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What is Monetary Policy? [Impact of monetary policies on economic growth]

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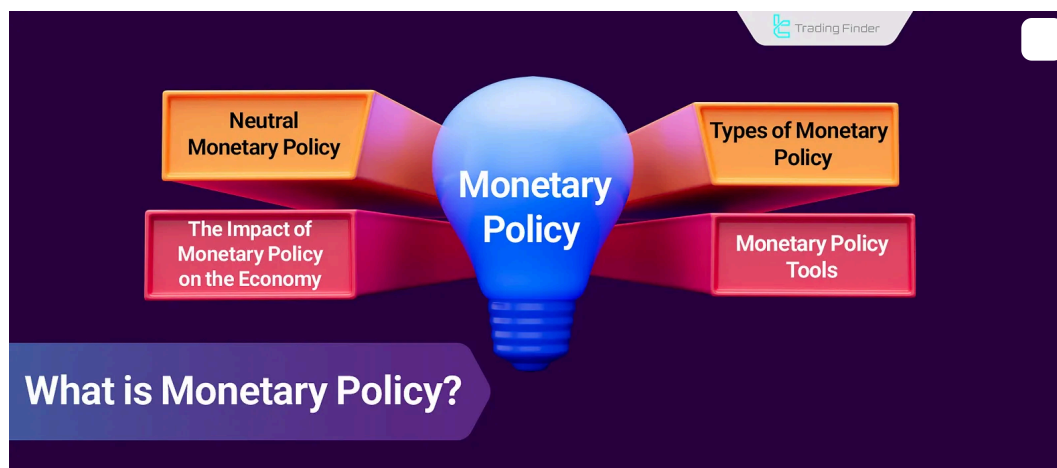
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Monetary policy shapes the cycles of economic expansion and **recession**. Therefore, understanding **monetary policy**, its tools such as **interest rates**, **bonds**, **discount rates**, **reserve requirements**, and the **central bank's approach** in adopting these policies helps to **choose the best market for investment** in any economic phase.



Monetary policy refers to the actions taken by a central bank to control inflation or stimulate employment and economic growth

What is Monetary Policy?

Monetary policy refers to the actions taken by a central bank to control **Economic inflation** and regulate the **unemployment rate** at an optimal level.

Central banks of different countries implement their own **monetary policies** using various tools, and these policy differences directly impact **volatility in the forex market**.

Forex traders use **differences in monetary policies** to capitalize on market fluctuations based on central bank actions. **Differences in monetary policy** refer to the divergence in **approaches** between central banks.

For example, the ECB (European Central Bank) may start **cutting interest rates** and adopt an **expansionary policy**, while the **Federal Reserve** (U.S. central bank) continues with a **contractionary policy**. This creates a **monetary policy divergence**, which may **strengthen the U.S. dollar**.

Monetary Policy Tools

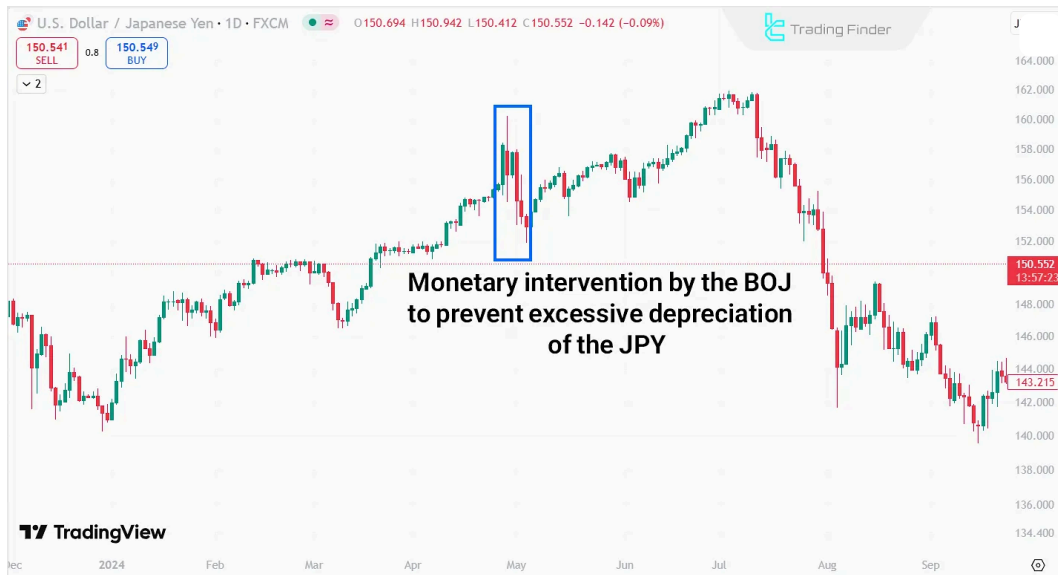
Central banks have multiple tools to implement **monetary policy**, which affects liquidity levels by either increasing or decreasing them.

