



## **Tools of Monetary Policy**

Last week we discussed the role and function of the central bank, this week we will discuss how the central bank controls domestic prices and the growth of the economy. From our article last week we learnt that the central bank uses monetary policy to effect change in the economy. Through its use of monetary policy the central bank affects the real economy via three channels:

- The cost of borrowing in the market
- The exchange rate
- The price of financial assets

To achieve the objectives outlined above central banks manipulate the money supply to achieve the following macroeconomic objectives:

- Full employment
- Maintain stable price levels
- Maintain favorable balance of payments
- Promote economic growth
- Achieve an even distribution of income and wealth

There are five conventional tools that central banks use to affect monetary policy, which are classified as either direct or indirect instruments. These are open market operations, legal reserve requirements, discount policy or bank rates, moral suasion and finally selective credit controls. Let's look at each tool in a little more detail.

### **Open Market Operations**

Open market operations describe trading on the secondary market between the central bank and specifically designated authorized security dealers. This is basically the purchase or sale of securities by the central bank in the money market. This has the effect of either increasing or decreasing the amount of reserves held by banks which in turn would either increase or decrease the money supply.

### **Legal Reserve Requirement**

The reserve requirement states the amount of deposits that a financial institution must retain as liquid assets or on hold at the central bank. In the case of the Eastern Caribbean Currency Union 6% of all deposit liabilities held by a commercial bank must be retained as liquid assets. By increasing the amount of the legal requirements the central bank can make fewer funds available to a bank for lending thus decreasing the money supply. Conversely a decrease in the legal requirements can have the opposite effect.

### **The Discount or Bank Rate**

The discount rate also known as the minimum lending rate is the rate at which commercial banks borrow from the central bank. This can be manipulated by either increasing or decreasing the rates. An increase in the rates would decrease lending and decrease the money supply while a decrease in the interest rates would result in an increase in borrowing by commercial banks and result in an increase in the money supply. The discount rate also affects the interest rate that commercial banks offer on loans and the how attractive their interest rates would be on savings and other deposits.

### **Moral suasion**

From time to time as necessary central banks may send letters to commercial banks concerning their financial decisions. It may even come in the form of a verbal statement from the Governor of the central bank. In our area the ECCB holds an annual conference with the commercial banks and uses this forum to effect moral suasion.

### **Selective Credit Control/Special Deposits**

The central bank can choose to give preferential treatment to banks that conform to its policies. This is used to discourage certain lending and investment activities. The preferential treatment can come in the form of preferred rates on loans.

Special deposits are another way of controlling the liquidity of a commercial bank. The central bank can from time to time require that a bank hold a specific amount on deposit thus decreasing the amount available for lending.

We discussed the role and function of a central bank and what tools it uses to manipulate the money supply, we trust do hope that the information provided was both informative and educational.