);
- 2. Rising interest rates will limit borrowing and modify portfolio management (capital cost effects, negative wealth effect, substitution effect);
- 3. Inflationary expectations will be dampened by the announcement effect of this policy.

Nevertheless, the anti-inflationary policy has its limits. This policy does not solve the problem of rigidity of supply, it may even aggravate the inelasticity of production since the monetary financing of production decreases. Finally, its effects are questionable in the case of income inflation.

Inflation by income, also known as inflation by costs, is not monetary, but is mainly caused by an increase in income that is greater than the productivity gains that would allow a compensatory increase in available production. In this mechanism are involved the wages 'their indexation leads to a wage-price spiral', the cost of raw materials, financial charges and the policy of maintaining the 'margins' of enterprises, especially in sectors 'protected' from international competition (services and local shops). This type of inflation persists in periods of under-employment of equipment and personnel: it is the phenomenon of 'stagflation'. In this situation, a restrictive monetary policy can act through two channels:

- 1. By announcing the determination of the responsible authorities to fight inflation;
- 2. A brutal and deep slowdown of internal demand with a worsening of the fall in activity and socially difficult to admit unemployment rates, to which is added the risk of the disappearance of entire sections of the national productive structure.

In reality, cost inflation demands other types of policy: income regulation, which should not apply only to wages, action on production structures, fiscal policy.

## External objective: exchange rate stability:

Considering both the nature of Morocco's trade relationship with what it implies, the external objective of monetary policy is exchange rate stability. The exchange rate depends on the confrontation of supply and demand for foreign currency, linked to commercial and financial flows.

Monetary policy may influence current transactions through two channels: the modulation of internal demand and the action on the inflation differential.

Within an economy where the propensity to import "import ratio or gross domestic product GDP" is high, any change in the money supply can be passed on to imports via domestic demand. Hence, in Morocco, 40% of final demand (consumer and capital goods) is for foreign products. That is to say that any expansion of domestic demand will result, for more than a third, in an increase in imports. As this will not necessarily be compensated by a similar increase in exports, the risk of a deficit in current transactions and especially in the trade balance is high.

All other things being equal, this deficit will lead to downward pressure on the exchange rate. One of the solutions will then be to try to reduce demand by slowing down the money supply (negative liquidity effect). If this action also succeeds in containing domestic prices, reducing or reversing the inflation differential vis-à-vis foreign competitors, the effect on the rebalancing of current transactions could be reinforced by better competitiveness which will boost exports and slow down the penetration of foreign products. However, "relative" prices are not the only factor of competitiveness; other factors come into play, such as the quality and technology of products, the orientation of exports towards solvent developed economies, the existence of distribution networks and after-sales service. Monetary policy cannot do everything in terms of trade; on the other hand, it has an essential impact on these financial flows.

The convertibility of currencies and the return to free exchange, but also the international integration of capital markets have made the influence of capital movements (90% of the volume of transactions on the foreign exchange market) predominant in the variation of exchange rates. These movements are the result of portfolio management that is becoming more international and takes into account interest differentials, possible exchange gains and losses, with expectations playing a key role here. The impact of monetary policy is direct: a central bank that wants to support the exchange rate of its currency will practice a policy of raising interest rates. In most cases, this will be short-term capital, floating capital, or hot money, which can be distributed equally and has risen even more.

Capital movements depend on exchange rate valuation expectations, in a floating exchange rate regime, also in a fixed exchange rate regime, where one can speculate at the least risk on devaluations or revaluations. From this perspective, any factor that may lead to expectations of a change in the exchange rate leads to capital movements that accelerate the process of a currency's depreciation or appreciation. Sometimes these factors are real (oil discovery in the North Sea for the pound sterling), but more often they are monetary: higher growth rate of the money supply (or budget surplus). In this respect, monetary policy will play a role through its announcement effects and credibility.

#### Internal and external objectives conflict :

A major concern for monetary authorities is whether they are able to reconcile two objectives: one external, to defend parity; the other internal, to control inflation while avoiding too great a decline in activity that would lead to increased unemployment. Four situations may arise that can be clarified in a square table. In two of them the objectives are compatible, in the other two there is a conflict of objectives.

Table:- Compatibility or conflict between internal and external policy objectives.

Internal External	Relative price stability - low activity	Inflation
Currency decrease	I Conflit	II Restrictive policy
Currency increase	III Expansionary policy	IV Conflit

#### In case of conflict, internal and external situations require contradictory monetary policies:

- 1. In I, support calls for a restrictive policy, the internal situation calls for an expansive policy.
- 2. In IV, it is the opposite, but the case is rarer: appreciation despite inflation.
- 3. Such conflicts, especially in case I, can be momentarily resolved by using monetary policy in the external framework and a fiscal stimulus policy in the internal framework. Purely monetary transitional solutions are also possible using the various instruments of monetary policy.

# **Conclusion:-**

Considering the macroeconomic context and the monetary and financial environment, the central bank has to make judicious choices regarding the internal and external objectives of monetary policy. Nevertheless, the central bank is supposed to have a coherent vision in space and time, in order to avoid that the internal and external objectives of monetary policy conflict. In this sense, the central bank has to keep a continuous watch on the evolution of macroeconomic, monetary and financial indicators on the one hand. In this sense, the central bank must continuously monitor the evolution of macroeconomic, monetary and financial indicators on the one hand, and adapt its monetary policy strategy to fluctuations in its environment on the other.

Attaining the internal and external objectives of monetary policy requires appropriate choices in terms of transmission channels in order to modulate, influence and guide the economic and financial behaviour of agents in an efficient manner.

Reinforcing the credibility of monetary policy and the confidence of agents is a sine qua-non condition for the effectiveness of these channels. With a consistent, adapted, fluid and harmonised articulation between the objectives of monetary policy, the choice of transmission channels and the choice of related instruments, the monetary policy strategy can effectively achieve the priority objective of price stability on the one hand, and the objectives of employment, growth and economic development on the other.

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