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**MONETARY POLICY IN SMALL OPEN ECONOMY**

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**Abstract:** Money and stabilization are the central problems of macroeconomics and macroeconomic policy today. Since the Great Depression money policy has been getting significant meaning. Dirigible money is created in the true sense of the word, i.e. money that is fully subordinated to the purposes of the national economic policy.

By leaving the automatism of the golden rule regarding the mechanism of the monetary regulation, not just inside the economy but also in the external economy, it led to taking over the responsibility of the state for the development of internal monetary situation and a system of international payment relations, i. e. external liquidity of the economy. The state takes over directly (with the Central bank) the responsibility for the monetary credit policy in general, for the regulation of money supply, and also for the regulation of the basic commodity-money relations inside the economy, the stability of the economy, prices and the exchange rate.

Is monetary policy able to substantially support development, especially in small open economy? Yes. Adequate liquidity with relative price stability, credible monetary institutions and a high degree of confidence in the domestic currency and financial institutions and markets are one of the pillars of sustainable economic development. Small open economies are still far from these standards and still much can be improved.

**Keywords:** monetary policy, money, small open economies

**INTRODUCTION**

In an open economy the conduct of the monetary policy becomes complex because of several circumstances; firstly in open economies, the fluctuation of prices is no more a result of domestic circumstances (domestic demand, domestic rentals etc.) but the inflationary process to a large extent is influenced by the exchange rate through which the effects of the external occurrences are transmitted; secondly in open economies some additional channels appear that affect the creation and withdrawal of money, that the central bank has no longer strong control over the money supply; and thirdly, the stabilization policy in open economies is greatly burdened with the effect of the monetary and real shocks that occur from the external surroundings. Small open economies are in an asymmetric position with regard to the rest of the world because, on the one hand, domestic shocks have no influence on the world economy, and on the other hand, every shock that hits the world has a great impact on the domestic economy.

Yet, the world shocks have influence on the world interest rates and the prices of the exchangeable products and through these variables their effect is transmitted on the small open economies. Furthermore, the effect of the external shocks is especially expressed in developing small open economies because of their specific economy structure where on the one hand, the participation of the intermediary import products is big, and on the other hand, their export is mostly concentrated on one or few products. The response of the monetary policy to the effect of the external shocks depends crucially on several circumstances such as: the type of external shock, the duration of external shock, the preferences of the policy holders, the time distribution of the effect of the monetary policy, credibility etc.

In the macroeconomics new consensus on the monetary policy is settled: high stability in prices as a base priority of the monetary policy; zero inflation rate is undesirable, because it makes the structural adjustment of the economy difficult and creates inefficient monetary policy in the time of the depression; the political independence of the central bank vis a vis the government and its credibility and accountability are an important assumption for maintaining of a low inflation rate; monetary policy based on the rules is preferred over discretionary monetary policy and the central banks with more independence vis a vis political authorities with monetary policy founded on the rules could solve the problem of inconsistency of the policies over time.

Namely, on the one hand new theories of business cycles emerged: business cycles determined by the unanticipated changes in the money supply, i.e. monetary surprise, the theory of real business cycles, business cycles determined by political elections.

Over the last few years these changes and breakthroughs of the contemporary macroeconomics have contributed to an increase in the number of scholars of this sphere who believe that the monetary policy should be founded on

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long-term rules, although part of the most controversial ones continue to exist and they are subject to further discussion.

Nevertheless, it seems that regarding the possibilities, the limits and the efficiency of the monetary policy, the macroeconomists today are closer to consensus, than they were twenty or thirty years ago.

This kind of turning point in the monetary policy is connected to the latest discussions in the theory on further crucial questions:

- 1) The only purpose of the monetary policy is stability of prices and equilibrium of balance of payments and should this purpose be the only one (the balance and the stability of the exchange rate), i.e. just to complement the relation income – expenditure for regulation of the employment, economic growth and regional (structure) development;
- 2) What is the nature of the monetary process and the domain of operation of the monetary policy regarding other regulative measures of the economic policy;
- 3) In a strategic performance, what are the limits of the functioning of that policy and every economy should take responsibility for those limits when certain measures are implemented, i.e. when there is an upheaval in the general orientation, i. e. to deliberately regulate money flows.
- 4) To what extent the monetary policy could be a factor of initiating development, and to what extent could be a factor of initiating inflation;
- 5) What is the mechanism of transmission of the monetary operation in the economy;
- 6) Which instruments of the monetary regulation are more efficient in certain phases of the development of the economy, which are less efficient –especially when choosing strategy of the monetary policy.

