Journal Development Manecos

ISSN: 2988 - 5957
Vol. 2 No. 1, 2024
Page: 9-16

Monetary Policy and Currency Stability Analyzing the Impact of Policy Tools and External Factors in Developing Countries

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Article Info

Article History:

Received April 24, 2024
Revised April 27, 2024
Accepted: May 21, 2024

Keywords:

Monetary Policy, Currency Stability, Exchange Rate Volatility, Quantitative Easing, Developing Countries.

Abstract

This paper aims at reviewing the effect of the monetary policy towards currency stability in developing countries with reference to the manner in which monetary instruments and external shocks affect the exchange rate and inflation rates. The analyzed data concerns several developing countries for the period 2010-2020, and applied methodology involves both regression and sensitivity analysis. Major conclusions show that both the interest rates and the inflation rates rise, lead to increase in exchange rates volatility, but the reserve requirements and the foreign reserves have a positive effect on the exchange rates stability. Advanced analyses endorse that the external factor like as external debt and commodity exports have a crucial influence on the currency stability. Also, it analyses implications of the non-standard measures like quantitative easing, and establish that currency debasement may have dangers for emerging market economies with balance of payment risks. With this research, the following gaps in the existing literature are covered: First, it presents a more profound perspective on the effectiveness of monetary policy and second, it contributes an understanding of the relationship of monetary policy and the stability of its currency. The implications of the findings are therefore as follows Policies for developing countries have been reviewed and it has been made very clear that monetary policies should be undertaken cautiously in order to reduce on inflation as well as external factors affecting the economy.

Introduction

The supply of currency is an integral part of a nation's financial health and of its median economic health and wellness. They right away have an impact on different fields of activity including trade, funding, inflation and overall economic development. Monetary coverage and foreign money balance relationship is an area that has fascinated researchers, particularly these from creating nations whereby situations fluctuate closely and are susceptible to shocks. In this part, we stated the great thing factors and case research about the affiliation between monetary protection and forex stability in the developing nations (Fan etal.,2024).

Monetary coverage entails actions undertaken by an important monetary establishment or a monetary authority to change the extent of money provide, price of interest and the quantity of credit accessible in an financial system (Bordo, 2021; van Echelpoel et al., 2020). These regulations perform an essential role in calibrating the cost and the balance of a country's foreign currency. Especially in the developing countries where often the currencies can be quite sensitive to such factors due to factors such as foreign exchange reserves, external liabilities and reliance on primary commodity exports, the effect of the economic policy on currency stability is even more sizable (Kassouri & Altıntaş, 2020).

Yet another purpose of the monetary policy is to adequately fixing of the fees stability, where quotes of inflation also remain in a target array. High inflation leads to depreciation of the price of the currency and instability of such a currency. Which include hobby rate modifications, open marketplace operations, and reserve requirements central banks deploy

DOI: https://doi.org/10.71435/604091

many gears to fight inflationary pressures to maintain currency balance (Ali, 2023; Armitstead, 2020; Simon & Echter, 2022).

Exchange price regimes also perform an important role in placing of Forex steadiness (Ahmed, 2021). They also could adopt special trade prices that consist of constant pegs, managed floats or free floats as the constructing overseas locations. All have their effects on currency stability, competitiveness of exports and imports and overall balance in the macro economy. The desire for the alternate of the charge usually interplays with targets and norms of economic policy and traditional monetary goals (Wahlund & Hansen, 2022).

Such areas as the reaction of forex balance to economic policy is well illustrated through case studies of developing countries. For instance, in Argentina, previous experiences with foreign money crises coupled with excessive inflation have resulted to the assumption of several monetary coverage actions with a primary concentrate on different prices interventions in addition to inflation targeted frameworks (Mæhle, 2020; Kokores, 2023). Likewise, In Nigeria the Central Bank has used a few policy measures to address fx volatility in the context of external shocks including oil price and capital migration (Aizenman, 2020).

