Enhancing economic sustainability of financial sector through economic policies

Jaya Shukla\textsuperscript{1,*} and Gaurav Bajpai\textsuperscript{2}

\textsuperscript{1}Kigali Institute of Management Kigali, Rwanda; \textsuperscript{2}KIST, Kigali, Rwanda. Corresponding author: js.jayashukla@gmail.com

Abstract

Economic sustainability is the term used to identify various strategies that make it possible to use available resources to their best advantage. This is done to ensure the use of available resources in a way that is both efficient and responsible, and likely to provide long-term benefits. In the case of a business operation, it calls for using resources so that the business continues to function over a number of years, while consistently returning a profit. Economic sustainability can be achieved through economic policies. Economic policies play an important role in economic sustainability as they are designed according to available resources of economy. This paper investigates with help of secondary date using descriptive statistical technique role of monetary policy in strengthening economic sustainability of financial sector in developing economies. Paper concludes that weak monetary policy can lead to fall of financial sector affecting investment and growth of economy. Paper develops a model based on experience of other countries suitable for developing economies in enhancing their financial sustainability.

**Keywords:** Economic Sustainability, Monetary Policy, Financial sustainability.

1. Introduction

Economic policies play an important role in economic stability and sustainability. Instability can affect the development of economy by affecting major indicators like unemployment, production, investment. Two major economic policies include monetary and Fiscal policy. After failure of Fiscal policy during great depression of 1930’s monetary policy has become an important economic policy for stability (Laidler, 2007). Monetary policy is the policy used by the government of a country to control inflation or deflation in an economy, and this policies is been implemented by the central bank through the ministry of finance. While commercial bank is a financial institution set up for the purpose of keeping depositors money. Monetary policy not only affects availability of credit but also affects expectations leading to inflation. It also affects asset prices, prices of goods exchange rate, consumption and investment. Thus monetary policy has impact on both domestic and global economy.

2. Problem statement

Economic Policies affect the sustainability of economy through economic stability. Recent economic recession has raised doubt on credibility of both fiscal and monetary policies. A growing number of developed economies have fallen into a deep recession. Those in severe public debt crisis moved even deeper into recession, caught in the downward spiralling dynamics from high unemployment, weak aggregate demand compounded by fiscal...
austerity, high public debt burdens, and financial sector fragility. Growth in the major developing countries and economies in transition has also decelerated notably, reflecting both external vulnerabilities and domestic challenges. Most low-income countries have held up relatively well so far, but now face intensified adverse spillover effects from the slowdown in both developed and major developing countries. These spillover effects are due to weak financial sector in developing countries.

A strong central bank provides base of strong financial sector. The central bank tries to maintain price stability through controlling the level of money supply. Thus, monetary policy plays a stabilizing role in influencing economic growth through a number of channels. What monetary policy can do over the long run is ensure low inflation, but bad monetary policy will ensure high inflation and recurrent recessions. The role of fiscal policy in economic stability is small as it is more development oriented and is affected by political ups and downs both nationally and internationally.

3. Importance of monetary policy in developing economies

In developing countries many factors hinder the economic growth. Economic policies are formulated to remove such hurdles for maintaining equilibrium in the economy. Among these policies, monetary policy leads the economy towards economic growth by providing required acceleration. It plays an important role in economic stability required for sustainable economic growth.

Monetary policy in developing countries is framed by Central bank to achieve some objectives of development. To achieve those objectives the central bank guides the expansion and contraction of the quantity of money and credit towards appropriate direction. That is, the central bank will control inflation and deflation as required through monetary policy (Friedman, 1968).

The importance of monetary policy in the underdeveloped and developing countries can be presented as follows:

1. Development of banking and financial institutes
2. Monetization of the rural sectors
3. Development of organized money market
4. Price stability
5. Increase in investment
6. Capital formation
7. Appropriate balance of payments

Instruments of Monetary policy in developing economies for price stability within country include Bank Rate, Open Market operations and Variable reserve ratio.

1. Among various objectives Economic Growth and price stability are more important in line of priority. Developing countries on one hand want high growth at same time price stability as condition for economic stability is more important.
2. Out of various instruments open market operations is less effective in developing countries due to absence of well developed securities market in these countries.
3. Variable reserve ratio with cash reserve ratio has impact on internal investment.
4. Bank Rate or interest rate is more effective instrument for raising investment in developing countries.

