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Opinion Article

Note on History of Monetary Policy

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DESCRIPTION

Interest rates and credit availability are linked to monetary policy. Short-term interest rates and bank reserves through the monetary base have been used as monetary policy instruments. For many centuries, monetary policy consisted of either changing currency or issuing paper money. While interest rates are currently considered part of monetary authority, they were not always coordinated with other types of monetary policy at the time. The authority with seigniorage was in charge of monetary policy, which was considered an executive decision (the power to coin). The ability to specify the currency value in terms of gold or silver, as well as the price of the local currency in terms of international currencies, arose with the development of broader trading networks. Even if the official price differed from the market price, it might be enforced by law.

In 7th century China, promissory notes known as "jiaozi" gave rise to paper money. Jiaozi were used alongside copper coins, not as a replacement for them. The subsequent Yuan Dynasty was the first to adopt paper currency as the primary medium of exchange. Faced with huge shortages of specie to wage war and retain their control later in the dynasty's reign, they began producing paper money without constraints, culminating in hyperinflation.

The idea of monetary policy as separate from administrative action was established with the establishment of the Bank of England in 1694, which was given the right to manufacture notes backed by gold. The goal of monetary policy was to keep the value of the coinage stable, create notes that traded at par with specie, and keep coins out of circulation. The aim to keep the currency's tie to the gold standard and trade in a narrow currency band with other gold-backed currencies prompted industrialising nations to establish national banks. To do this, national banks began setting the interest rates they charged both their own borrowers and other banks in need of liquidity as part of the gold standard. The maintenance of a gold standard necessitated virtually monthly interest rate modifications.

The gold standard is a system in which the national currency's price is fixed in relation to the value of gold and is maintained by the government's guarantee to buy or sell gold at a predetermined price in terms of the base currency. The gold standard can be seen of as a variant of "fixed exchange rate" policy or a type of commodity price level targeting. In today's world, no government uses this form of monetary policy.

The industrialised nations developed central banking systems between 1870 and 1920, with the Federal Reserve being the last to do so in 1913. By this time, the central bank's role as "lender of last resort" had been established. Interest rates were also becoming more widely recognised as having an impact on the entire economy, thanks in part to a growing understanding for the marginal revolution in economics, which revealed that people's decisions were influenced by changes in their economic trade-offs.

Monetarist economists have long argued that the growth of the money supply has an impact on the macroeconomy. Milton Friedman, for example, argued early in his career for government budget deficits during recessions to be covered in equal measure by money creation in order to assist increase aggregate demand for production. Later, he advocated for merely growing the monetary supply at a modest, constant rate as the best method to keep inflation low and production growth consistent. However, when United States Federal Reserve Chairman Paul Volcker adopted this approach in October 1979, it was determined to be impracticable due to the unstable link between monetary aggregates and other macroeconomic factors. Milton Friedman eventually admitted that direct money supply was not as effective as he had intended.

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