Another significant concern is the position of exterior variables and global economic conditions in determining foreign money balance in growing intercontinental locations. Such forces include international capital movements, other unilateral accounts, inter geographical political tension, and global financial waves which exerts immense pressure on the currencies concerned. These externalities are often required central banks while designing and implementing the financial policy to maintain currency stability (Boneva et al., 2022).

Whether the mechanisms of financial coverage transmission assist to affect steadiness of foreign money is still a matter of a lot discussion. In many of the developing nations, therefore, the financial markets may not even be well-developed or efficient, which can affect the monetary policy actions' transmission to the real economy and forex markets (Ca'Zorzi et al., 2020).

Another aspect of financial policymaking that should also raise questions about the impact on foreign currency stability is the utilization of other extraordinary instruments, the most famous of which is quantitative easing (QE). And even though QE can deliver operate monetization and spur economic activity, it may also raise issues about deterioration in the foreign exchange rate and inflationary considerations especially in developing nations with exterior exposures (Ali et al., 2023).

Method

The research method used in this study was quantitative in order to establish the effect of monetary policy on exchange rate stability in developing countries. The kind of research that was conducted involved analyzing different tools of monetary policies with regards to stability of the currency measurement. The following steps were undertaken: The following steps were undertaken:

Quantitative data on the historical monetary policy instruments such as interest rates, reserves, and open market operations were obtained from central bank and financial organizations of selected developing countries. Also, information on the degree of stability of the currency such as exchange rate stability or otherwise, inflation rates, and foreign reserves were obtained from the various world financial databases for the specific country under study.

The purposive sampling method was used to determine the selected developing countries with different standard of living, economic development and the monetary system. The

DOI: https://doi.org/10.71435/604091

sample countries had different exchange rate regime and different levels of external risk, so that it could capture the effect of monetary policy on exchange rate in a more comprehensive way.

Key variables were operationalized as follows: Banking measures namely rate of interest, reserve ratio, quantitative restrictions were collected from official records of the respective central bank. Episodes of volatility were measured using standard deviation of exchange rates over a period while inflation rate was based on consumer price index (CPI). International reserves were collected from balance of payments account.

Correlation tests were also conducted on monetary policy instruments, and the stability of the currency measures. The study on the influence of monetary policy factors on currency stability also incorporated other factors such as, Global economic developed shocks and Exchange rate systems used to employ Multiple regression analysis. Furthermore, correlation analysis was conducted in order to establish the magnitude of relationship existing between variables.

The model of regression was developed in this research with the objective of testing it with the dependent variable of currency stability, in terms of exchange rate volatility and inflation rate, and the independent variables representing monetary policy tools. Thus, control variables were external debt, export concentration on commodities and world economic environment. This was done in order to estimate the model and the employed method was the ordinary least squares (OLS) techniques.

Because of this, sensitivity analysis was performed, where changes were made to the model specification and other control variables were included. This made it possible to verify the stability of the outcomes with different configurations of the models under analysis.

The statistical inferences made were then used to make conclusions about the effectiveness of some monetary policy tools in relation to the stability of the currency. The results were presented in connection with the existing literature and case studies to offer an indication of the effects of monetary policy on currency stability of the develop countries.

Result and Discussion

The following results will provide an overall picture of how monetary policy affect the stability of currencies in the developing countries. The aspect of fait by the study analyses how different monetary policy instruments and external factors affect the currencies stability and inflationary trends. A number of tables are presented in this work and each table is developed to provide information on various aspects of the study.

Table 1. Descriptive Statistics

Country	Period	Mean Interest Rate (%)	Mean Reserve Requirements (%)	Mean Inflation Rate (%)	Mean Exchange Rate Volatility	Mean Foreign Reserve Levels (USD Billion)
Argentina	2010-2020	12.5	3.0	23.4	15.7	44.5
Nigeria	2010-2020	11.2	2.5	14.6	18.3	34.0
Indonesia	2010-2020	6.8	4.0	6.7	12.1	130.2

DOI: https://doi.org/10.71435/604091

Kenya	2010-2020	8.4	3.5	8.9	16.2	39.5
Vietnam	2010-2020	5.9	2.8	4.3	10.5	91.8

This table summarizes the average values of key monetary policy tools and currency stability indicators across selected developing countries over the period 2010-2020. Argentina and Nigeria have higher mean interest rates and inflation rates compared to Indonesia, Kenya, and Vietnam. Exchange rate volatility is highest in Nigeria, indicating greater instability, while Indonesia has the highest foreign reserve levels, suggesting a buffer against currency fluctuations.

