

Monetary Policy and Its Impact on Economic Stabilization

Posted on July 27, 2022

Introduction

Monetary policy is utilized by the government for money management through the central bank, which impacts macroeconomic objectives such as a high level of employment, price stability, balance of payment, sustainable economic growth, etc. As described by Gnahe & Huang (2020), the monetary policy defines certain measures that regulate the cost and supply of money based on the level of [economic growth and development](#) in the country. In this regard, various direct or indirect instruments are used to get the desired outcomes and level of economic development depending upon the certain conditions of the economic problems.

However, there are two broad categories of monetary policy, i.e., [expansionary monetary policy](#) and restrictive monetary policy, which are often implemented by the federal government. The expansionary monetary policy reduces the interest rates and thus increases the borrowing activity, while restrictive monetary policy increases the interest rates to slow down the borrowing activities. In this way, the monetary policy changes the available quantity of loanable funds, affecting the aggregate demand and business activities in the market. Governments utilize these measures to stabilize economic activities and counterbalance the different upswings and downswings. The following essay, in this regard, further discusses the significance of monetary policy in economic stability, especially its effect on macroeconomic goals such as inflation and unemployment.

How Monetary Policy Impacts The Economic Stabilization

According to Gnahe & Huang (2020), monetary policy is the art of controlling the supply of credit in the economy to stabilize prices and economic growth. As explained earlier, the primary purpose of both types of monetary policies is to impact business activities. When the interest rate increases in the case of restrictive policy, financial investments become more attractive than investments in physical capital, which will also reduce consumer borrowing. On the other hand, as the interest rate decreases according to expansionary policy, businesses find it more attractive to invest their money in physical capital, which increases economic activities and brings job opportunities. Therefore, if the economy is struggling from a recession and high unemployment, the expansionary monetary policy can boost economic activities to help countries return to their potential GDP.

In comparison, in restrictive monetary policy, the control bank reduces the supply of credit and money in the economy, which increases the interest rate and lowers the price level and real GDP. These measures help governments reduce the inflation rate and economic prices. For example, as noted by Onyeiwu (2012), the monetary policy had a very positive effect on Nigeria's GDP growth, which resulted in very positive outcomes related to some prominent macroeconomic variables such as employment and prices. Similar results were obtained by Nwosa & Amassoma (2011), who stated that the monetary policy positively influenced the price stability in Nigeria.

Moreover, Twinoburyo & Odhiambo (2018) arguably said that monetary policy impacts economic growth in a positive way, referring to many previous studies. However, this impact is mainly dependent on the neutrality of the central banks, which can operate independently without any influence from the central government to alter the interest rate and money supply in the economy. Therefore, Twinoburyo & Odhiambo (2018) highlighted that the positive outcomes of the monetary policy are relatively more observed in financially developed countries than in developing economies that do not have well-established financial markets and are not directly linked to global economic markets. Furthermore, the size and competition within the financial sector, the degree of openness, and exchange rate regimes are also strong determinants to explain the mutual relationship between economic stability and policy.

However, the real positive outcomes of the monetary policy to stabilize the economy cannot be achieved successfully without its effective institutional implementation. Therefore, Gnahe & Huang (2020) highlighted in their studies that the desired objective of the monetary policy in West Africa was not achieved due to poor coordination of the policy and other inappropriate measures of other economic variables, such as foreign [direct investment](#), etc. that directly influenced the outcomes of the policy. In this regard, Twinoburyo & Odhiambo (2018) recommended intensive financial development measures and structural reforms, especially in developing countries, to effectively address supply-side deficiencies.

It is also important to note that monetary policy is not used to achieve any long-term objectives but only to overcome the prevailing conditions of either unemployment or inflation for a particular duration of the economic cycle. This means that once the desired objective is achieved through either the expansionary or restrictive monetary policy, the economic conditions change significantly, which invites governments to use other measures of economic growth such as foreign investment, fiscal policy, loans, quantitative easing, etc. However, there is strong evidence of the destructive consequences of the poor monetary policy on economic growth. For example, as addressed by Lacker (2016), if monetary policy is poorly managed, it can give rise to a high and variable inflation rate that can interfere with prices and thus misguide the economists and business owners in allocating the resources to their most valuable use.

Inflation itself does not affect economic decision-making as long as the relative prices of the different goods and services remain unchanged and don't affect the demand and supply mechanism. However, in the case of poor monetary policy, inflation changes prices at different rates and hence distorts the

whole production and consumption phenomenon. To further illustrate this point, consider that if the price of drywall changes more rapidly than the prices of other goods and services, it may be misinterpreted as the net increase in aggregate demand, which can result in overproduction. Consequently, the resources in the whole economic activity are inefficiently allocated, leading to poor economic performance.

Similarly, poor monetary policy can also encourage people to spend their resources wastefully in an effort to avoid holding money and investing it in physical capital because money becomes a bad instrument for savings when inflation rises significantly and reduces the opportunity cost of holding money in the bank and making frequent withdrawals. In this way, the resources that are used to economize on money holdings could be better used in the production of goods and services. Thus, this shows that poor monetary policy can have adverse effects on economic stability.

Conclusion

Monetary policy is one of the most effective tools for regulating the money supply in the economy. Therefore, it has a direct impact on the various macroeconomic variables such as employment and inflation. Governments can deploy expansionary monetary policy or restrictive monetary policy to decrease or increase the interest rate and affect the business activities in the market. As shown, many scholars have highlighted the positive role of monetary policy in economic development and stability, citing examples from real economies. However, they also emphasize that monetary policy cannot generate long-term economic outputs.

However, as discussed, to avoid the negative consequences of poor monetary policy, governments need to ensure the effective implementation of either expansionary or restrictive policy based on the prevailing economic conditions.

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