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The role of the monetary policy in the correlation between the banking sector and the economy

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Abstract

Article examines the casual relationship between the effectiveness of monetary policy and financial inclusion in developed and underdeveloped countries. Structural Vector Auto-regression methods have been used to investigate the relationship between monetary policy effectiveness and financial inclusion. A causal relationship between financial inclusion and the effectiveness of monetary policy in developed countries. Thus, effective monetary policy increases financial inclusion in the country, and higher financial inclusion lowers inflation and makes monetary policy more effective. In less developed countries, a causal link can be observed from the effectiveness of monetary policy to financial inclusion. The use of the Structural Vector autoregressive technique and the three-dimensional financial inclusion index to examine the relationship between monetary policy effectiveness and financial inclusion in developed and developing countries is an important contribution to the study.

Keywords: *bank, economy, monetary policy, inflation, liquidity*

Introduction

Effective monetary policy increases financial inclusion in the country, and high financial inclusion lowers inflation and makes monetary policy more effective. In less developed countries, a causal link can be observed from the effectiveness of monetary policy to financial inclusion. The use of the Structural Vector autoregressive technique and the three-dimensional financial inclusion index to examine the relationship between monetary policy effectiveness and financial inclusion in developed and developing countries is an important contribution to the study.

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Management of the monetary policy

The main role of central banks is to conduct monetary policy and help manage economic fluctuations to achieve price stability (low and stable inflation). The policy framework in which central banks operate has undergone significant changes in recent decades. [Publications, 2013]

Since the late 1980s, inflation targeting has emerged as the leading framework for monetary policy. Central banks in Canada, the Eurozone, the United Kingdom, New Zealand and elsewhere have set an open inflation target. Many low-income countries are also moving from targeting monetary aggregates (the size of money in circulation) to targeting inflation. Recently, amid growing concerns about the erosion of the policy space in the context of low equilibrium interest rates and low inflation expectations, major central banks are reconsidering their monetary policy frameworks.

Central banks pursue monetary policy by regulating money supply, generally through open market operations. For example, the central bank can reduce the amount of money by selling government bonds under a "sale and purchase" agreement (repo and reverse repo), and thus withdraw money from commercial banks. The purpose of such open market operations is to manage short-term interest rates, which in turn affects long-term interest rates and overall economic activity. In many countries, especially in low-income countries, the remittance mechanism is not as effective as in advanced economies. Before moving from monetary targeting to inflation targeting, countries need to develop a framework to ensure that the central bank targets short-term interest rates.

Economic growth, low unemployment and stable inflation are the primary goals of the central bank. These goals can be achieved only if monetary policy works effectively. The monetary authorities of a country approve monetary policy by managing interest rates or money supply in the economy to achieve certain goals, i.e. by promoting price stability, economic growth, financial stability, and controlling inflation. There are various transmission mechanisms by which policy actions are transmitted to the economy.

In the aftermath of the global financial crisis, central banks in developed countries ease monetary policy by lowering interest rates until short-term interest rates approach zero, which limits the option of further lowering policy rates (i.e., limited conventional monetary options). With the threat of rising deflation, central banks have pursued unconventional monetary policies, including the purchase of long-term bonds (especially in the United States, the United Kingdom, the Eurozone, and Japan) to further lower long-term interest rates and ease monetary lending. **Conditions**. Some central banks have even taken short-term rates below zero.

In response to the COVID-19 pandemic, central banks around the world have taken unprecedented policy measures to ease monetary policy, provide greater liquidity to key financing markets, and maintain credit flows. To reduce stress in the foreign exchange and local bond markets, many emerging market central banks have used foreign exchange interventions and introduced active buying programs for the first time.

In order to assess the criteria for sustainable development of the banking system, decisions are made on its components and steps are taken. The criteria that affect the stability of the banking system with this approach are: [Mishkin, 2007]

1) The ability to perform the obligations arising from its functions. For example, the mediation functions of the banking system. This includes not only the activities of banks as payment intermediaries, but also the redistribution of funds between businesses. Regulation of cash flow means proper use of cash and non-cash means of payment control over the inflation process and currency regulation.

