

WEEK 10- ROLE OF MONETARY POLICY IN A DEVELOPING ECONOMY

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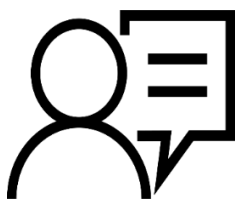
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1.0 INTRODUCTION



In a developing nation, monetary policy is crucial for boosting economic growth because it affects the cost and accessibility of credit, manages inflation, and keeps the balance of payments in balance. Therefore, the main goals of monetary policy in a country like this are to manage credit in order to manage inflation as well as to stabilize

the price level, the exchange rate, to achieve equilibrium in the balance of payments, and to encourage economic growth..

1.0. OBJECTIVES



At the end of this unit, you should be able to:

- History of Monetary Policy
- Understand the role of monetary policy in a developing economy
- Know the limitations of monetary policy in less developing countries.

3.0. MAIN CONTENT

3.1. History of Monetary Policy

The availability of credit and interest rates are influenced by monetary policy. Short-term interest rates and bank reserves obtained through the monetary base have both been tools of monetary policy. There were only two types of monetary policy for many centuries:

- (i) coinage decisions; and
- (ii) the choice to produce paper money in order to expand credit.

Even while interest rates are currently regarded as a component of monetary authority, they were not always coordinated with the other aspects of monetary policy at the time. The authority with seigniorage, or the power to coin, was typically given

control over monetary policy because it was viewed as an executive choice. The capacity to establish the price between gold and silver as well as the price of the local currency relative to other currencies emerged with the development of broader trading networks. Even if the official price differed from the market price, it might still be enforced by law.

Promissory notes were the precursor to the paper currency known as "jiaozi" in 7th-century China. Jiaozi were used alongside copper coins and did not take the place of metal money. The succeeding Yuan Dynasty was the first to employ paper money as the main form of circulation. When they ran out of precious metals in the later years of the dynasty to pay for the war and to rule China, they started manufacturing paper money freely, which led to hyperinflation.

The notion of monetary policy as distinct from administrative action was first established with the establishment of the Bank of England in 1694, which was given the duty to produce notes and back them with gold. The purpose of monetary policy was to keep coins at their face value, produce notes that would exchange for specie at par, and stop coins from being withdrawn from circulation. The need to retain the country's peg to the gold standard and to trade in a constrained range with other gold-backed currencies was then related with the founding of central banks by industrializing nations. In order to achieve this goal, central banks started determining the interest rates they paid to both their own borrowers and other banks in need of liquidity as part of the gold standard. Interest rates had to be adjusted virtually monthly to maintain a gold standard.

The industrialized countries established central banking systems between 1870 and 1920, with the Federal Reserve becoming one of the latest in 1913. By this time, it was known that the central bank served as the "lender of last resort." The marginal revolution in economics, which illustrated how people would alter a decision depending on a change in the economic trade-offs, also contributed to the growing understanding that interest rates had an impact on the entire economy.

The rise of the money supply, according to monetarist economists, could have an impact on the overall economy. One of them was Milton Friedman, who early in his career argued that in order to help boost aggregate demand for output during recessions, government budget deficits should be covered in equal measure by the creation of new money. Later, he suggested that the best method to ensure low inflation was to simply increase the money supply at a slow, steady rate. Inflation and steady economic expansion. This approach was adopted by Federal Reserve Chairman Paul Volcker beginning in October 1979, however due to the extremely unstable link between monetary aggregates and other macroeconomic variables, it was proven to be ineffective. Milton Friedman himself eventually admitted that direct money supply targeting had not been as effective as he had intended.

3.2 The Role of Monetary Policy in a Developing Economy

The roles of monetary policy in a developing economy are discussed as follows:

1. To Control Inflationary Pressures

Monetary policy necessitates the employment of both quantitative and qualitative methods of credit control in order to curb inflationary pressures that arise during the economic process. Because the bill market is low and underdeveloped, open market

operations (OMO), one of the tools of monetary policy, are unsuccessful in containing inflation in developing nations. Because commercial banks are not entirely under the supervision of the central bank, they maintain an elastic cash -deposit ratio. Due to the relatively low interest rates on government assets, they are likewise hesitant to invest in them. Additionally, they prefer to preserve their reserves in liquid forms like gold, foreign currency, and cash rather than investing in government assets. Additionally, rediscounting or borrowing from the central bank is not a common practice of commercial banks.

2. The Bank Rate Policy

Bank rate is also less effective in these nations because of:

- (i) the absence of bill of discount
- (ii) the small size of the bill market
- (iii) the size of the non-monetized sector
- (iv) the presence of indigenous banks that do not discount bills with the central bank.
- (v) Commercial banks' propensity to maintain sizable cash reserves, and
- (vi) the existence of a sizable unorganized money market

3. The Use of Variable Reserve Ratio

In LDCs, the variable reserve ratio is a more effective tool for monetary policy than open market operations and bank rate policy. Open market operations (OMO) fail because the market for securities is so limited. However, a rise or decline in the central bank's variable reserve ratio only affects the amount of cash that is available to commercial banks, not the pricing of securities. Once more, commercial banks

maintain sizable cash reserves that cannot be decreased by a rise in bank rates or a central bank sale of securities. However, increasing the cash reserve ratio decreases bank liquidity. There are some restrictions on the usage of variable reserve ratio in LDCs. The non-banking financial intermediaries are unaffected because they do not maintain deposits with the central bank. Second, afflicted banks are more numerous than those who do hold surplus liquidity.

