

Forum: Economic and Financial Committee (GA2)

Issue: Assessing the limitations of monetary policy as a financial stability method

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INTRODUCTION

Globalization being a multifaceted phenomenon affecting every country in the world, economic connectivity between nations has become prevalent, creating an international economy and market. Due to the interdependence of countries' economies and the establishment of international trade, the so-called economic globalization was observed and declared as an important system of the 21st century. Individual economies have remarkably benefited from globalization as there is greater equality in regards to the separation of wealth, more opportunities for development and improvement of economic output. The international economy has influenced greatly individual economies since its establishment, however, it is influenced greatly by each of them as well. The domestic economic activity affects not only the country individually but also the global economic stability which has consequently become a priority for the majority of countries.

The macroeconomy of a country is monitored and studied in order to preserve the state's economic health as well as to reach financial stability and have economic growth. A significant aspect of macroeconomics is the monetary policy of the state. As this strategy defines the money supply and the liquidity of the market, it influences greatly the domestic market and economy. Monetary policies have a great impact on the economy within a country's borders but also on the global economy, as it controls the interest rates, the unemployment and inflation rate. In case the monetary policy is planned and implemented correctly, it can help the country achieve economic stability. Even though monetary policy has the potential to provide economic balance to a state, there are specific limitations restricting its use. Assessing those limitations can contribute greatly in achieving economic stability for many countries and thus for the global economy.

DEFINITION OF KEY-TERMS

Macroeconomics

“Macroeconomics is the branch of economy that studies the behavior and performance of an economy as a whole.”¹ These studies focus on “economy-wide phenomena such as inflation, price levels, rate of economic growth, national impact, gross economic product (GDP) and changes in unemployment.”²

Monetary Policy

Monetary policy is the macroeconomic strategy created by the central bank involving the management of money supply and interest rate. “It is the demand side economic policy used by the government of a country to achieve macroeconomic objectives.”³

Gross Domestic Product (GDP)

The Gross Domestic Product of a country is the economic output of all the goods and services produced within its borders during a specific time period.⁴

Inflation

“Inflation is a measure of which the average price level of basket of selected goods or services increased in an economy over a specific period of time.”⁵

Fiscal policy

“Fiscal policy is the means by which government adjusts its spending levels and tax rates to monitor and influence a nation’s economy.”⁶

Interest rates

An interest rate is the amount of a lender’s charges for the use of assets, usually expressed as a percentage of a principal.⁷

¹ “What Is Macroeconomics? Definition of Macroeconomics, Macroeconomics Meaning.” *The Economic Times*, economictimes.indiatimes.com/definition/macro-economics.

² Segal, Jim Chappelow and Troy. “Everything You Need to Know About Macroeconomics.” *Investopedia*, Investopedia, 7 Apr. 2020, www.investopedia.com/terms/m/macro-economics.asp.

³ “What Is Monetary Policy? Definition of Monetary Policy, Monetary Policy Meaning.” *The Economic Times*, economictimes.indiatimes.com/definition/monetary-policy.

⁴ Chappelow, Jim. “Gross Domestic Product (GDP).” *Investopedia*, Investopedia, 1 June 2020, investopedia.com/terms/g/gdp.asp.

⁵ Chen, James. “Inflation.” *Investopedia*, Investopedia, 7 July 2020, www.investopedia.com/terms/i/inflation.asp.

⁶ Kramer, Leslie. “What Is Fiscal Policy?” *Investopedia*, Investopedia, 9 June 2020, www.investopedia.com/insights/what-is-fiscal-policy/.

⁷ Banton, Caroline. “Interest Rate: What the Lender Gets Paid for the Use of Assets.” *Investopedia*, Investopedia, 17 May 2020, www.investopedia.com/terms/i/interestrate.asp.

