MONETARY ECONOMICS

Monetary policy

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Monetary policy

What?
A set of actions

Who takes?
taken by a country's central bank

Why?
to influence the economy

How economy gets influenced?
achieve price stability, high employment, and economic stability

Balance of payments (BoP)

- looks at an economy's transactions with the rest of the globe.
- an important indicator of an economy's health.
- should be zero, meaning that assets (credits) and liabilities (debits) should balance, but in practice, this is rarely the case.
- Thus, it can tell the observer if a country has a <u>deficit or surplus</u> and from which part of the economy the discrepancies are stemming.

Components of BoP

1. Current Account (CA): Trade in goods and services, income, and transfers.

2. Capital Account (KA): Investment, loans, and grants.

3. Financial Account (FA): Portfolio investment, direct investment, and reserve assets.

Effects of Monetary policy on BOP

1. Current Account:
   - Tighter monetary policy (higher interest rates) → Appreciating currency → Reduced exports → Worsening CA.
   - Easier monetary policy (lower interest rates) → Depreciating currency → Increased exports → Improving CA.

2. Capital Account:
   - Higher interest rates → Increased capital inflows → Improved KA.
   - Lower interest rates → Reduced capital inflows → Weakened KA.

3. Financial Account:
   - Monetary policy affects portfolio investment and reserve asset flows.

Monetary policy in an open economy

Exchange rate

In an open economy ->affect the exchange rate -> affects net exports.

For example, a central bank can depreciate its currency to increase net exports.

Effectiveness of policy

To be most effective, monetary policy should **target** goods and assets that are **isolated from world trade.**

Monetary policy tools

Central banks use monetary policy to manage economic fluctuations and achieve price stability.

Central bank actions

Actions by monetary authorities in other countries can also influence a country’s net exports.

Monetary policy in

CLOSED ECONOMY

1. Autonomous monetary policy
2. No capital mobility
3. No trade
4. Focus on domestic inflation, output, and employment
5. Central bank controls money supply and interest rates

OPEN ECONOMY

1. Interdependent monetary policy
2. Capital mobility
3. Trade and foreign exchange
4. Considerations: exchange rates, foreign inflation, and global economic conditions
5. Central bank manages interest rates, exchange rates, and capital flows

Digital currency

- available entirely in electronic form
- exclusively exchanged through virtual means
- does not leave a computer network

Cryptocurrency
using cryptography to secure transactions

CBDC
Regulated by its central bank

Stable coins
Value is pegged to another asset

Exchange rate

- Some rate of exchange ratio has to be determine when goods and services are exchanged
- Forex rate between the currencies of two countries means the number of units of one national currency that I needed to buy 1 unit of other national currency

Monetary Policy's Impact on Exchange Rates:

1. Interest Rate Effect: Higher interest rates → Appreciating currency

2. Money Supply Effect: Increased money supply → Depreciating currency (as excess money chases fewer goods)

3. Inflation Expectations: Tighter monetary policy → Lower inflation expectations → Appreciating currency

4. Central Bank Intervention: Direct intervention in foreign exchange markets to influence exchange rate.

Exchange Rate's Impact on Monetary Policy:

1. Inflation Import: Weaker currency → Higher import prices → Inflationary pressures

2. Export Competitiveness: Weaker currency → Increased export competitiveness → Economic growth

3. Capital Flows: Exchange rate fluctuations → Changes in capital inflows/outflows → Monetary policy adjustments

4. Balance of Payments: Exchange rate affects trade balance and capital account → Monetary policy responds

Conclusion

1. Monetary policy has significant implications for BOP.
2. However, the RBI through its monetary policies can only control demand and pull inflation to a limited extent
3. Coordination between monetary and exchange rate policies is vital.
4. DC Makes it easier for people to make electronic payments and transactions, which could increase financial inclusion and lead to economic growth.

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