4. The Qualitative Credit Control Measures

The allocation of credit and, consequently, the pattern of investment are more easily influenced by qualitative credit management methods than by quantitative ones. Instead of investing in the alternative productive channels like agriculture, mining, plantations, and industry that are available to LDCs, there is a significant propensity to do so in gold, jewelry, inventory, real estate, and other assets. For limiting and controlling credit facilities used for such unproductive activities, selective credit controls are more appropriate. They are helpful in limiting speculative actions in raw resources and food grains. They are more effective in containing the economy's "sectional inflations." By requiring importers to deposit an amount equal to the value of foreign currency in advance, they reduce the demand for imports. Insofar as their deposits are moved to the central bank as a result, this also has the impact of lowering the bank reserves. Changing the margin requirements against specific types of collateral, regulating consumer credit, and rationing credit are some examples of the selective credit control measures.

5. To Achieve Price Stability

A key tool for achieving price stability is monetary policy. It brings about a good balancing of the supply and demand of money. The price level will show any differences between the two. Growth will be slowed down by a lack of money supply, while inflation will result from an excess of it. Due to the gradual monetization of the unmonetized sector and the rise in agricultural and industrial production, as the economy grows, the demand for money rises. These will result in a rise in the demand for speculative and transactional reasons. Therefore, in order to prevent inflation, the monetary authority will need to increase the money supply above what is proportionate to the demand for money.

6. To Bridge Balance of Payment Deficit

The interest rate policy of monetary policy, which helps close the balance of payments deficit, is crucial. To achieve the targeted development goals, underdeveloped nations experience severe balance of payments issues. Underdeveloped nations must import capital goods, machinery, raw materials, spare parts, and components, which increases their imports, in order to establish infrastructure such as power, irrigation, transport, etc. and directly productive activities such as iron and steel, chemicals, electrical, fertilizers, etc. However, exports remain essentially stagnant. They are expensive because of inflation. As a result, there is an imbalance between imports and exports, which causes the balance of payments to be out of equilibrium. Through high interest rates, monetary policy can aid in reducing the balance of payments imbalance. A high interest rate draws in outside capital and aids in closing the balance of payments gap.

7. Interest Rate Policy

A high rate of interest policy in a developing nation encourages greater savings, fosters banking habits, and expedites the monetization of the economy—all of which are necessary for capital formation and economic growth. A high interest rate policy is also anti-inflationary in nature because it deters speculative borrowing and foreign currency investment. Additionally, it encourages the distribution of scarce capital resources through more advantageous pathways. Because high interest rates deter investment, some economists advocate for low interest rate policies in these nations. However, empirical data reveals that, in poor nations, investment in business and industry is interest-inelastic since interest makes up such a small fraction of the total cost of investment. The monetary authority should adopt a discriminating interest rate policy, which entails charging high interest rates for non-essential and unproductive purposes and low interest rates for productive applications, despite these opposing viewpoints.

8. To Create Banking and Financial Institutions

The development of banking and financial institutions is one of the goals of monetary policy in a developing nation in order to promote, mobilize, and direct savings toward capital formation. The monetary authorities ought to promote the opening of branch banking offices in both urban and rural locations. Such a policy will promote saving and investment for capital development as well as assist in monetizing the unprofitable sector. It should also develop and organize the financial and capital markets. These are necessary for a development-oriented monetary strategy that also incorporates debt management to succeed.

9. Debt Management

One of the crucial roles of monetary policy in a developing nation is debt management. It attempts to issue government bonds at the right time, stabilize their prices, and reduce the cost of servicing the national debt. The main goal of debt management is to establish the framework for yearly increases in governmental borrowing. In these nations, public borrowing is necessary to finance development initiatives and manage the money supply. But low interest rates must apply to public borrowing. Low interest rates increase the cost of government bonds and boost their appeal to the general public. Additionally, they minimize the debt load.

However, as previously mentioned, an effective monetary policy aids in reducing inflation, closing the balance of payments gap, boosting capital formation, and fostering economic growth.

3.3. Limitations of Monetary Policy in Less Developing Countries.

The experience of underdeveloped nations shows that monetary policy has a relatively small impact there. The following justifications are provided in favor of this viewpoint.

1. Large Non-Monetized Sector

The success of monetary policy in these nations is hampered by a sizable unmonetized sector. The majority of people reside in rural areas where barter is common. However, monetary policy is unable to have an impact on this sizable sector of the economy.

Due to the existence of an extensive non-monetized sector, changes in the money supply of the country or the changes in the interest rates do not have any effect on the level of economic activity. It is because money does not enter into this sector and all the transactions conducted therein are merely barter exchanges. Therefore, non-

monetized sector creates many problems in the smooth working of the monetary policy.