The monetary- credit policy is a relative category that has its content and meaning only if it is considered together with the objectives of the other sectors of the economic policy and it is successful only when the measures of the monetary–credit policy are complementary and well-timed with the measures of the other sectors of the economic policy.

The modern macroeconomic theory starts from the assumption of the indispensability of the state intervention in the economic mechanism in order to remove: a) the inflation or the general increase of the prices, i. e. market-monetary instability, b) massive unemployment and low level of national income and c) to ensure sufficient high rate of growth and a structure of development of the economy.

Because the economy is a very complex dynamic system with numerous reflexive correlations , it is not possible to find a solution for the economic stabilization using a control mechanism that will constantly hold it in a dynamic stability or will bring it back in this kind of a position, and because of that, there is a necessity of integrating the policies.

The monetary policy is part of the instruments of the general economic policy whose primary objective up until recently was regulating only the necessary money supply in the economy.

Thus, creating and withdrawal of money with the objective of free development of the process of production, distribution and consumption is the primary role of the monetary credit policy. It needs to ensure optimal monetary conditions for normal development of the actions of extended reproduction.

However, by adopting the policy of “ active money” and using money as a means of accomplishing certain developing and other objectives in the economy , the monetary policy gets other numerous tasks. Foremost with its selective operating on certain forms of production, consumption (connected to deficit financing) especially affecting the import, it significantly affects the structure, the time and the stability of the economic development.

The monetary policy commonly attaches to the movement of the social product. The character of the monetary policy is determined by the relation between the rate of increasing the social product and the money supply.

Namely, if the increasing rate of the money supply is greater than the increasing rate of the social product in that period, an expansive monetary policy is conducted, and if it is lower, then a restrictive money policy is conducted.

With a monetary infusion in the economy through an expansive monetary policy in the struggle against recession and crisis, as well as with the other complementary measures of the macroeconomic policy, the aggregate demand can be increased relatively fast and easily and for a short period of time, leading to balancing the aggregate demand and supply. However the stability and the balance cannot be sustained without economic growth in a long term, and as a result of that, there is an increase of the aggregate supply, and also an adequate actuality in the balance of payments.

All of this needs to be taken into account when it is approached to an expansive monetary policy and creating primary money and money supply over the balance level (objectively necessary amount of money).

Contrary to the expansively conducted monetary policy, the contractionary policy needs to diminish the money supply in circulation by hardening the conditions of crediting and by other instruments that are restrictively set.

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There is a policy of expensive money i.e. commonly said, a restrictive credit policy.

The sterilization of the excess of money, by limiting the increase of credits of the banks, should diminish the purchase power of the population that will lead to overheating the demand. The increase of money demand must be adjusted to the increase of GDP. The limiting of the bank credits and the restrictive policy of the open market are the ones that have a crucial role in controlling of the inflation. The decreasing of the public consumption and a moderate growth of personal demand should lead to calming the conjuncture. The restrictive monetary policy needs to ensure strengthening the foreign currency reserves and the policy of stable exchange rate.

The attempt of getting a financial stability exclusively through limiting the global money demand probably will lead to a greater loss in the increase rate and the employment.

The general credit restrictions, that are anti-inflationary directed, in most cases do not lead to stability, but they regularly affect the growth rate, so they should be administered carefully and in defined dosages.

Steady and rightly dosed contractionary policy of money and credits should lead to decreasing or removing the inflationary process, though the chances in theory and reality are very small when it comes to modern inflation. The problem of contractionary policy is that the decreasing of prices reacts not flexibly enough on the decreasing of money supply and the purchase power demand and that should be an assumption for greater efficiency in this policy.

To put it simply, the essence of this concept illustrated in the example of the monetary policy can be seen in the following: the government and the central bank are determined on maintaining a low level of inflation, in the interest of all the citizens and to declare that to the public. Thus, the participants in the economic life expect high price stability (low inflation rates), and therefore there will not be a demand for a pay raise and increasing the prices of the other inputs of the production (raw materials, energy and so on) That is good for the businesses.

But in this case the government and the central bank can be tempted to increase the inflation rate through a more liberal monetary policy so that they can decrease the unemployment temporarily. But, thanks to the rational expectations, the participants of the economic life will quickly realize the intentions of the government and the central bank and they will adjust their behavior to the new situation.

The expectations of higher inflation (increase of prices) will be inserted in the prices of the products and services by the managers, and the employees will ask for a pay raise. With the pay raise, the employment will return to its earlier level. Obviously, because of the inconsistency of conducting the economic policy through time (the bearers of the economic policy stated low inflation rate but later they were not consistent and they abandoned that kind of policy), the announced policy of low inflation loses its credibility, and also the credibility of the institutions, which are in charge of implementation of the announced policy, is diminished.