For example, central banks use **monetary policy tools** like **interest rates** and **open market operations (OMO)** to control inflation.

Key Monetary Policy Tools:

- ⚡ **Interest Rates:** Changes in interest rates influence deposit levels and **loan demand**, thereby increasing or decreasing liquidity;
- ⚡ **Open Market Operations (OMO):** The central bank's buying and selling of government bonds. **Buying bonds** increases liquidity, while **selling bonds** reduces it;
- ⚡ **Credit Ceiling:** The central bank sets **credit limits** to control bank lending;
- ⚡ **Reserve Requirement Ratio:** The percentage of deposits banks must **hold in reserve** at the central bank. Increasing it reduces liquidity, while decreasing it boosts liquidity;
- ⚡ **Discount Rate:** The interest rate banks pay when borrowing from the central bank. Raising it **reduces** liquidity, while lowering it **increases** liquidity;
- ⚡ **Inflation Targeting:** Central banks use **hawkish or dovish stances**, **inflation targets**, **policy statements**, and even the **tone of speeches** to influence inflation **expectations**. These are modern **monetary policy tools** that affect **market sentiment**;
- ⚡ **Currency Intervention:** Central banks **directly intervene** in forex market to control exchange rates in emergencies.



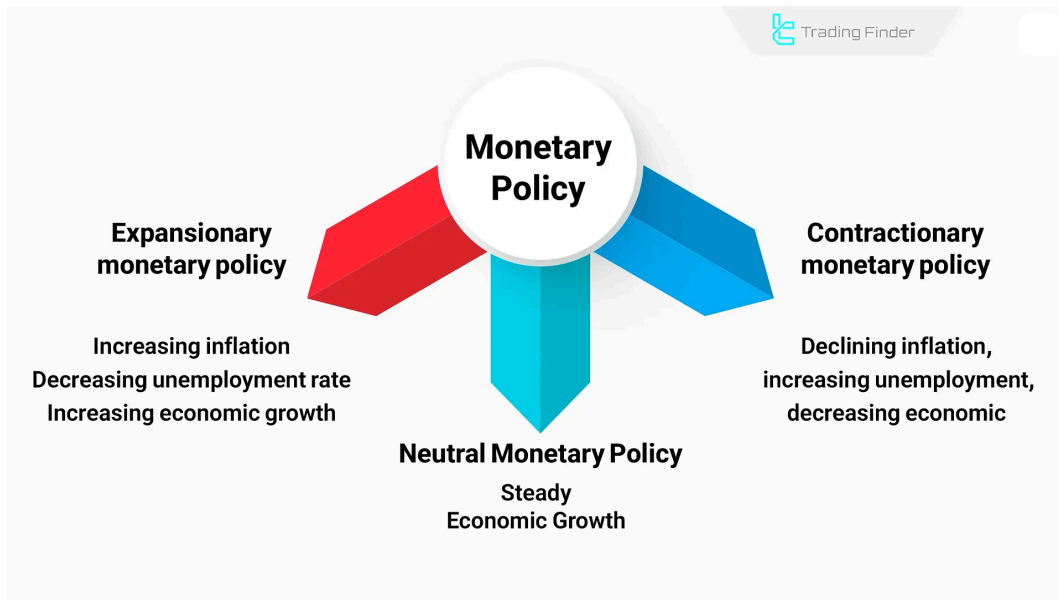


Example of the Bank of Japan's (BOJ) monetary intervention in forex, which caused extreme market volatility

The image above shows the **BOJ's monetary intervention** in forex when the yen hit historic lows against the dollar. Notably, the BOJ spent **¥9.8 trillion (~\$62.7 billion)** on this intervention.

