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Applying monetary regulation to current trends in small open economies

Abstract

Significant changes in approaches to the monetary regulation of economic stabilization and growth are currently being completed. The processes of change that began under the influence of the global financial crisis have now become inevitable. Determining the main directions of these changes and the possible consequences for small open economies is one of the most important tasks of scientific research. Timely adaptation of national monetary systems in the initial stages of transformation can enable countries to overcome the consequences of the pandemic and make up for lost time. The article analyzes a number of the most characteristic changes in practice and theoretical views on monetary policy. Among them is the change in views on the role and purpose of inflation targeting under the influence of many years of massive emission practices. The identified synchronism of inflation for developed and developing countries gives reason to expect attempts at quantitative easing on the part of developing countries. While they may be postponed due to the acceleration of producer price growth. The tendency to revise the fiscal component in the dualism of fiscal policy to strengthen the targeting of emission is substantiated. The low efficiency of measures of monetary easing and stimulation through the credit channel is noted. The limited impact on the growth of aggregate demand with an increase in the debt burden should lead to a revision of the existing practice of emission and reduction of interest rates. One of the important drivers of changes in monetary regulation is the process of digitalization. Despite certain risks of deficiencies in the effectiveness of central bank monetary policy, the spread of shadow banking, digital currencies and direct lending operations, digitalization is creating new opportunities for financial control and audit. On the basis of the analyzed trends, a conclusion was made about the current tasks of modernization of monetary policy in countries with small open economies, including Ukraine.

Keywords

Monetary policy, central bank, financial regulation, inflation, pandemic, financial openness, quantitative easing

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1 Introduction

The global financial crisis has led to significant changes in approaches to monetary policy and financial regulation. Among the many changes, three extremely important elements of pre-crisis policy underwent fundamental reconsideration. The first important element of the pre-crisis monetary consensus, which was gradually revised in 2008-2021, was the possibility of monetary easing. The impunity of long-term monetary easing led to the idea of targeted emissions and unconditional basic income.

The second factor of change derived directly from the first and concerned the epochal revision of the attitude to inflation. It was caused by its zero level after a long and unprecedented monetary easing. The question arises, is inflation necessarily the only consequence of monetary expansion and a real threat to financial stability? The lack of regular inflation as a result of such a problem has swayed the dominant inflation targeting and raised questions about the adequacy of monetary policy objectives and the limits of monetary easing.

The third key point is the return to the agenda of the issue of permissible limits of state regulation of economic processes. In the pre-crisis period, the idea of minimizing state influence on economic processes was widespread, which was aimed at ensuring the implementation of economic freedoms and the release of market mechanisms of self-regulation. Instead, it was government initiatives and increased fiscal spending that were the first effective tools to deal with the effects of the crisis. After the Global Financial Crisis (GFC), the need to control short-term volatile international capital flows was approved.

In the context of the global COVID-19 challenge, market participants have already called for active policies in the financial sector by government agencies. Indeed, it was the global pandemic that became an indicator of the contradictions in the former monetary system and accelerated the processes of transformation in the field of monetary policy.

The significant impact of these transformations on the global financial architecture will have a decisive impact on small open economies as well. That is why the analysis and identification of promising forms of transformation and possible implications for emerging markets is a relevant scientific problem today.

2 Results and discussion

The reasons for the intensification of discussions on reassessing the role and defining future forms of monetary regulation are the consequences of the ongoing liberalization measures for the development of small economies (Masci, 2008), their accumulation of a hub of systemic risk and the transmission of external shocks. These processes are exacerbated by the global challenge of the COVID-19 pandemic.

This has necessitated special measures on the part of monetary and financial regulators. Such measures should support composite demand, business activity and prevent unwanted bankruptcies. For central banks, these objectives overlap with the need to ensure the stability of financial markets, expand the supply of credit, and prevent unwanted inflation. In attempting to solve these problems, central banks have traditionally relied primarily on interest rate cuts and quantitative easing policies.

As early as March 2020, the vast majority of central banks in OECD countries announced a reduction in bank reserve requirements. As a result, the rates of many developed countries were in the 0-0.25% range. Central banks in Central and Eastern Europe (CEE) and emerging economies also cut their rates. Official interest rates were cut in Romania (from 2 to 1.5%), Poland (from 1 to 0.1%), the Czech Republic (from 2.25 to 0.25%), and Hungary (from 0.9 to 0.6%).

