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MONETARY POLICY

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Abstract

This work is an entry for the second edition of Sage's Encyclopedia of Business Ethics and Society. It is a brief description of the theory and practice of monetary policy, one of the most important policies, along with fiscal policy, for achieving macroeconomic stability. The entry discusses its objectives and implementation, as well as the main ethical problems involved given the importance of its results for citizens.

Keywords: Money; Monetary Policy; Interest rates; Central Bank; Ethics.

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MONETARY POLICY

Monetary policy is the control that a country's central bank exercises over the money supply or a short-term interest rate to influence key macroeconomic variables, such as the rate of growth or inflation. Along with fiscal policy it is the most important policy for achieving macroeconomic stability. These results are very important for citizens, which justifies the ethical relevance of this policy.

The Design of Monetary Policy

The design of monetary policy has changed over time according to the circumstances, the progress of economics, and political and social preferences. Here we will provide a brief explanation of the theory and practice of monetary policy until the financial crisis that began in 2008; later we will present the "unconventional" monetary policy of recent years.

Designing and implementing monetary policy is the job of the central bank, a public institution that specializes in controlling the money supply, credit and interest rates; examples include the Federal Reserve System (Fed) in the United States, the European Central Bank (ECB) in the euro zone, the Bank of England or the Bank of Japan; a central bank is often also responsible for the stability of the financial system.

In recent decades, the objectives of monetary policy have been a low and stable rate of inflation, a growth rate of the real product close to its potential (to maintain employment rates at a level close to full employment), or a stable exchange rate. To achieve these objectives, the central banks have used various instruments: such as a short-term interest rate, which is established as a guide for financial markets and bank operations, and a procedure for providing or withdrawing liquidity from banks, such as the open market operations of the Fed (buying or selling debt to the banks) or the main refinancing operations of the ECB (periodic auctions of credit, targeting the banks' liquidity), as well as other extraordinary operations.

How Monetary Policy Works

In the traditional version of monetary policy, the central bank is the provider of the monetary base, i.e., the most liquid of financial assets (ones that can be converted into money most easily, at no cost): namely, cash (coins and notes in circulation) and the so-called bank reserves (the assets that banks use to meet their liabilities to the central bank, which tend to be mainly deposits held at the central bank). When the monetary authority creates these reserves and makes them available to banks, it is encouraging them to extend more credit and is thus stimulating the growth of demand and prices: monetary policy, in this case, is expansionary. Conversely, when the central bank withdraws liquidity, monetary policy is contractionary; this means less money, less bank credit and higher interest rates.

What the monetary authorities actually do, therefore, is modify the composition of banks' portfolios by providing (or withdrawing) liquidity to the banks, which react by extending more (or less) credit to their customers, while lowering (or raising) the interest rates on those loans. In doing so, they change the consumption, investment and borrowing decisions of households and firms; ultimately, monetary policy ends up affecting production and employment, as well as price levels. Eventually, through the inflows and outflows of capital, monetary policy also affects exchange rates. In short, monetary policy is intended as a powerful instrument to influence demand, production, employment and prices.

A passive monetary policy is aimed at financing the growth of the real activity at a level near the full employment of resources, but without creating excess liquidity that might fuel inflation, while keeping interest rates stable and exchange rates competitive and likewise stable. An active monetary policy is intended to correct economic imbalances, such as high inflation, a current account deficit, a sudden capital flight or a recession. In a country that has experienced rising prices for a long period, the monetary authorities may want to lower inflation expectations as quickly as possible. This risks a major impact on the value of assets and debts, and thus on the distribution of wealth and income. Monetary policies, therefore, must balance activism with stability and economic results with fairness.

Some Ethical Issues

A monetary policy that is too restrictive can have a negative impact on employment and the standard of living of many citizens, but an expansionary policy may cause high inflation, which also has negative effects on many people. In addition, it generates external imbalances and bubbles in the real estate and other financial markets, which, in the long run, are unsustainable. Thus, monetary policy has implications for welfare and social justice. Consequentialist ethical approaches are useful for understanding and balancing these implications; distributive justice focuses attention on the fairness with which the impacts of monetary policy are distributed throughout society.