What Are the Types of Monetary Policy?

Monetary policy has different types, each affecting the economy differently. Central banks choose policies based on their objectives.



Overview of monetary policy types and their economic impact

Expansionary Monetary Policy

Expansionary monetary policy is typically implemented via **interest rate cuts** or **bond purchases**, increasing **liquidity**.

Central banks use **expansionary monetary policy tools** during recessions to **stimulate GDP** and **reduce unemployment**.

Credit and Liquidity Programs and the Balance Sheet

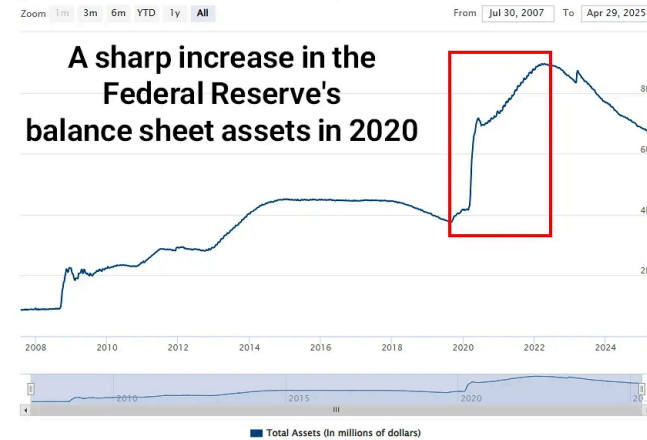


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Recent balance sheet trends

Choose one of the 5 charts.

Total Assets of the Federal Reserve



Sharp rise in the Federal Reserve's assets due to expansionary policy during COVID-19

The image above shows the **Federal Reserve's balance sheet expansion** in early 2020 (Source: federalreserve.gov). This was due to **bond purchases**, an **expansionary monetary policy** combined with **interest rate cuts**, leading to **economic growth**, **lower unemployment**, and **higher inflation**.

Impact of Expansionary Monetary Policy:

- ⚡ **Unemployment Rate:** Stimulates economic growth and demand, reducing unemployment;
- ⚡ **Economic Growth:** Boosts demand, liquidity, and easier credit access, enhancing growth.

Contractionary Monetary Policy

Contractionary monetary policy is usually implemented via **interest rate hikes**, reducing liquidity and weakening demand, which slows economic growth.

This policy is used to **control inflation** or **prevent overheating**.

Impact of Contractionary Monetary Policy:

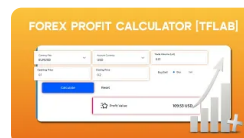
- ⚡ **Unemployment Rate:** Reduces consumer demand and pressures producers, increasing unemployment;
- ⚡ **Economic Growth:** Lowers liquidity and suppresses demand, slowing growth. Prolonged contractionary policies may lead to recession.

Neutral Monetary Policy

Neutral monetary policy maintains interest rates at a level that neither stimulates nor restricts growth. The economy grows at a **steady rate**.

Note: Central banks estimate the neutral interest rate and is not precisely defined.

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Conclusion

Central banks implement **monetary policies** to **stimulate growth, improve labor markets,** or **control inflation.** Tools include **interest rates, bond purchases/sales, reserve requirements, discount rates,** and **credit ceilings.**

Central bank policy stances significantly impact forex, bonds, stocks, **Cryptocurrency,** and commodities. Understanding **monetary policy cycles** helps traders and investors identify optimal opportunities.

FAQs

- What is monetary policy? ▼
Monetary policy refers to central bank actions to **control inflation, unemployment,** and **economic growth.**
- What are the tools of monetary policy? ▼
Key tools include interest rates, open market operations , reserve requirements, discount rates, and **credit ceilings.**
- How does expansionary monetary policy affect financial markets? ▼
It increases liquidity and **risk appetite,** boosting **high-risk markets.**
- How does contractionary monetary policy affect financial markets? ▼
It reduces liquidity, leading to **corrections in risk assets** and a shift toward **low-risk investments like bonds.**



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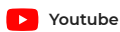
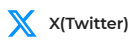


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