Immediately, another wave of "monetary easing" was launched. This time, its total announced volume is 30 times greater than the Marshall Plan, and three times greater than the issuance volume during the 2008 crisis. The G20 announced plans to issue $5 trillion. The ECB expanded its current asset-purchase program (APR) by another 120 billion euros and launched a special PPP program (Lane, 2020; Marmefelt, 2020). The estimated volume of the latter program is 1.35 trillion euros, and the duration is until June 2021. In total, 54 countries' governments plan to allocate more than $10 trillion to support their economies (Cassim, 2020).

3 Inflation attitude changes

With general trends toward monetary expansion in high-income (or developed) countries and middle- and lower-middle-income countries (Ukraine also belongs to the latter group), it is difficult to see a significant difference between them. According to the World Bank, among the countries in the second group, inflation varies synchronously, but steadily higher:

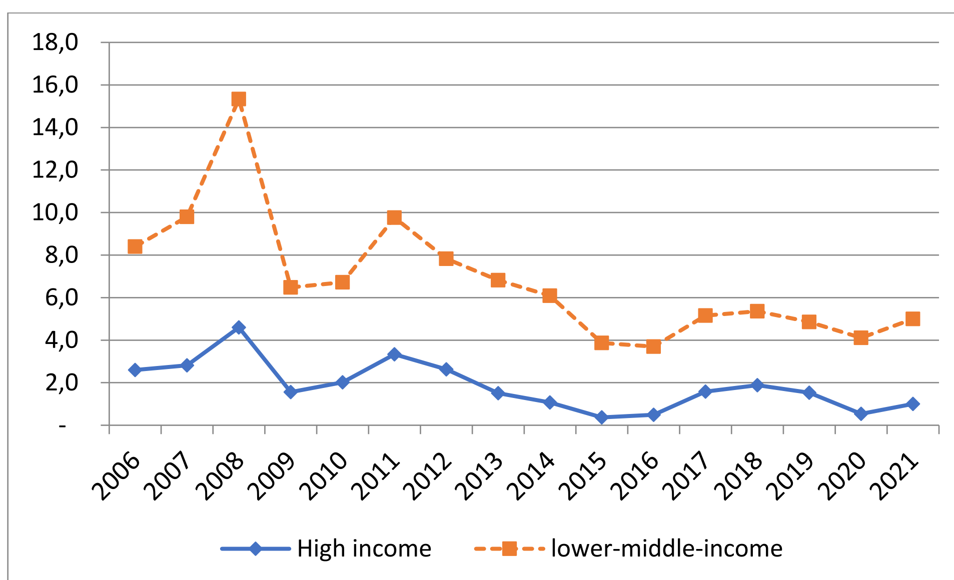

FIGURE 1 Comparison of inflation in high- and lower-middle-income countries, CPI (annual, %)
Source: The World Bank. URL: https://databank.worldbank.org/

This fact inspires regulators of small open economies and stimulates further monetary expansion. At the same time, it forms a powerful factor of systemic risk accumulation. The fact is that such monetary support due to the underdevelopment of financial market institutions is limited in supporting economic growth.

At the same time, the group of developing economies has seen a significant increase in the loan debt burden. The quarterly growth during 2020–2021 was about 8.9% to GDP (BIS statistics). Obviously, the growth of the loan debt burden in a shrinking economy does not lead to an expansion of effective demand. According to ECB experts, in such market circumstances the effect of credit issuance may be very limited. Borrowers expect market conditions and incomes to deteriorate and limit their consumer and business activity. Also, banks note the decline in demand for credit, deterioration of macroeconomic expectations and tightening requirements for borrowers. This situation is negatively complemented by a real decline in solvent demand of households.

Overcoming this double negative relationship, which has grounds for self-reinforcing, is only possible with a set of coordinated policies: monetary, fiscal, macroprudential and communication. In addition to monetary expansion, fiscal policy should support effective demand, macroprudential policy should free up reserves to reduce the supply of credit, and communication policy should ensure the reliability of government support for all market participants.

A natural effect of the current monetary measures has been the spread of low and negative interest rates on financial asset allocation. Rates initially fell below 0.5% and then went into negative territory in the following countries: Japan, the United States, the United Kingdom, the euro area, the Czech Republic, Sweden and Switzerland. Rates also fell to near zero in Canada, New Zealand, Israel, and Chile. Central and Eastern European central banks also cut their rates in the face of the pandemic.

