Published on (http://www.bnm.md)

01.11.2012

Monetary policy - macroeconomic stabilization instrument

Technical box extracted from:

Inflation Report no.4, November 2012 [1]

The monetary policy rate (base rate in the Republic of Moldova) is one of the instruments of the monetary policy through which the monetary authority of a country affects the national economy in line with the targets in place. The monetary policy rate is used to influence the demand for money. When the monetary authority lowers the monetary policy rate, it stimulates the banks' interest for refinancing, so that they require more loans, which are used for lending to the economy. Conversely, by increasing the base rate, the central bank "marks up" its credit, discouraging the practice of refinancing and reducing the potential of banks to lend to the economy.

If price stability is the primary objective of the monetary authorities, the monetary policy rate is an indirect instrument of influence on medium and long term inflation. For example, increasing the monetary policy rate determines the financial institutions to increase the interest rates, which inhibits investment and consumption in favor of savings. Thus, the aggregate demand decreases and, given the aggregate supply rigidity to monetary policy, in the short run, it creates "excess supply", resulting in decreasing prices and, respectively, in a lower inflation. The reduction of rate is an alternative to stimulate economic activities in periods when aggregate demand is below its potential level and to eliminate the disinflationary pressures. From the CIS countries, in the recent years, Armenia (2006), Georgia (2009) and the Republic of Moldova (2010) have passed, explicitly or implicitly, to the inflation-targeting regime. Other CIS countries, such as the Russian Federation, Ukraine, Kazakhstan, Belarus are in the process of transition to inflation-targeting regime. Price-targeting is also promoted by the monetary authorities of the Czech Republic (1997), Poland (1999), Hungary (2001), Turkey (2002), Romania (2005), etc.

In some countries, the monetary policy is oriented towards the exchange rate stability. The monetary policy rate change, in that case, is used to avoid destabilization in the exchange rate from the target as a result of pressures arising through uncovered interest parity. Typically, the monetary policy decisions are strongly correlated with the monetary policy decisions of the economy whose currency serves as reference currency. Therefore, this implies a reduced independence of the monetary policy. This type of regime is found mainly in Asian countries (Hong Kong, Singapore, Sri Lanka, etc.) - which is explained by their orientation towards exports, however, such policies are still present in some CIS countries, Bulgaria etc.

At the same time, the monetary policy rate of the main economic players represents a global indicator that reflects the global economic tendency. The monetary policy decisions related to the base rate of the Federal Reserves System of the USA, Central European Bank, People's Bank of China, and of the Bank of England are of material importance for the financial markets, their modifications leading to significant changes in global financial operations. For example, the reduction of the monetary policy rate at the beginning of July by the European Central Bank and People's Bank of China have convinced the international stock exchanges of the imminent regress of the global economy, which determined the significant decrease of oil and raw material prices.

In 2012, as a result of the euro area crisis and disruption of world trade, but also of reduced pro-inflationary tensions, several countries have decided to lower the monetary policy rate in order to support national economic activities and to prevent a possible economic recession. However, considering the time intervals in which the impulse spreads after lowering the policy rate, the anticipation of the disinflationary phenomenon and preventive decisions taking led to

obtaining successful results for some monetary authorities. Since January 2012, for 3 consecutive months, the National Bank of Moldova decreased the monetary policy rate by 1.0, 2.0 and 2.0 percentage points respectively, up to the level of 4.5 percent. For a more detailed analysis and comparison, Table no.1 describes some of the monetary policy decisions of neighboring countries and of some important economies:

Table no.1. Monetary policy decisions taken in 2012 neighboring countries and of some important economies

Country	Monetary policy	Inflation targeted in 2012	Inflation in the month prior to the monetary policy decision		Date of changing the monetary policy rate	Monetary policy rate	
			annual	monthly		Unchanged	Changed
Armenia	Inflation-targeting	4% ± 1.5 pp	Since September 6, 2011 - 8.0%				
Georgia	Inflation-targeting	6.0%	2.0	0.5	January, 18 2012	6.75	6.5
			-2.2	-0.2	April 25, 2012	6.5	6.25
			-2.1	0.0	May 23, 2012	6.25	6.0
			-3.3	-0.9	June 20, 2012	6.0	5.75
Republic of Moldova	Inflation-targeting	5% ± 1.5 pp	7.8	0.2	January 6, 2012	9.5	8.5
			6.9	0.3	February 3, 2012	8.5	6.5
			6.1	0.5	March 2, 2012	6.5	4.5
Russian Federation	Price stability – transition to inflation-targeting regime	5.0 - 6.0%	5.9	0.1	September 14, 2012	8.0	8.25
Romania	Inflation-targeting	3.0% ± 1.0 pp	3.1	0.2	January 6, 2012	6.0	5.75
			2.7	0.4	February 3, 2012	5.75	5.5
			2.6	0.6	March 30, 2012	5.5	5.25
USA	Maximum employment, stable prices, and moderate long-term interest rates	2.0%	Since December 16, 2008 interest rates fall within the range of 0.0 - 0.25%				
Euro area	Inflation-targeting	2.0%	2.3	-0.1	July 11, 2012	1.00	0.75
China	Currency stability and ensuring economic growth	-	3.0	-0.3	June 7, 2012	6.56	6.31
			2.2	-0.5	July 5, 2012	6.31	6.00

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