International marketing

International marketing can be defined as the trade of goods and services between two or more countries in a framework created by the participant countries. It refers to the marketing and economic activities of state all over the globe.⁸

Deposits

The economic term of a deposit can be defined as the money held at a bank.⁹

Liquidity

Liquidity is the ease in which an asset or a security can be turned into cash but not affect its original value.¹⁰

BACKGROUND INFORMATION

Objectives of monetary policy

As previously defined, monetary policy consists of the drafting, announcement and implementation of the central bank's plan of action that controls the amount of money in an economy and the channels supplying new money to the market. Monetary policy manages the money supply according to its three objectives; inflation, unemployment and interest rates. Such policies target inflation levels which are considered healthy only at low stages. This plan of action can also influence the unemployment rates of an economy as it controls the money supply and thus the business activities of a market. Moreover, they promote moderate interest rates that can possibly be preserved in the long-term.

Interest rates

An interest rate is the percentage of principal charged by a lender, either a bank or a citizen, for the use of its money. Both banks and people pay interest rates to each other as they are both borrowing money from each other, either in a form of deposits or of loans. An interest rate is applied on the unpaid portion of a loan and must at least be paid in each compounding period in order to preserve the height of the debt. Interest rates are charged according to the nature of a loan. When a loan will more likely not be repaid, then a bank charges a higher interest rate. Loans for personal use such as credit cards are usually assigned higher rates of interests. However, the economic

⁸ B, Vishakha. "What Is International Marketing? - Definitions, Scope, Factors, Significance." *Economics Discussion*, 5 May 2020, www.economicdiscussion.net/marketing-2/international-marketing/what-is-international-marketing/32402.

⁹ Kagan, Julia. "Deposits: What You Need to Know." *Investopedia*, Investopedia, 27 May 2020, www.investopedia.com/terms/d/deposit.asp.

¹⁰ Chen, James. "Liquidity Definition." *Investopedia*, Investopedia, 28 July 2020, www.investopedia.com/terms/l/liquidity.asp.

status of a person can influence the rate, too as banks lower their interest rates to those who have a high credit score as they are more likely to repay their loan.

Drafting and Implementation of monetary policies

Monetary policy decision-making is of high global significance for economists, investors, analysts and experts in the field. Monetary policies' outcome have an impact on the international economy and market. When drafting a monetary policy, inputs from several sources are gathered such as macroeconomic factors (GDP, inflation), the development of industry and business and reports of organizations and the government. Such plans are regulated by the central bank, currency board or other monetary activity.

Central Banks

It is important to differentiate central banks and commercial banks. The central bank is the institution responsible for managing the banking system and financial need of a country aiming for the national maximum welfare. On the other hand, commercial banks hold the responsibility of accepting deposits and giving loans, but the most importantly make profit by investments. Central banks form the banking system when commercial banks influence it greatly.

Currency board and Monetary authority

When a country as a specific fixed exchange rate for its currency to foreign ones, then the currency board is created. In this case, the central bank is no longer responsible for the exchange rate and the money supply but the currency board holds these responsibilities. Under a currency board, the monetary authority manages abovementioned responsibilities. In comparison to central banks, currency boards have limited power. Even if they keep inflation under control, they create some important issues to a country's economy. Governments are not allowed to determine the interest rates which are controlled by the economic conditions of a foreign country.

Types of monetary policies

Monetary policies can broadly be separated in expansionary and contractionary.

Expansionary monetary policy

This expansionary approach aims for the increase of economic growth and the expansion of economic activity. Countries facing high unemployment rates, the monetary authority lowers the interest rates increasing money supply in order to boost investment and spending. As the interest rates are low, businesses and individuals can more easily afford loans increasing economic activity. This type of monetary policy is the one important for the currently discussed issue as it is the one promoting economic development and thus financial stability.

Contractionary monetary policy

The increase of money supply in market can lead to higher inflation and Contractionary policy comes to deal with such a situation. As the interest rates increase and the money supply decreases, inflation come to a more sustainable point. However, this policy increases unemployment and slows economic activity, thus it is only applied in cases of high inflation.