There are forecasts of zero and negative rates for the next ten years (Demertzis, 2021). The root cause of this process is the decline in the value of financial capital due to its low productivity and demand for money in the countries of the economic core. The global context of this phenomenon is shaped by long overdue technological changes.

4 Targeting monetary expansion

At the same time, lower interest rates have limited or even negative effects on business activity (Heider, 2019). This is because institutions that in previous periods provided their own funding by raising deposits now need income assets to offset the cost of those deposits. Reducing reserve requirements to zero for active transactions also has a limited effect (Eggertsson, 2019). But the cheapening of household savings income further reduces effective demand and narrows the prospects for lending to small businesses and innovative projects.

Monetary and fiscal expansion has aggravated the problem of sovereign debt. At the same time, there are peculiarities of its formation at the present stage. Among middle- and above average income countries, the growth of debt outpaces the corporate sector, while in low-income countries the public debt segment grows almost exclusively (Kose, 2020). The outpacing growth of public debt in advanced nations reflects their inherent advantage in their ability to finance budget deficits. Falling into the liquidity trap and the declining effectiveness of monetary policy instruments has led to the role of fiscal policy being increasingly seen as leading relative to monetary policy.

While quantitative easing during the GFC was aimed at financial markets, in a pandemic the implementation of financial support through the purchase of mainly government bonds allows not only to maintain activity in financial markets, but also strengthens the purpose of emission through the mechanism of stimulus spending. In line with this trend, most developed countries and a number of emerging economies have significantly increased their budget deficits. Nine of the G20 countries had budget deficits exceeding 10% of GDP by 2020. China (18.2% of GDP) and the United States (15.8% of GDP) had record deficits in 2020 (Global Financial Stability Report, 2021).

In this transformation of quantitative easing policy, the main focus of monetary support remains the resumption of economic activity while maintaining zero or negative interest rates. In addition, the risk of unproductive effects of increased money supply, speculative price fluctuations, default and interest rate risk is eliminated. A similar process of monetary and fiscal policy synergy will be observed in the coming years. This is confirmed by the reorientation of the monetary policy objectives of developed countries.

For example, the U.S. Federal Reserve's August 2020 Declaration of Long-Term Monetary Policy Goals and Strategies demonstrates a change in approach to balancing inflation and unemployment within the Phillips curve and a decrease in the priority of inflation targeting in favor of maximum employment in the economy. It should be added that the growth of unemployment at this stage is an objective phenomenon of increasing labor productivity and changes in the technological way of life, which naturally leads to the re-profiling of production professions. Ensuring full employment in such conditions in the traditional way provokes the risk of creating unnecessary and unproductive jobs.

In other words, achieving full employment at present will not necessarily lead to economic development. The opposite effect is also possible. Rather, it should be a question of providing financial opportunities for the self-training of citizens. As for the composition of monetary and fiscal instruments, the initiative to create a mutual fund "Next Generation EU" and the introduction of the European Commission bond auction look interesting. On the one hand, these initiatives expand the potential of monetary stimulus in times of crisis, and on the other hand, relieve some of the burden on the ECB's finances and its responsibility to restore economic growth (Krauss, 2020). At the same time, these initiatives strengthen the function of socially oriented fiscal tools of economic stimulation.

5 Digitalization trends and subsequences

Digitalization is important in changing the nature of monetary policy. The proliferation of shadow banking and cryptocurrencies, on the one hand, as well as central banks' digital currencies and direct lending operations, on the other, are shaping changes in the institutional characteristics of the entire financial sector. The proliferation of big databases and IT technologies create new opportunities for financial control and auditing as well as communication policy. The acceleration and simplification of financial transactions ensure the process of globalization of economic relations. Of course, there are many more of these channels at the micro-level, and the overall potential of digitalization processes cannot be underestimated.

The nature of these processes remains largely uncertain. Its underlying driving forces are formed not only in the financial or technical sphere, but also in the social, psychological and market spheres. Monetary regulators are unlikely to lead this process. However, they need to be closely monitored, with priority given to protecting the interests of owners from financial losses and markets from abuse and excessive speculation. The implementation of existing and prospective monetary policy measures in the countries of the economic core, primarily the expansion of the money supply and corresponding fiscal stimulus measures will have a natural manifestation in the markets of the peripheral economies. Most likely, the direct impact of large-scale issuances and state financial assistance programs in the countries of the economic core will come through the channel of cross-border capital flows to emerging country markets.

