THE MONETARY POLICY BETWEEN LIQUIDITY AND INFLATION IN EURO AREA

MONETARNA POLITIKA IZMEĐU LIKVIDNOST I INFLACIJE U PROSTORU EURA

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Abstract: *In a market economy, there is a preference for liquidity and also a preference for debt, so it must be managed the ratio between own resources and debts with a normal degree of risk and relationship between income and liquidity. In the evolution of so-called monetary framework placed in the attention of central banks, it has been outlined more and more the necessity of a nominal anchor which will base on expectations for establishing or changing the general level of prices. The nominal anchors became targets of the monetary polic.*

Key words: *price stability, inflation, monetary policy, liquidity*

Sažetak: *U tržišnom gospodarstvu naglasak se stavlja na likvidnost i dugovanja tako da se mora ostvariti omjer između vlastitog dohotka i dugovanja s uobičajenim stupnjem rizika i odnosa između prihoda i likvidnosti. Razvojem takozvanog monetarnog okvira središnjih banaka sve je izraženija potreba za nominalnim učvršćivanjem koje bi se zasnivalo na predviđanjima za određivanje promjena razine cijena. Nominalno učvršćivanje postalo je cilj monetarne politike.*

Ključne riječi: *stabilnost cijena, inflacija, monetarna politika, likvidnost*

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1. Introduction

Monetary policy as a component of economic policy aims to achieve the final economic objectives. The transmission and implementation mechanism of the monetary policy measures try to set up some intermediate and specific operational objectives and the usage of some elaborated tools. The modern role of monetary policy is based on the fact that it was an authorities fast intervention tool on the people's economical behaviour. This policy advanced from a direct intervention on the currency by currency and people to indirect and complex intervention with short or long term effect on the entire economy.

2. Current matters of monetary policy

Modern monetary policy emphasizes the improvement of transmission mechanism of monetary policy impulses and also the efficiency and transparency co-ordinates. Even the traditional monetary policy objectives were multiple - maintaining of a constant economical growth, control inflation, preventing financial crisis, stability of real exchange rate - the practice has shown that assuming multiple objectives through monetary policy is a mistake, especially if they are treated equally. Experience has shown that in many cases, objectives became opposite and divergent. In this manner, the modern monetary policy is using two ways of action in the economy: 1. through direct control over liquidity based on the administrative banking rules, first for the amendment of the volume and structure of monetary aggregates and, secondly, for the money supply (offer) and for the money demand; 2. through indirect influence of monetary supply using tools and indirect intervention techniques, attached to the market economy mechanisms, with direct influence over the money supply. It can be observed, however, a preference for indirect intervention, which allows a natural processes arrangement, but pragmatic and efficiency considerations will not exclude using of some strict rules or even direct intervention measures.

2.1 What we understand by liquidity?

Modern monetary policy trys, in essence, to provide the liquidities neccessary for the economy in terms of growth and stability, because a shorten quantity of payment's means may force companies to limit their activities (measured by macroeconomic indicators: production, investment, consumption, export, import) and a higher quantity of payment's means lead to higher prices (with inflation phenomena). Therefore, it appears the monetary policy's place between need for liquidity and its concern for controlling the inflation phenomenon. In modern economies, there are several forms of wealth or assets, with different degrees of liquidity, so that have the quality of being quickly processed and without loss in money. We agree that the liquidity are considered in view of four levels (Daianu & Lungu, 2005): an asset liquidity or of a particular financial tool; liquidity of a nonfinancial issue; liquidity to the national economy; liquidity at the international level. By their analysis we can appreciate that the liquidity of a particular asset or financial tool are contradictory elements, because one and the same form of fortune has a different degree of

liquidity, depending on its owner and that the one to whom is selling. The only kind of wealth, absolutely liquid, is money itself, in a classical meaning, money being considered primary or perfect liquidities. Economically speaking, the liquidity of a financial tool is depending on the combination of three elements: security funds, which reflects the degree of confidence in maintaining the value of an asset or financial instrument; negotiability, which is the degree of confidence in maintaining market value (the course) of a financial instrument until it is the due date, which may be one day, one month, one year; the possibilty of achieving it, that depends on a probable market value which can be achieved in the short term. The liquidity of entire economy is consists in the aggregate that express monetary mass and other forms of financial wealth. There is also a keyword for international liquidity. This is about the ability of a government to pay foreign debts and it may be defined as all payment means of a state comparing with the requirements from other countries, which can be real assets; financial assets. According to the monetary theory (Giese & Tuxen, 2007), international liquidity structure is based on two elements: an international reserve currency, held by the central monetary authority, a series of assets that can be converted into currency or which are accepted in extinguishing the external debt.