Advantages of implementing expansionary monetary policies

Steady rate of inflation

An important benefit of this type of monetary policy is that it offers price stability in the market keeping inflation rates at a low point. Inflation affects the way people spend money and the value of the goods and services provided. When the value of the preferred goods or services is known to the interested consumers, it is more likely that they will actually choose to make a purchase and thus, initiate a transaction. This whole process keeps inflation rates stable as the value of the money used is also comparable.

Low interest rates creating investment opportunities

Interest rates are an important asset to a country's economy and can lead to economic growth. They influence a country's money supply and consequently its economic prosperity. When the interest rates are high, then the loans become more expensive and less accessible to the public. People and businesses find it more difficult to afford a loan and thus the amount of credit available for funding purchases decreases. The capital available for the expansion of businesses is also reduced. As a matter of fact, the liquidity of the economy is reduced, affecting negatively the economy. When interest rates are low, there is the opposite effect on the economy. As loans are more affordable to the public and deposits remain low, people decide to spend more and make profitable investments. Hence, economic activity is boosted, translating into additional money liquidity and often decrease in the unemployment rates.

Rise in GDP and low unemployment

One of the main purposes of monetary policy is to promote the growth of aggregate demand in the market. When the aggregate demand is higher, meaning that consumers' call for products increases, the companies are urged to produce more as they have a higher income. The economic activity in the market and its economic output increases. Thus, the GDP is boosted as well. Moreover, the reduction of unemployment is one of the most important economic and social issues in multiple countries. As mentioned previously, the economic activity of companies increases alongside with the need for workers due to the increase of demand in the market. Consequently, more positions of employment are created and the unemployment rate decreases.

Quantitative Easing

Monetary policies allow central banks to use quantitative easing. Due to monetary policy, the money supply in the market increases and thus, the cost of money as well. Consequently, the interest rates are lowered as the banks are able to lend in

simpler terms. However, when the interest rates approach zero percent, there is a need to increase that percentage and that's when the central bank imposes quantitative easing. In order for central banks to increase the money supply in the market, they buy government bonds and other securities and encourage investments. Quantitative easing increases banks' liquidity but also serves the low interest rates and provides balance to the market.

Disadvantages of implementing expansionary monetary policy

Risk of hyper inflation

Hyper inflation is an economic problem that threatens the economy and is a possible outcome of monetary policy. Inflation at low levels is positive for the economy as it boosts its activity. However, over time, the increase of price of products can have a negative impact on the economy and be a burden to its growth. If the central bank loses control of the money supply which suddenly increases greatly, then the inflation rates begin to increase as well causing hyper inflation. Due to this phenomenon, the value of the money currency begins to decrease constantly and the price of basic products increases enormously. In extreme cases of hyper inflation, the price of basic goods increases within the time period of an hour. By result, such products are not longer approachable to the public and a great economic problem is caused damaging immensely the economy. Hyperinflation is most of the times accompanied by the flourishing of the black market, which leads to further degradation of the currency's value and collapse of the economy. This issue effects the country's economic status in the international community, too, as the currency rates are lowered remarkably and thus the external trade of the country faces great difficulties as its economy is of really low value globally.

Not guaranteed economic growth

Implementing monetary policy does not guarantee result in the economy. Businesses' and people's reactions to the the new strategy cannot be predicted. It is not guaranteed that they will invest their resources. As it is not assured how the public will respond to the central banks, it is possible that such a policy will not have any or positive impact on the economy.

Possible discouragement of companies to expand

Although the interest rates are lowered due to this policy, there are still chances that they will increase in the near future. In such case, businesses will not be willing to expand their activity being less productive and therefore the prices will increase. Due to the higher prices of products, consumer will be incapable of consumers to afford such goods and services. Thus, there will be great damage to their economic activity. Their recovery will need a large amount of time but there are high chances that such a situation will lead to their end.

Limitations of monetary policies in LEDCs and developing nations

There are several factors limiting the impact of monetary policy in an economy. Most of these limitations refer to LEDCs as they are the ones facing the greater financial instability.