Fiscal Policy Vs Monetary policy

In developing countries monetary policy can play an important role in economic stability due to its strengths over fiscal policy like:
Apart from above one reason for higher credibility of monetary policy is effective transmission mechanism. Monetary policy not only influences financial conditions in the economy (not just the costs, but also the availability of credit or banks’ willingness to assume specific risks) but also influences expectations about economic activity and inflation. Monetary policy can affect the prices of goods, asset prices, exchange rates as well as consumption and investment.

Interest Rate Transmission mechanism

Exchange Rate Transmission mechanism

M= Money Supply
i=interest rate
E=Exchange rate
NX= Net Export
Y=Output/Income

Monetary policy and exchange rate for stability

Expansionary economic policy is aiming at enhancing income/output in economy. As shown in figure above expansionary policy increases output but expansionary fiscal policy decrease final output by affecting exports.

Contractionary Monetary policy

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Contractionary economic policy is aiming at reducing income/output in economy. As shown in figure above contractionary policy reduces output but contractionary fiscal policy increases final output by increasing exports.

**Types of monetary Policy for Developing Economies**

*Inflation targeting*
A low inflation rate ranging between 1 and 3 percent is generally considered to be effectively consistent with price-level stability, with the increase in prices merely reflecting growth of economy.

The degree to which explicit inflation targets contribute to the success of price stabilization policies has not been conclusively established. From the records of three inflation targeting economies, Australia, Canada, and New Zealand, and compare them to the US, it is found that the inflation targeting countries have substantially lower inflation pressure and that inflation targeting reduces the size of interest rate changes needed to moderate inflation (Siklos and Weymark, 2009).

![Inflation Targeting](image)

**Price level Targeting**
A stable price level or a low inflation rate is sometimes proposed as the ultimate goal of monetary policy. A fairly stable price level reduces the risks in entering into long-term financial contracts and fixed real investments, and promotes the formulation and realization of optimal saving and investment, which in turn increase output and employment. By comparison, high and variable inflation rates inhibit economic growth by introducing uncertainty into long-term financial contracts and investment (Kahn, 2009).

![Inflation Targeting](image)

Figure 1a shows how an inflation-targeting central bank might respond to an economic shock that caused inflation to rise above the central bank’s inflation target of \( \pi^* \). In particular, if inflation were initially at its 2 percent (per year) target and the inflation shock caused inflation to rise to 3 percent in period 1, the central bank would adjust its policy instrument to push inflation back to its 2 percent.
of above-target inflation would have to be matched by a period of below-target inflation. As a result, as shown in the bottom right panel, the price level would temporarily rise above the 2 percent price path but eventually return to the path as shown on figure 2b. Over the medium term, under a price-level target, economic decision-makers could count on prices remaining close to a predetermined path.

Price-level targeting has a number of features that make it potentially appealing as an alternative to inflation targeting. It reduces uncertainty about the level of prices far in the future. It allows for higher flexibility for developing economies.

4. Suggestions for Economic Sustainability

In developing countries economic stability is very important issue for long term economic sustainability. Economic policies can play an important role in achieving goal of long term economic sustainability. Both fiscal and monetary policies are important. Fiscal policy is growth oriented but being influenced by political factors is unstable especially for countries with unstable governments. Strong Central bank can contribute towards strong financial sector which will lead to price and economic stability in long run.

So there is need for providing more autonomy to central banks in developing economies as they can act as an important economic stabilization agent for developing economies. Central banks to be more effective should try to bring-

1. Complete monetization of economy.
2. Complete control over financial sector of economy including Cooperatives and Micro finance Institutions.
3. Long run objectives of economic stability and development.
4. Complementary policies to fiscal policy of country.
5. Conclusion

Economic policies are important for sustainability for every economy. In developing economies fiscal policies have been less stable as compared to monetary policy. Monetary policies have effective transmission mechanism. Developing countries can achieve objective of sustainable economic development through strong independent central bank. Monetary policy should be complementary to fiscal policy of country.

References


