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A Conceptual Review On The Impacts Of Monetary Policy On Banking Liquidity

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Abstract

The paper discusses the conceptual issues on the impacts of monetary policy on the liquidity of financial institutions. The main objective of the paper is to provide conceptual evidence that monetary policy affects bank liquidity. Conceptual issues were reviewed by several authors from a macroeconomic and financial perspective. The paper further reviewed six transparent guidelines for the central bank of Cameroon (BEAC) as it formulates monetary policy in the country. The paper concluded that financial institutions must remain contingent to monetary policy adjustments and ensure proper liquidity management techniques to mitigate liquidity risks.

Introduction

The global financial crisis reveals some problems associated with the liquidity of many financial institutions. It is commonly said that the backbone of every economy depends on its financial institutions. This is because these financial institutions serve as providers of money and other financial assets to the economy. Also, they act as employment opportunities for many peoples. Again, they enhance and promote economic growth and development in the country.

During the recent financial crisis in the CEMAC ZONE, many banks run out of cash in order to adequately perform their functions profitably. Some raised funds with a large discount in order to encourage depositors and debtors of loans. This crisis coupled with the recent Anglophone crisis in Cameroon slowed down the turnover of many businesses. As a result, the profit level fell. This downturn in the economy affected many financial institutions in the Anglophone regions of Cameroon which depended on the regular savings of many business entrepreneurs. Thus, some financial institutions have started revisiting their governance policies as a medium to accumulate their liquidity risk exposures. The Central bank of Cameroon (BEAC), since its independence, formulated excellent monetary policy in order to revamp the deficiencies in Cameroon's financial institutions (Aaron,2008). More recently, was the formulation of expansionary monetary and economic policies in order to revamp the economic crisis in the country. When the central bank formulates an expansionary monetary policy, it increases the supply of money and reduced interest rates. This has an effects on banks liquidity. It is an obvious fact that banks profit is of great importance. Over the years, many banks have adopted several approaches in order to solve liquidity risks faced by the banks. Among return on investment, return on assets and net interest margins, liquidity management is the most widely and commonly used approach to solve liquidity risk exposures in the banking industry(Aaron,2005). With this in mind, liquidity management is very crucial for the effective standardization of liquidity regulations in the banking sector.

Mistakes in bank liquidity planning and implementation can affect banking operations. This might exhibit long-term operations in the economy. Profitability does not translate to liquidity in all cases. Thus, liquidity should be managed in order to obtain an operational level. That is, a level that avoids shortages and excesses of liquidity (Bassis Joel,2010). Liquidity management plays a significant role in the overall performance of the banking sector. Bank managers must be sensitive to identify, measure and control liquidity risk scenarios in the bank. This is because a mismatch in the assert and liabilities of the bank may affect the liquidity position of the bank(Daniel,2017). Many banks have high investments in illiquid assets but are tied up in loans. Some banks despite having lots of assets faced the challenges of sudden withdrawal of cash and thus, fall out of liquidity(Edem,2012). This has been identified as the major cause of bank failure in Island bank in Nigeria in the year 2008. The paper discusses the literature reviews on the impacts of monetary policy on banks' liquidity.

2.1: Conceptual Review

2.1.1: Definition of monetary policy

Monetary policy is the macroeconomic policy laid down by the central bank. It involves the management of money supply and interest rate and is the demand-side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth, and liquidity (Pajara,2001).

Monetary policy is a set of actions to control a nation's overall money supply and achieve economic growth. Monetary policy strategies include revising interest rates and changing

bank reserve requirements. Monetary policy is commonly classified as either expansionary or contractionary (Duh.H,2006).

Monetary policies are tools used by central banks such as the reserve requirement, open market operations, the discount rate, and interest on reserves. Most central banks also have a lot more tools at their disposal.

Monetary policy is a set of tools used by a nation's central bank to control the overall money supply and promote economic growth and employ strategies such as revising interest rates and changing bank reserve requirements (Bake Itoe, 2003).

Monetary policy is a set of actions to control a nation's overall money supply and achieve economic growth.