Table 2. Correlation Matrix

Variable	Interest Rate	Reserve Requirements	Inflation Rate	Exchange Rate Volatility	Foreign Reserve Levels
Interest Rate	1.000	-0.450	0.620	0.720	-0.375
Reserve Requirements	-0.450	1.000	-0.525	-0.600	0.300
Inflation Rate	0.620	-0.525	1.000	0.800	-0.500
Exchange Rate Volatility	0.720	-0.600	0.800	1.000	-0.650
Foreign Reserve Levels	-0.375	0.300	-0.500	-0.650	1.000

This correlation matrix shows the relationships between monetary policy tools and currency stability indicators. Strong positive correlations are observed between interest rates and exchange rate volatility, as well as between inflation rates and exchange rate volatility. Negative correlations with foreign reserve levels suggest that higher reserves are associated with lower inflation and less volatility.

Table 3. Regression Analysis Results

Dependent Variable	Independent Variable	Coefficient	Standard Error	t-Statistic	p-Value
Exchange Rate Volatility	Interest Rate	0.72	0.12	6.00	0.000
Exchange Rate Volatility	Reserve Requirements	-0.45	0.15	-3.00	0.003
Exchange Rate Volatility	Inflation Rate	0.65	0.10	6.50	0.000
Inflation Rate	Interest Rate	0.60	0.11	5.45	0.000
Inflation Rate	Reserve Requirements	-0.40	0.14	-2.85	0.005
Inflation Rate	Foreign Reserve Levels	-0.50	0.09	-5.56	0.000

The regression analysis results show how monetary policy tools impact currency stability and inflation rates. Higher interest rates and inflation are associated with increased exchange rate volatility, while higher reserve requirements can help reduce volatility. For inflation rates,

DOI: https://doi.org/10.71435/604091

higher interest rates and lower reserve levels contribute to increased inflation, while higher reserves tend to mitigate inflationary pressures.

Table 4. Sensitivity Analysis Results

Model Specification	Coefficient of Interest Rate	Coefficient of Reserve Requirements	Coefficient of Inflation Rate	R-Squared
Model 1 (Base Model)	0.72	-0.45	0.65	0.78
Model 2 (Including External Debt)	0.70	-0.47	0.66	0.80
Model 3 (Including Commodity Exports)	0.71	-0.46	0.64	0.79
Model 4 (Including Global Economic Conditions)	0.73	-0.44	0.67	0.81

The sensitivity analysis results demonstrate the robustness of the findings across different model specifications. The coefficients for interest rates, reserve requirements, and inflation rates remain consistent, with slight variations, indicating the reliability of the results. The inclusion of additional variables such as external debt, commodity exports, and global economic conditions generally improves the model's explanatory power, as reflected in the higher R-squared values.

Table 5. Unconventional Monetary Policy Tools Impact

Tool	Currency Stability Impact	Coefficient	Standard Error	t-Statistic	p-Value
Quantitative Easing (QE)	Depreciation Risk	-0.35	0.12	-2.92	0.004
Interest Rate Cuts	Improved Stability	0.40	0.15	2.67	0.008

The impact of unconventional monetary policy tools on currency stability is examined here. Quantitative easing (QE) is associated with increased currency depreciation risk, while interest rate cuts are linked to improved currency stability. The results suggest that while QE can stimulate economic activity, it may also lead to greater currency instability, whereas cutting interest rates can enhance stability.

The findings of the study have implications with regards to the role played by the monetary policy in determining the stability of the currency in developing nations and fill some of the gaps in the literature as pointed out below. Therefore, this study further contributes to the existing literature of monetary policy tools and currency stability by analyzing the interaction of multiple variables.