2. Underdeveloped Money and Capital Markets

Money and financial markets are still in their infancy. The lack of bills, stocks, and shares on these markets restricts the effectiveness of monetary policy.

The money market in developing countries is highly under-developed. Due to the unorganized nature of the money market and lack of its integration with the central bank, the traditional methods of credit control like bank rate policy, open market operations and variations in the reserve ratio etc., have got limited effect.

The central bank extends its control only to the organised sector and not to the unorganized sector. This creates several complicated problems for the central bank when it tries to control the money market of the country. The money market is also conspicuous by the absence of a well-developed bill market.

3. Large Number of NBFIs

In these nations, non-bank financial intermediaries like local bankers are widely used, although they are not regulated by the monetary authority. The effectiveness of monetary policy in these nations is constrained by this aspect.

4. High Liquidity

Most commercial banks have large liquidity levels, which shields them from the effects of the central bank's credit policies. This also lessens the effectiveness of monetary policy.

5. Foreign Banks

Commercial banks with foreign ownership are present in practically every developing nation. By selling overseas assets and taking money from their headquarters when the nation's central bank is pursuing a strict monetary policy, they also impair the effectiveness of monetary policy.

6. Small Bank Money

The fact that bank money makes only a small fraction of the nation's total money supply further contributes to the failure of monetary policy in these nations. As a result, the central bank is unable to efficiently manage credit.

7. Money Not Deposited with Banks

The wealthy don't put their money in banks; instead, they spend it on things like jewelry, gold, real estate, investment, conspicuous spending, etc. Due to the fact that such actions are not under the monetary authority's control, they foster inflationary pressures.

Therefore, economists recommend using fiscal policy in addition to monetary policy because of the limitations of monetary policy in a developing nation.

The well-to-do people do not deposit money with banks but use this money in buying jewelry, gold, real estate, and in conspicuous consumption etc. In other words, investment is made in unproductive channels instead of productive channel and as a result, it retards the economic development of underdeveloped countries.

8. Lack of Integrated Interest Rate Structure

The various types of interest rates prevalent in the money market do not bear any definite relationship with the bank rate of the country. Any changes affected in the bank rate do not produce proportional changes in the other interest rates. The result is that the central bank of the country is unable to control the money market in an effective manner and monetary policy fails in its operation.

9. Proportion of Credit to Money

The proportion of credit to money in the monetized sector is very small. Nearly 70-75% money supply consists of currency in active circulation. The bank deposits in such an economy form only a small and insignificant portion of the total money supply. This seriously limits the working of monetary policy.

10. Shortage of real factors

Another problem in developing countries exists that there is a shortage of real factors like capital, entrepreneurial ability etc., therefore, monetary policy can do nothing about it.

11. Lack of Banking Facilities

In a developing economy, adequate banking facilities are not available specially to those areas in the country which are either un-banked or under-banked. The idle savings of the people cannot be mobilized. Moreover, sometimes commercial banks do not cooperate with the central bank. Thus lack of banking facilities creates number of problems in the way of monetary policy.

12. Existence of Inflation

A developing economy is highly sensitive to inflationary pressures. Government incurs huge expenditure on various types of development projects. It increases the effective demand much more than the output of consumer goods. The result is a sharp rise in the internal price level. Moreover during the course of hyperinflation, tools of monetary policy fail to work properly.

13. Black Money

In underdeveloped countries, large quantity of black money exists due to political and economic factors. Black money is used for activities such as hoarding and speculative motives etc. As a result, it hinders the true spirit of the various objectives of monetary policy.

14. Deficit Financing

In the modern world, deficit financing is the main source of financing development activities. But heavy doses of deficit financing has proved inoperative to achieve the objectives of monetary policy. For example, monetary authority wants to check the supply of money while deficit financing helps to increase its supply. The two factors may not operate simultaneously.

15. Only Persuasive Policy

Generally monetary policy in underdeveloped countries is soft, lenient, persuasive and this leads to ineffectiveness. As its role is not compulsive but permissive only which creates serious limit on the efficacy of monetary policy.

16. Lack of Honesty

In underdeveloped countries administrative honesty and firmness are not very rigorous. This leads to the problem of tax evasion, antisocial elements, black money etc. This parallel economy helps speculations and illegal trading and thereby reduce the efficiency of monetary policy.

17. Disequilibrium in Balance of Payments

In less developed countries, monetary expansion generally leads to increased imports and unfavorable balance of payments. This puts a limitation on the monetary policy.

18. Limited Application of Weapons of Credit Control

In the developing economies, people mostly rely on currency in circulation and bank deposits which forms only a small proportion of money supply. This being the case, weapons of credit control have only limited application.

4.0 CONCLUSION

The unit concludes that monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency.

In this unit, we have discussed extensively on history of monetary policy, role of monetary policy in a development economy and the limitations of monetary policy in less developing countries.

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5.0 SELF-ASSESSMENT EXERCISE

1. Explain the principal instruments of monetary policy.
2. Discuss the role of monetary policy in an economy
3. What are the limitations of monetary policy in less developing countries?

6.0 REFERENCES/FURTHER READINGS

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