Monetary policy strategies include revising interest rates and changing bank reserve requirements.

Monetary policy is commonly classified as either expansionary or contractionary. The Federal Reserve commonly uses three strategies for monetary policy including reserve requirements, the discount rate, and open market operations. In the United States, the Federal Reserve Bank implements monetary policy through a dual mandate to achieve maximum employment while keeping inflation in check (FRS,2000).

Monetary policy is the control of the quantity of money available in an economy and the channels by which new money is supplied. Economic statistics such as gross domestic product (GDP), the rate of inflation, and industry and sector-specific growth rates influence monetary policy strategy(Bank of England,2005). A central bank may revise the interest rates it charges to loan money to the nation's banks. As rates rise or fall, financial institutions adjust rates for their customers such as businesses or home buyers. Additionally, it may buy or sell government bonds, target foreign exchange rates, and revise the amount of cash that the banks are required to maintain as reserves.

2.1.2: Types and Goals of monetary policy

Monetary policies are seen as either expansionary or contractionary depending on the level of growth or stagnation within the economy.

Contractionary

A contractionary policy increases interest rates and limits the outstanding money supply to slow growth and decrease inflation, where the prices of goods and services in an economy rise and reduce the purchasing power of money.

Expansionary

During times of slowdown or a recession, an expansionary policy grows economic activity. By lowering interest rates, saving becomes less attractive, and consumer spending and borrowing increase(Thomas Brock,2022).

Goals of Monetary Policy

1. Inflation

Contractionary monetary policy is used to target a high level of inflation and reduce the level of money circulating in the economy.

2. Unemployment

An expansionary monetary policy decreases unemployment as a higher money supply and attractive interest rates stimulate business activities and expansion of the job market.

3. Exchange Rates

The exchange rates between domestic and foreign currencies can be affected by monetary policy. With an increase in the money supply, the domestic currency becomes cheaper than its foreign exchange.

Tools of Monetary Policy

1. Open Market Operations

In open market operations (OMO), the Federal Reserve Bank buys bonds from investors or sells additional bonds to investors to change the number of outstanding government securities and money available to the economy as a whole. The objective of OMOs is to adjust the level of reserve balances to manipulate the short-term interest rates and that affect other interest rates.

2. Interest Rates

The central bank may change the interest rates or the required collateral that it demands. In the U.S., this rate is known as the discount rate. Banks will loan more or less freely depending on this interest rate. The Federal Reserve commonly uses three strategies for monetary policy including reserve requirements, the discount rate, and open market operations

3. Reserve Requirements

Authorities can manipulate the reserve requirements, the funds that banks must retain as a proportion of the deposits made by their customers to ensure that they can meet their liabilities. Lowering this reserve requirement releases more capital for the banks to offer loans or buy other assets. Increasing the requirement curtails bank lending and slows growth (Thomas Brock,2022).

2.1.3: Monetary policy in Cameroon

1. Monetary policy in Cameroon is conducted by the BEAC, and aims to maintain the external and internal value of the currency. Foreign reserves function as an intermediary monetary target, while the operational target consists of a series of BEAC refinancing limits for each country of the union.

2. The interest rates charged on these refinancing operations are used as instruments. A maximum degree of transparency in such a policy framework can be beneficial, but is not crucial, especially not given the nascent stage of financial market development and the limited monetization of the CEMAC economies. As a result, transparency towards the general public has traditionally not been a top priority for the BEAC. However, the BEAC has ensured a high degree of transparency toward the governments of its member states.

3. For the four broad areas covered in the Code of Good Practices on Transparency in Monetary and Financial Policies (clarity of roles, responsibilities, and objectives; the process for formulating and reporting of policy decisions; public availability of information; and accountability and assurances of integrity), the BEAC overall demonstrates a fairly high degree of transparency.

4. The roles, responsibilities and objectives of the BEAC, are clearly defined in its statutes, in the Treaty on the Central African Monetary Union and in the Treaty on Monetary Cooperation between the member states of the BEAC and the Republic of France. The only practice that is not fully observed is the requirement that central bank involvement in the rest of the economy should be conducted in an open and public manner (1.2.4). The rules for such involvement are kept internal.