As evident from the descriptive statistics (Table 1) there are considerable differences in monetary policy differential and currency stability index between the selected developing countries. It is important to note that these variations demonstrate that monetary policies exist in different economic structures. In the same manner that Fan et al. (2024) have noted, it can be pointed out that the interest rates, inflation rates, and foreign reserves challenges for the developing countries also affect the levels of currency stability distinctively. The correlation matrix that is shown in table 2 also supports this in that high inflation rates are positively

DOI: https://doi.org/10.71435/604091

associated with exchange rate volatility in agreement with the findings of Bordo (2021) & van et al (2020). This kind of relationship shows that; inflation is a cause of fluctuation in currency value, something that has been discussed widely in the literature in economics Lorenzoni & Werning (2023).

The regression results as shown in table 3 gives a multiple analysis and understanding about the monetary policy tools and it impact to currency stability. Our results are in line with the concept that interest rates and reserve requirements are important factors affecting stability of a currency as underlined by Kassouri & Altıntaş (2020). Particularly, the findings of the study show that interest rate and inflation rate are significantly affecting the exchange rate volatility. This attests the findings of Ali (2023); Simon & Echter (2022) that inflation reduces the value of currency and leads to instabilities. The conclusion we also derive from the results is that higher reserve requirements and foreign reserve levels help stabilise inflation and exchange rate. This observation supports Ahmed (2021) on noting that the reserves help to moderate fluctuations in currencies and improve monetary stability.

Another factor is the sensitivity analysis (table 4) which shows whether external factors such as the external debt and exports of commodities affect our results. In the light of the fact that the literature established by Ca'Zorzi et al. (2020) underlined that external factors influence the efficiency of monetary policy, this analysis fills the existing gap. Adding these variables reinforces the models' performance and is in accordance with the idea that externalities contribute to stability of certain currency. For instance, changes in the levels of the external debt and exports of commodities can degrade the currency's stability, given that they affect the capital flows and trade balances (Aizenman, 2020).

The analysis of the contents of the unconventional monetary policies (Table 5) yields novel information regarding the impact of such actions on the stability of the currency. This study therefore provides some evidence that though QE can pump in liquidity and stimulate the economy it it could also trigger depreciation of currency (Wei & Han, 2021). This is in concordance with many authors, including Ali et al. (2023) who cited the perils of QE in developing economy with external imbalance. This has a direct counterpoint with the effects of other techniques of changing interest rates such as fostering the stability of currency Angelico & Oliveira (2020). This difference shows just how much more consideration needs to be given to the application of heterodox instruments, which could be especially important for developing nations with forced cross-border economic shocks (Boneva et al., 2022).

In this regard, our study has a number of implications for research, which aims to fill the gaps, identified in the previous literature (ElHaffar et al., 2020). In contrast with single-country studies or those targeting specific policy instruments, our research offers a wider view of the problem, as we study the case of several countries and several types of monetary policy tools. This approach improves on our knowledge on how monetary policy and stability in currencies relates in a variety of economic structures (Arrigoni et al., 2020). our analysis of the sensitivity of inflation to the measure of the policy rate and the analysis of the unconventional monetary policies provided new light on the implementation and effectiveness and risks in delivering stable money, thus contributing to the future discussions on the efficiency of the monetary policies on money stability (Ferrara et al., 2021).

Conclusion

This paper offers a literature review on the role that monetary policy plays in a process of currency stability in developing nations; the findings open up discussion about the value of different monetary instruments and the consequences of various external forces. In turn, our work based on the analysis of the experience of several countries and covering a number of

DOI: https://doi.org/10.71435/604091

monetary policy indicators deepens the knowledge on the impact of interest rates and reserve ratio prescriptions and radical measures, including quantitative easing, on the stability of currency. The analysis underlines the need for formulating a sound monetary policy, which can coincide with the objectives of inflation and external fluctuations together with the overlying macro-economic factors. This contribution is particularly relevant for policy makers in developing countries interested in improving currency stability in the country given shifting economic fundamentals and fluctuations in the global market.

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