The theory of determination of the business cycles by the political elections starts from two general assumptions: **firstly**, the voters have short memory and are strongly affected by the economic situation right before the elections, and **secondly**, the government knows how to use the monetary and the budget policy that will cause recession. However, before the beginning of the next elections, the government will lead an expansive monetary and budget policy and it will succeed in increasing the production and the employment for a short period of time.

The voters will think that the government has succeeded in putting the economic situation under control, and because of that they will entrust it a mandate. The common congruence of the length of the economic cycle (4-5 years) with the election process is used as an argument for the validity of this theory. In addition, a greater flexibility in the basic strategic acting is required from the monetary policy that in the case of using money and credits for a number of non-economic purposes is very difficult.

Today, in the monetary regulation and the monetary policy, there is a certain overturn especially under the impact of the process of the liberalization and deregulation with a transition from selective (qualitative) of the quantitative or global (indirect regulation). It is connected directly to the deregulation of the money market and the capital market.

It is considered that the change of the system of the monetary regulation will help with the increasing of the efficiency of the monetary policy regarding the goals of stabilization (the question remains open also for the goals of development and structure) and with the process of deregulation, it will provide more flexible management of the policy of managing the interest rate – that will lead to increasing of saving and more efficient investments.

The central bank is not in a position of affecting the sector formation of money supply (that is a result of distribution of income and money flow in the system), but it affects the money form insignificantly, thus the global regulation of money supply is not an important indicator for its success and efficiency and the real supply of the economy with the money supply and credits. In this case there has been a necessity of another concept for a long time.

Global and structural (selective) monetary policy must be managed only with flexibility and orientation. That means that not only the global and the macroeconomic effects are sufficient but also the structural effects of the money flow. Complete control of the credit supply is possible and necessary. The central bank should put under control or

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eliminate all illegal and uncontrolled money flow and without this, the management of efficient and controlled monetary policy is not possible.

Despite that, the basic channel of primary emission is the credits of the state and foreign exchange transactions. It is not possible to manage efficient monetary policy through this flow when there is a great deficit of the balance of trade, while the foreign exchange reserves are created exclusively from the transactions with the population sector. Holding the control of the money supply leads to unfavorable sector structure (greater growth of cash in the sector population, thus less efficient monetary policy).

### CONCLUSION

The basic question that is commonly asked in the managing of an active monetary policy is to what extent the monetary factors within the rest of the development factors can affect the economic growth, i. e. to what extent they can be stimulators or limiting factors for the optimization of economic development. The reasons for this is the fact that in the monetary theory the consideration of the role of money and credits changed greatly- from money and credits as basic instruments in the regulations of economic flow and the means of stabilization, to rejecting the belief of an active role and the common disbelief in the efficiency of the monetary policy in the regulation of real economic flow (production, investments, employment, export, import, growth of the gross domestic product etc.)

What remains to be done is to confirm the answers to the questions.

The monetary policy has great limitations in accomplishing the defined objectives as well as in the operational managing and the choice of measurements and finally the expected effects. It is about several basic limitations which narrow the range of operating of the monetary policy:

- 1) Balance of payments flows and change of foreign exchange reserves (creation of money and capital);
- 2) Great participation of import and export in the economy (openness of the economy) which fundamentally changes the relations of the domestic commodity market (supply of goods and services) and the money market.
- 3) The structure of GDP and the dominance of financial services, trade and so on which mostly are not affected by the acting of the monetary and credit policy;
- 4) The structure of money supply M1 is under the dominant influence of the distribution, a separate participation of the public sector (taxes, expenses, fees, customs, and public debt) and the sector population.

The sector scheme, and also the amount of money supply are under the dominant influence of the exogenous factors on which the monetary policy cannot act upon.

The money flow is created ex post under the effect of the above-mentioned factors. . Efficient instruments of the monetary policy cannot be built on a completely distorted composition of the function of the total consumption and demand and to determine and apply a correlated adjustment of the prices of the factors (salaries, interest rates, exchange rates, amortizations) they must be reciprocally nullified or mutually stimulated.

It could be clearly seen how firm the influence of the monetary policy is, and thus its efficiency in accomplishing the defined goals.

The central bank must decrease the influence of those limitations, and together with the commercial banks, they must focus the credit policy and the other instruments on the economy sector. Prepared erupted changes in the monetary –financial flows are necessary but also in the conjuncture of the small open economies (because without development all the above-mentioned measures would mostly have short-term effects

The macroeconomics that is in unfavorable surrounding and financial disagreement it must be reoriented from a concept that is deflationary -crises to a concept that is offensively developing.

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