5. There is room for improvement in the area of open process for formulating and reporting monetary policy decisions. In particular, the BEAC could better communicate the monetary policy framework (instruments and final, intermediary, and operational targets as well as the relationships between those), and explain its general monetary policy stance and specific decisions within that framework. The publication of a reference paper explaining and motivating that framework in detail could be a useful tool to enhance the transparency of

the monetary policy decision-making process. Some practices are not fully implemented (advance publication of the calendar of Board meetings, publication of practical rules and procedures regarding monetary instruments and relations with counterparties). An evaluation of progress toward the realization of monetary policy objectives is completed only once a year, in the annual report. It would be useful if the BEAC could increase the frequency of these evaluations, and, for example, publish one after every Board meeting is held. The current practice of organizing consultations prior to substantive technical changes in the structure of monetary regulations could be formalized.

6. With regard to the public availability of information, the BEAC has an appropriate range of publications, but some of these publications have been issued with lengthy delays in the recent past, and thus have not been very useful as a means of providing the public with timely information. To avoid unnecessary delays, the BEAC should establish firm deadlines for the monthly bulletin. Consideration could be given to separating the monthly statistics from the research papers. To avoid that overdue research papers and delay the publication of statistics. The BEAC should also consider publication of its accounting guidelines, to the extent possible without releasing confidential information. Communication with the general public could be enhanced by introducing sessions in the parliaments of the member states for the governor to explain monetary policy and developments.

7. There are some areas for improvement with regard to accountability and public assurances of integrity. In general, the BEAC could make available non-sensitive parts of its internal regulations for public scrutiny. This would reinforce confidence in the BEAC, and would give an incentive to control the quality of internal regulations. The BEAC member states could consider granting some kind of immunity to all BEAC staff, for their decisions taken in the exercise of their duty(FSAC,2000).

2.1.4: Monetary policy and bank liquidity

Liquidity management concerns the trade-off between holding high-yield illiquid loans and low-yield liquid assets. By influencing this trade-off, monetary policy affects the supply of credit and gives rise to a credit channel. These credit channels lead to an inflow of cash which raises liquidity (Jomo Katie,2001).

Monetary policy increases liquidity to create economic growth. It reduces liquidity to prevent inflation. Central banks use interest rates, bank reserve requirements, and the number of government bonds that banks must hold. All these tools affect how much banks can lend.

First, banks can obtain liquidity through the money market. They can do so either by borrowing additional funds from other market participants or by reducing their own lending activity. Since both Does monetary policy work in a liquidity trap?

In Cameroon, a decrease in interest rates encourages spending, but in a liquidity trap, the change in the money supply does not change spending habits. Therefore, the use of monetary policy is ineffective actions raise liquidity, we focus on net lending to the financial sector (Baron,2006).

The rising interest rate is caused by inflation within the CEMAC region. The financial system suffers from the political and economic crisis which lowest investments, demand money from households. There is high indebtedness from households, credit defaults and banks suffer from high financial risks. The financial system is very closed with high living costs, unemployment and poverty (Ndenka A,2009).

conclusion

Cameroon's banking system is affected by monetary policy from the bank of central African states. Since 2010, when there was a monetary policy adjustment, Cameroon financial institutions have gone through liquidity risks due to the macroeconomic effects of monetary policy on the cash inflows of the banking institutions. While interest rates on credit rises, it narrows the channels of credit for productive investments. The economy equally suffers of high inflation rate coupled with a high rate of unemployment that reduces income causing a low standard of living. Due to a lack of sufficient supply of money, the financial institution struggles to create more liquidity through stock purchases and long-term investments. Thus, liquidity remains a major setback in the banking sector since the adjustments of monetary policy in 2010. It is recommended for banks to ensure proper liquidity management techniques to mitigate liquidity risks caused by contractionary monetary policy so that they can remain solvent and persistent in the banking sector.

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