Unorganized sector

Monetary policy cannot be implemented in countries where their GDP is affected by the unorganized sector of the country, meaning markets that are not monitored by the government. The central bank cannot influence undocumented sources of income and transactions. Monetary policy can only have an impact on the organized sector of a country and its documented economic activity. In such a case, where the unorganized sector covers a large percent of the economic activity, there will be almost no effect on the economy after the implementation of such a policy.

Incapability to affect interest rates between transactions

When the aforementioned sector exists, the central bank cannot determine the interest rates in such undocumented markets. Consequently, the goods and services in these markets are usually either overcharged or exchanged with another product. Generally, these markets work under completely different rules and frameworks that are not set by the central bank but by themselves. Due to the unorganized sector, high inflation rates are a possible outcome as the government cannot affect the prices or even monitor them. The interest rates set by the central bank can only influence the economic activity between banks and individuals but do not have the capacity to affect the transactions between individuals. The interest rates between them are completely different from those set by the central bank.

Lack of production and facilities

Multiple countries do not have many factors of production such as capital, entrepreneur that are ways in which a country's GDP can be raised. As there is lack of facilities or of the economic capability to have entrepreneur actions, an implemented monetary policy will not have any impact on the economy and will not raise the domestic economic activity. Moreover, there are not enough or trustworthy banks in a country. Usually, they are incapable of controlling the money supply in the market or cannot be organized due to their large number of institutions. When the number of banks is not appropriate in a country, then the monetary policy cannot be implemented correctly. When the banks are fewer than those needed, then there cannot be adequate implementation of the money supply and correct bank rates. When the number is larger than those needed, then there is not efficient cooperation between the banks so that they can correctly monitor the economic activity of the country.

Non-financial of external institutions and organizations

In many countries, the responsibilities of central bank are separated to smaller institutions. The cooperation between these organs is usually hard and they are not capable to control the whole economy. By result, the central bank loses its strategic role in the economy and is incapable to influence the economic activity.

External bank institution

Due to the natural resources in some regions, many states have drawn the interest of many powerful countries that wish to take advantage of the area's natural wealth. In order for them to take part in the state's market, they set banks in the area participating in the local economy. Selling foreign assets and foreign goods, they gain more and more power within the state lowering the dominance of the central bank.

MAJOR COUNTRIES AND ORGANIZATIONS INVOLVED

International Monetary Fund (IMF)

The IMF has been actively participating in the efforts for economic stability globally. It provides advice to member states and monitors the health and development of the global monetary and financial system. The organization is also capable to provide technical assistance to the member states in order to help them improve their institutional capacity. The IMF helps countries for the implementation of policies by consulting and monitoring. First of all, the economies of participant countries are observed annually and negotiations with its experts over appropriate economic and financial developments take place. Secondly, the IMF, through periodic reports, monitors the international and regional economic development and contributes greatly in the global economic cooperation through discussions and assessments. Regarding monetary policies, the IMF has been active upon the matter through multiple reports aiming for economic stability. An important action of IMF regarding the topic is its support for central banks to guarantee the creation and implementation of appropriate monetary policies.

World Bank (WB)

The World Bank is an important organization providing help to countries aiming for financial growth. Through promoting frameworks according to global economic standards and the creation of international bodies, the World Bank intends to guarantee the participation of both MEDCs and LEDCs in the global economic activity. Alongside with IMF, the World Bank provides both diagnostic and technical assistance regarding the economic and financial institutions and frameworks including the banking system of a country. Regarding monetary policies, in cooperation with IMF, the World Bank has been active upon the matter. There are a few differences between IMF and the World Bank, mainly due to the different purposes of the two organizations. The IMF maintains and monitors the economic systems of countries providing them with help to achieve economic stability, when the World Bank raises the economic productivity of states and promotes economic development.