2) Ability to resolve conflicts in their activities;

3) Sustainability of the development process or ability to withstand shocks, despite the impact of destructive external and internal factors;

4) Complex development, except for shortcomings in the scale and quality of banking activities;

5) Synchronous development of all elements, balance function accompanied by diversification of activities;

6) Positive interaction with the external environment - different sectors of the economy, different types of markets;

7) Favorable geographical location according to the place of production, etc. In general, let's look at the conditions under which the banking system is stable:

- No crises;

- Accumulated capital is distributed efficiently;

- Capital turnover is provided;

- Stability (balance) is maintained despite increasing imbalances or negative external shocks;

- ability to assess and manage risks, etc.

Assessment of the banking system development

The established criteria provide access to indicators to assess the development of the banking system at the macro level. If it uses the above-mentioned functions of the banking system, its development can be assessed on the basis of the following indicators:

- Ratio of assets (liabilities) of the banking system to GDP;

- Ratio of total income of the banking system to GDP;

- Ratio of banking system capital to GDP;

- Share of loans to the real sector of the economy, GDP and total bank assets;

- The ratio of the volume of securities acquired by banks to GDP;

- Profitability of other sectors of the economy, including the profitability of the banking system; [Mbutor, 2007]

- The ratio of cash in the banking system to GDP and cash income of the population, the ratio of reserves of enterprises and organizations in the banking system to GDP.

These indicators allow us to identify the strengths and weaknesses of the country's banking system, as well as some systemic risks of its operation. While the first concept focuses on the overall aggregate of banks and the banking infrastructure, the latter characterizes the performance of only part of the banking system; therefore, the functions of the banking system represent a broader process that characterizes the activities of individual banks and the system as a whole. The banking system performs such functions as providing economic entities with cash and non-cash means of payment. Ensuring the credibility and security of the entire economic system is an important condition for this [Gang J., Ojan Z. 2015].

Main functions of the banking system

At the same time, it is necessary to look at the indicators those characterize the functioning of these functions of the banking system in the economy as a whole:

- Currency stability;

- Stability of cash flows;

- The level of monetization of GDP;

- the level of inflation (on the one hand, inflation leads to an increase in funds for banking activities, on the other hand, inflation can lead to an increase in overdue loans);

- Effectiveness of monetary regulation of the economy. [Lapukeni, 2015]

Banks usually dominate the financial systems of developing countries: bank deposits are the most important form of household savings, and bank loans are the main source of external finance for firms. As shown below, Latin American countries generally have such a financial structure. This section focuses on the specific features that distinguish the banking systems of developing countries from those of industrialized countries, and the special role played by the banking sector as a source of economic growth in developing countries.

Banks in both industrial and emerging economies may differ from other financial institutions by a unique feature called the "franchise value of banks" here, i.e. the special authority given by the bank's charter to issue obligations means of payment. The state of the legal and accounting systems in developing countries makes it difficult for non-paying entities to issue short-term liabilities, such as commercial papers. Thus, banks are the only non-state issuers of these liabilities. Because investors demand borrowers' liquidity as proof of their solvency, borrowers are limited to the short-term market dominated by banks.

Conclusion

First, a higher degree of financial inclusion may force the central bank to emphasize core inflation more than core inflation. Second, higher financial inclusion has made interest rates an effective tool of monetary policy. Financial income provides entrepreneurs with the means to finance investments other than retained earnings, and lower policy rates stimulate debt demand. Third, the central bank may want to change the interest rate rule to ensure certainty and optimality. Optimal policy focuses more on stabilizing inflation rather than stabilizing production [Andrade, 2008].

The transmission of monetary policy through a bank lending channel is a fundamental phenomenon in economics / banking literature. This argument is supported by the user of the credit view transmission channel to reveal the link between monetary policy and financial development. The monetary policy channel is also affected by the individual's financial situation, as it determines their access to credit and the conditions under which it is granted. Excessive access to credit increases the risk of bad debt, which can lead to financial instability and inflation. Thus, increasing financial inclusion must be effective for the economy and the financial system.

The growth effect of monetary policy in advanced economies is more pronounced due to the strong financial structure compared to developing countries. The market is more noticeable in a market-oriented financial system than in a bank-centered financial system. Inflation rate is used for to test the effectiveness of monetary policy. Monetary policy rate is a better measure of the effectiveness of monetary policy, because inflation is only a result variable. To measure financial inclusion, an index is formed using supply and demand factors. The results suggest a two-way relationship between financial inclusion and monetary policy. The slowdown in GDP growth and inflation has a significant impact on financial inclusion. The decomposition of the changes shows that any shock in monetary policy has a significant impact on changes in financial inclusion in the long run, and vice versa.

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15 April 2022

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