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MONETARY POLICY: HOW CENTRAL BANKS REGULATE THE ECONOMY

Abdiraxmonov Anvarbek Akbar o‘g‘li
Student of Karshi engineering-economics institute

ABSTRACT

Monetary policy is the bedrock of any nation's economic policy, and everyone from part-time workers to huge financial institutions, both foreign and domestic, are impacted as it shifts. Here's how managing the supply of money affects you and the rest of the economy.

Keywords: *central bank, monetary policy, fiscal policy, bank system, money, customer, inflation, economy, business.*

АННОТАЦИЯ

Денежно-кредитная политика является основой экономической политики любой страны, и ее изменения затрагивают всех, от работников, работающих неполный рабочий день, до огромных финансовых учреждений, как иностранных, так и отечественных. Вот как управление предложением денег влияет на вас и остальную экономику.

Ключевые слова: *центральный банк, денежно-кредитная политика, фискальная политика, банковская система, деньги, клиент, инфляция, экономика, бизнес.*

INTRODUCTION

Monetary policy is the policy adopted by the monetary authority of a nation to affect monetary and other financial conditions to accomplish broader objectives like high employment and price stability (normally interpreted as a low and stable rate of inflation). Further purposes of a monetary policy may be to contribute to economic stability or to maintain predictable exchange rates with other currencies. Today most central banks in developed countries conduct their monetary policy within an inflation targeting framework, whereas the monetary policies of most developing countries' central banks target some kind of a fixed exchange rate system. A third monetary policy strategy, targeting the money supply, was widely followed during the 1980s, but has diminished in popularity since that, though it is still the official strategy in a number of emerging economies.

Main part.

What Is Monetary Policy?

Central banks use monetary policy to manage the supply of money in a country's economy. With monetary policy, a central bank increases or decreases the amount of currency and credit in circulation, in a continuing effort to keep inflation, growth and employment on track.

In the U.S., the Federal Reserve is responsible for monetary policy. Congress has tasked the Fed with a "dual mandate" that it pursues with monetary policy: maximize employment and maintain steady prices. In general, that means the Fed aims to keep unemployment low, but not zero, to foster productivity without inciting higher inflation. There's no official target range, but historically the Fed has focused on keeping unemployment at about 3,5% to 4,5%.

As for inflation, the Fed normally targets average annual price increases of about 2%. When unemployment is low and inflation is around the 2% level, consumers and businesses are in a good position to spend and invest money—as well as save adequate cash reserves — which meets the Fed's mandate for a highly functioning economy.

"The power of the Fed is derived primarily from its authority over these two prominent aspects of the economy," says Robert Johnson, professor of finance at Creighton University. "The Fed executes these objectives through its power to control the money supply." It was given these responsibilities in 1977 through a Congressional dual mandate, and it may enact its powers using a handful of tools.

Monetary Policy Tools

Federal funds rate. Commonly called the fed funds rate, or the fed funds target rate, this is the target interest rate set by the Federal Open Market Committee (FOMC) at its eight yearly meetings. Commercial banks reference the fed funds rate when they lend their excess reserves to each other overnight.

Open market operations. The Fed buys and sells government securities, like Treasury bills and bonds, in the open market. By buying back securities, the Fed effectively increases the supply of money circulating—conversely, selling securities lowers the supply. Historically, open market operations are the most commonly used tool to conduct monetary policy.

Reserve requirements. The Fed keeps a close eye on reserve requirements, or the amount of cash banks must have on hand at any time to comply with banking regulations. Those reserves must either be secured in bank vaults or via a deposit in a qualified Federal Reserve Bank to ensure they have money available should customers need it. By lowering the amount of cash banks are required to keep on hand, the Fed can encourage banks to lend out more money. And by raising that requirement, it can do the inverse.

The Discount rate. This is the interest rate charged by the Fed on short-term loans to financial institutions. Generally, these loans are meant to cover reserve requirements or liquidity issues banks can't meet through loans from other banks, which offer a lower federal funds borrowing rate. Typically, when the U.S. economy is humming on all cylinders, discount rates are relatively high because the Fed doesn't need to make borrowing money cheap to incentivize activity. However, when the economy is in a slump, the Fed often lowers interest rates to spur lending and credit to individuals and businesses.