This can be argued by analogy with the previous period of quantitative easing policies. The volume of capital issued by developed country governments between 2008 and 2012 led to a doubling of international capital flows to emerging country markets. In the absence of developed financial market instruments, the inflow of foreign capital concentrated on markets for high-yield assets, including real estate and consumer lending.

Subsequently, under the influence of changes in the commodity markets and signals about possible interest rate increases in the U.S., there was a sudden fleeing of foreign investment from the markets of these countries. As a result of the financial crisis caused by this flight, capital controls were updated and approaches to floating exchange rates were revised. Recent research shows that exchange rate controls are a prerequisite for monetary independence, and that countries with floating exchange rate regimes are at risk in periods of high volatility of cross-border capital flows (Bekaert, 2017).

A policy of controlling cross-border capital flows, which can be implemented with the help of macroprudential instruments, is an indispensable element in ensuring financial stability of the national economy. Overall, the proliferation of global regulatory initiatives aimed at eliminating the transmission of negative factors from the economic core to the periphery is a relevant trend in the financial sector as well (Jones and Knaack, 2019). In particular, the Financial Stability Board and the Basel Committee created a working group to assess the impact of regulatory reforms on emerging markets.

6 Conclusions

The analyzed trends confirm the existence of processes embodying a significant transformation of approaches to the definition of objectives and instruments of monetary policy in different countries. The main consequences of this process, which are now being reconsidered, are a shift away from the priority of the inflation target, an expansion of the money supply with a gradual refocusing on targeted programs to finance economic development.

In this context, the effectiveness of monetary policy will be enhanced by expanding controls on financial transactions in the area of international capital flows and strengthening cooperation with fiscal authorities. Changes in these areas, among others, will encourage monetary authorities to pursue macroprudential policies. The functionality of this policy provides opportunities for such interaction, as well as for regulating the parameters of financial transactions in the interest of eliminating the systemic risk of financial instability.

Targeted financing of strategic areas of innovation and industrial development of the economy should be considered as a promising measure. This will require a complex balancing of state regulation and deregulation measures in responsible cooperation with the business environment. It may require a new formation of institutional relations with the state.

The current trends toward a more regulatory approach should be seen as the embodiment of a more productive process of economic integration. Perhaps this is a temporary, incipient process. At the same time, the implementation of such regulatory initiatives should be seen as freedom for a wide range of economic agents from the powerful risks of financial losses and uncertainty inherent in the current stage of development of socio-economic relations.

Under these conditions, the challenge for small open economies is to improve monetary policy in line with current global trends. The key points on this path are:

1) Reassessment of regulatory measures with the priority of supporting and stimulating economic growth. At the same time, it should be taken into account that for Ukraine, as a small open economy, the critical element of a stimulating macroeconomic policy is the balancing of the emission by a stable source of foreign exchange inflows. Otherwise, in the absence of developed institutions of financial markets, as well as their own industrial production, the issued funds will finance the demand for consumer goods and imported products. The result would be inflation, a depreciation of the national currency, and a worsening of the double deficit. On the other hand, the mere drain on foreign exchange reserves without an accompanying expansion of the money supply in the national currency only increases the dead weight of capital in reserves. An alternative is to counterbalance accumulated reserves by expanding the money supply in the form of directed credit. It is also important to strengthen the institutional capacity of the national regulator by introducing IT innovations in the field of monetary and communication policy.

2) Hedging the risks of the counterproductive effects of monetary stimulus measures undertaken by the authorities of the economic core countries. The liberalization of international flows of capital in Ukraine points to high risks of rapid growth in consumer lending, the formation of price imbalances in the real estate market and increased trade deficits. This nature of international capital flows is highly likely to lead to the realization of these risks without the possibility of preventing them in the current policy environment. That is why, in addition to the use of macroprudential policy instruments, capital controls should be considered.

3) Implementation of international regulatory issues. Despite the temporary nature of the de-globalization processes accompanying the post-2008 economic downturn, it is important to implement global regulatory initiatives to protect small open economies from the risks of external financial shocks and protect their interests in complex integration processes. This will lay a solid foundation for more productive economic integration in the future.

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