European Central Bank

The European Central Bank is an independent institution aiming to maintain price and economic stability within the countries of the European Union. By influencing the monetary policies of the Union's member states, the Central Bank obtains an integral role in the economic life of the continent, and thus in the global economy. The objective

of the organization is to keep inflation rates at a low point, a goal which is achieved through a main monetary policy strategy and an operational framework for its implementation. Moreover, the European Central Bank monitors the stability of the financial systems and analyse the observed risks and opportunities and also supervises the commercial banks of the member states. Due to the financial crisis that Europe faces since the last decade, this institution became more important as it is the main organ responsible for solving such economic issues within the Union.

TIMELINE OF EVENTS

DATE	DESCRIPTION OF EVENT
27 December 1945	The International Monetary Fund (IMF) was created
July 1944	The World Bank was established as the primary banking organization connected to the UN
1 June 1998	The European Central Bank was created.
2008	An important failure of monetary policy occurred in the United States.
2009	The European debt crisis occurred within the eurozone.
2012	The Euro Crisis was successfully resolved.
2014	The European Central Bank started supervising the biggest commercial banks within the eurozone.

RELEVANT UN RESOLUTIONS, TREATIES AND EVENTS

The issue of monetary policy as a means of financial stability is not a topic greatly discussed within the United Nations, however, organizations focusing on the economic life of the state such as the IMF have set frameworks and provided relevant advice.

IMF Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles

One of the most important document regarding monetary policy are the principles for the responsibilities of a central bank and the objectives for the process of forming decisions over the monetary policy. The first part of the document referring to the central bank, creates the framework according to which the institution is supposed to work. First of all, it highlights that a relevant legislation or regulation is needed in order to set the responsibilities and the jurisdiction of the central bank. Secondly, it mentions that cooperation between the government and the central bank of a country is essential for it to work efficiently. In the second part, expert set the outline for drafting and implementing monetary policies. On a more general note, this section focuses mainly on how objectives, reports and possible changes should be published and be accessible to the wider public.

PREVIOUS ATTEMPTS TO SOLVE THE ISSUE

The use of monetary policy as a method for financial stability was recently introduced as an international topic. As the international community has not collectively attempted to reach stability of the global economy, the individual attempts within countries borders can be considered as previous efforts towards financial stability.

United States' monetary policy failure

One of the biggest failures of the US monetary policy occurred in 2008 and marked the beginning of a global economic recession. Today the US Federal Reserve is receiving unprecedented annual scrutiny by both the US Congress as well as Federal Government. The recovery from the 2008-2009 recession was a very slow process and was based mainly on low-interest rates and the conversion of great quantities of debt to money. The monetary system of the US ended up needing 15 months for its GDP to reach its pre-recession high in the last quarter of 2007. The US Department of the Treasury has stated that the monetary policy of the US hasn't been, and probably will not ever be, the same as the pre-recession one. The US Government doesn't believe that the Federal Reserve has properly served its role as overseer and regulator of the commercial banking system since 2008.

POSSIBLE SOLUTIONS

There are several possible measures to be taken to achieve financial stability. It is important to include several economic organizations such as the IMF and the World Bank which can contribute greatly in the solution of the issue. By analyzing the

economic performance and activity of member states, such organizations can provide tips and guidance for the drafting and implementation of appropriate monetary policies. The creation of an international framework creating the economic standards for such policies to be created could be another way towards states' economic stability. On a more general note, actions and resolutions preventing the harms of regional policies on the international economy are quite significant.

Regarding the regional solutions, the stabilization of the central bank as an official institution in order for it to make the necessary decisions and ensure its dominance in the economy is a crucial measure. Allowing to have completely jurisdiction over the monetary policy of a country will make its work more sufficient but also affect the international economy positively. Communication between businesses and the central bank is essential to achieve the correct implementation of the monetary policy as well as the monitoring of the actual economic activity of the state which will lead to appropriate economic policies and strategies. Moreover, the inclusion of all the sectors of the domestic economy is very important for the central bank to be able to correctly estimate its GDP and economic data when needed.

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