2.2. About inflation in euro area

As we mentioned before in this paper, liquidity analysis should be made in close touch with the inflation phenomenon. Inflationary process is present in all modern economies, being caused by a series of actions such as: making large expenditures for investment in relationship to the real potential of the economy; price increases caused by monopolies; financing on bank credit line of budget deficits; coverage through bank loan of some fixed resources; unequal exchange between foreign countries; record of loss value using in offsets some unstable currencies. In many countries, regardless their level of development, it considers that the main cause of inflation is the state usage of internal and external credits, the most serious matter being the involvement of money issue to cover spendings. It is recognized that there is an inflation in its slowly form, which manifests itself in almost all developed countries, following the budgetary imbalances that keep inflationary manifestations and exercise their harmful influence. Another point of view often invoked is inflationary spiral theory of wages and prices, which believes that increasing wages inevitably lead to increasing costs of enterprises, and in order to cover them they increased prices, but a new increase of the prices determine the increasing of wages, resulting a true vicious circle.

3. Monetary policy intervention in regulating the balance between the need for liquidity and inflation

In the previous chapter we tried to describe, in short,current problems of contemporary economies and for this the monetary policy trys to find an answer. In the same manner of dealing with the relationship between liquidity and inflation from monetary mechanisms point of view we can estimate the effects generated by direct

and indirect measures of monetary policy on the economic behavior of subjects and on the economy in general.

3.1. Short-term effect of a currency supply changing

If the supply of currency increase, took place the following steps: (i) people want to buy bonds, so their rate increases, reducing the interest rate (ii) an increased interest rate run to increasing of investment and expenditure, taking into account a series of multipliers (iii) when expedintures exceed initial production appears inflation together with price increases (iv) price increases reduce the real wealth, but they reduce the real money supply, and it appears the point inversion of the processes generated by high initial monetary offer (Popa & Bandoi, 2007). General effect created by increased supply of money is a stimulus to aggregate demand, increasing production, but prices and inflation. If money supply falls, the effect has reversed steps, as folowing: (i)the decreased demand of purchasing securities reduce their course, but increase the interest rate (ii) the place has decreased production and prices (iii) reducing demand at the level of supply to the point the inversione because if all people sell bonds, raise money mass, and therefore increase the supply of money. General effect created by the reduced supply of money is a brake on aggregate demand, reducing production, but also prices and inflation.

3.2. Long-term effect of a change of currency supply

If increase the currency supply follows all four steps outlined before on the short term and will be added the 5-th step, meaning the long-term adjustment by reducing aggregate supply, so that, even the current actual production is greater than production, continues to exist an up pressure on the prices of final goods. Nominal prices have increased, but the real ones remain unchanged, even the balance is achieved. The money come, therefore, to express the same quantities of real goods,returning to the point of balance between aggregate supply and demand. Reducing the supply of money on the long term would have the opposite effect, but it is not used in reality because the economy would collapse dramatically.

4. Conclusion

The target inflation strategy emphase the transmission mechanism of monetary policy impulses, because monetary policy decisions affect the economy in general and the price level in particular. Since the transmission mechanism is characterised by long delays, variables and even doubtful in response (time lags), it must be accepted the difficulty for precise forecasting of the effects of monetary policy measures. However, monopoly power conferred to the central bank in creating the necessary currency also gives the power to set interest rate of monetary policy, inside the mechanism, in order to ensure the banking system with funds and providing or asking interest for the service rendered. The interest rate of monetary policy directly affects the interest on the money market and indirect interest in deposits and loans offered by banks to customers. What should be noted is that the expectations of interest rate changes in monetary policy affects the level of interest on medium and long term, but

particulary the level of interest on the long term is determined by market expectations regarding interest developments on short term. In conclusion, the monetary policy transparency of central bank is a guide in economic agents' expectations regarding future inflation trends and therefore prices evolution. Thus, a high level of central bank credibility sets expectations regarding price stability, in this situation economic agents will not raise prices because of inflation and they will not reduce them because of dezinflation. The impact of this behavior on the economy financing conditions is major, with mention that the expectations which can be launched by monetary policy can make adjustments to the exchange rate and not only to the assets prices. As a result, the exchange rate may affect inflation expectations through imports of goods which will be for consumption. On the other hand, changes in consumption and investment as a result of interest rates changes or expectations for their level, may make changes in aggregate domestic demand in relation to national offer, which would induce pressure on prices. From all this possible chain effects, empirical estimates made for the euro area reveals different responses of the various components of GDP to interest rate changes. Studies show that the impact of monetary policy on investment process is greater than the consumption or other components of agregate demand. Investments are influenced by changes of usage capital cost, a variable which directly depend on interest rate. Investment in the euro area are sensitive too to the liquidity and cash – flow limits and to the ability of economic agents to place their debts on the market or to borrow from banks. The same empirical studies show that the response of consumer prices in modifying interest rate also depends on the influence of such changes on the exchange rate, in the sense that, the high is the appreciation of the euro, determined by the interest rate, the higher is the decrease of inflation. However, it must been accepted the idea that the central bank can not control other developments on the international money market foreign decisions which would affect the exchange rate for the euro.

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