Getting the right balance between expansion and contraction, inflation and stability, in the design of monetary policy is not an easy task. Economics is not an exact science; the recommendations of the experts are not always accurate and, moreover, are often contradictory. The monetary authorities often lack the necessary information to decide whether or not a change of policy is desirable. They also experience pressures from the government, public opinion and financial institutions, which negatively affect the desirable autonomy of the central bank. And the processes by which monetary policy operates are complex because they are the consequences of the decisions of thousands or millions of free agents. As a result, the ethical judgment on the design and implementation of monetary policy is not easy, at least until its long-term effects are observable.

The way the central bank operates also lends itself to an ethical analysis. The monetary policy needs to be credible and to inspire confidence even in politically volatile situations. There are several means to achieve this. One approach is to make the central bank an independent body whose mission is prescribed by a law or constitution that the government cannot easily change. Another approach is to appoint central bank governors and Boards (monetary policy decision makers) for long terms of office, which buffers them from political pressures. In these ways, monetary policy is more likely to be managed with integrity and to earn a reputation for responsible service to the public welfare.

The stability of the financial system is also among the responsibilities of the monetary authorities. Monetary policy works based on the process by which the banks create credit, so that if these financial intermediaries have liquidity or solvency problems, the process will be interrupted, credit will freeze, the payment system will stop working, the financial wealth of the citizens will be threatened and confidence in the system will collapse. The prevention and correction of those problems is another responsibility of the monetary authorities, shared, at least in part, by financial institutions and other regulators.

Ultimately, the assessment of monetary policy will be influenced not only by its ethical dimension, but also by the economic, political and social judgement regarding its objectives and results. What seems like an inflationary policy to one observer may be to another the right policy to bring the country out of a recession.

Unconventional Monetary Policy

In the years following the financial crisis of 2008 the execution of monetary policy experienced big changes. The situation of banks, which were the main channel for the transmission of monetary policy, worsened quickly: nonperforming loans increased; highly leveraged households and companies tried to reduce debt, which aggravated the recession; the value of the assets of the banks fell; many financial institutions had solvency problems, so markets halted funding; a credit crunch unfolded and the process of money creation was strongly disturbed.

At first, central banks insisted on traditional measures: a sharp reduction in interest rates and the flooding of banks with liquidity. But credit still did not flow for households and businesses, so the central banks had to implement nonconventional measures aimed at granting funding directly to the private sector, bypassing the bank channel. New instruments were devised: purchasing private and public debt directly from markets (quantitative easing) to reduce medium and long-term market interest rates on debt and move the demand of financial institutions towards the debt of firms; trying to convince the markets that medium and long-term interest rates would remain low in the future (forward guidance); etc.

This unorthodox monetary policy has been subject to criticism, also from the ethical point of view, mainly because of the risks of future inflation and disruption of markets when it comes to removing that liquidity, capital movements to emerging countries, the creation of financial bubbles in some markets, reduced sensitivity to risk, inefficiency in investment decisions with low interest rates, accumulation of illiquid assets and risk in the balance sheet of the central bank, etc.

In the late 2010s, monetary policy no longer has many common features with the traditional design explained above – at least in places like the United States, Japan, the United Kingdom or the euro zone. Ethical judgment on these matters should take into account the limited knowledge on the part of the decision makers, a reduced ability to maneuver, uncertainty about the effects of the measures adopted, the urgency of situations, conditions of the political game, etc. In any case, we now have big doubts about what monetary policy will look like in the future.

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See also Commercial and investment banks; Consequentialist ethical systems; European Central Bank (ECB); Federal Reserve System; Financial crisis of 2008-2011; Great Recession; Gross domestic product (GDP) and gross national product (GNP); Inflation; Interest; Money; Utilitarianism.

Further Reading and References

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