Quantitative easing (QE). With QE, a central bank like the Federal Reserve uses its massive cash reserves to buy up large-scale financial assets like government and corporate bonds as well as stocks. This may sound similar to open markets, but quantitative easing often takes place on a much larger scale in more dire circumstances, involves buying more than just shorter-term government bonds and generally occurs when interest rates are already at or near 0%, meaning the Fed has already fully extended one of its primary weapons. Central banks must be careful with QE, however, because continued large-scale asset purchases can lead to economic conditions monetary policy makers don't want, like higher inflation and asset bubbles.

Public service announcements. When implementing a nation's monetary policy, a central bank will announce to the financial markets and the general public its general outlook on the economy and any policy measures its taking. In and of themselves, these PSAs may influence the market and economy in ways that the central bank is hoping for.

Expansionary Monetary Policy vs Contractionary Monetary Policy

Depending on the economic circumstance, monetary policy may be categorized in one of two ways: expansionary monetary policy or contractionary monetary policy.

Expansionary Monetary Policy

Also known as loose monetary policy, expansionary policy increases the supply of money and credit to generate economic growth. A central bank may deploy an expansionist monetary policy to reduce unemployment and boost growth during hard economic times.

It usually does so by lowering its benchmark federal funds rate, or the interest rate banks use when they lend each other money to satisfy any reserve requirements. While in the U.S. the Federal Reserve cannot require a certain federal funds rate, it can set guidelines and influence the rate banks charge each other by altering the supply of money. In turn, this may lower other interest rates, like those banks use when they lend money to consumers, which helps spur consumer spending through increased credit and lending throughout the nation's economy.

For example, when the U.S. banking system collapsed leading to the Great Recession of 2007-2008, the Federal Reserve cut interest rates to near-zero to jumpstart the U.S. economy, thus "expanding" economic growth. It recently did the same thing to pull the country out of the 2020 Covid-19 recession.

Contractionary Monetary Policy

Also known as tight monetary policy, contractionary policy decreases a nation's money supply to curb rampant inflation and keep the economy in balance. A central bank will likely hike interest rates and try to slow the growth of money and prices.

At the outset of the 1980s, for instance, when the U.S. inflation rate soared to almost 15%, the Fed aggressively raised interest rates to nearly 20%. While that move led to a nationwide recession, it also brought inflation back to about 3%, helping set the stage for a robust U.S. economy for the remainder of the decade.

Monetary Policy vs Fiscal Policy

When it comes to regulating the economy, a country has two main levers it can pull: monetary policy and fiscal policy.

While they might sound similar—both involve words that suggest money or finance—they're quite different and are enacted by distinct sectors of the government. Monetary policy is controlled by the Federal Reserve; fiscal policy, on the other hand, is driven by the U.S. government's executive and the legislative branches.

Practically speaking, this means "fiscal policy deals with taxation and government spending," says Dr. Guy Baker, CFP, Ph.D., founder of Wealth Teams Alliance, in Irvine, Calif. In contrast, monetary policy involves effecting change by manipulating the monetary supply.

CONCLUSION

The tools of monetary policy vary from central bank to central bank, depending on the country's stage of development, institutional structure, tradition and political system. Interest rate targeting is generally the primary tool, being obtained either directly via administratively changing the central bank's own interest rates or indirectly via open market operations. Interest rates affect general economic activity and consequently employment and inflation via a number of different channels, known collectively as the monetary transmission mechanism, and are also an important determinant of the exchange rate. Other policy tools include communication strategies like forward guidance and in some countries the setting of reserve requirements. Monetary policy is often referred to as being either **expansionary** (stimulating economic activity and consequently employment and inflation) or **contractionary** (dampening economic activity, hence decreasing employment and inflation).

Monetary policy affects the economy through financial channels like interest rates, exchange rates and prices of financial assets. This is in contrast to fiscal policy, which relies on changes in taxation and government spending as methods for a government to manage business cycle phenomena such as recessions. In developed countries, monetary policy is generally formed separately from fiscal policy, modern central banks in developed economies being independent of direct government control and directives.

How best to conduct monetary policy is an active and debated research area, drawing on fields like monetary economics as well as other subfields within macroeconomics.

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