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The Impact of Monetary Policy on Financial Markets

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Abstract: This research addresses the interrelationship between financial markets and monetary policy, reviewing the impact of fluctuations in financial markets on the economic decisions taken by central banks. Financial markets are considered one of the most important tools through which monetary policies can be transmitted to the economy, as fluctuations in stocks, bonds and interest rates affect investment and savings decisions. The research shows how these fluctuations affect inflation rates and economic growth, highlighting central banks' crucial role in controlling liquidity and preventing financial crises. It also discusses how monetary tools such as interest rates and open market operations achieve economic stability. The research highlights that financial markets can act as a channel for transmitting monetary policy. Still, at the same time, they may complicate the economic decision-making process due to unexpected fluctuations. There is also a strong interaction between financial markets and monetary policy, which requires integrated strategies to achieve macroeconomic stability.

Keywords: Financial markets, macroeconomic stability, monetary policy.

Introduction: There is no doubt that monetary policies have an influential role in establishing frameworks that support sustainable economic growth because the primary goal of this policy, according to what is called the Kaldor square, is to achieve monetary stability, balance of payments, acceptance of low unemployment rates, and support for investment activity through lending policies, as it represents the main engine of the wheel of economic activity.

The financial market is a good space for applying monetary policy, especially when using indirect quantitative tools. These tools facilitate the work of the monetary authority in its attempt to control changes in the money supply and then the value of money. In this direction, the financial market works to create the necessary liquidity to facilitate economic growth and increase rates.

First: The importance of the study: Study Importance

The conditions of the financial market, which mirror the general economic situation, and the stability of these markets measure the success of economic policies, including monetary policy. Some aspects of these policies can also be modified or changed in a manner consistent with the stability of the financial market.

Problem of the Study

The study's problem is to examine the extent to which the financial market is affected by the monetary variables left by monetary policy.

Study Hypothesis

The study is based on a hypothesis that (monetary policies impact the financial market's performance, and the degree of this policy and its variables vary according to the level of economic activity in that country).

A The approach of the Study

The study adopted the inductive approach to reach the validity or falsity of the general hypothesis that we adopted,

Objectives of the Study

The study aims to understand the theoretical aspects of the financial market and monetary policy and the relationship between economic policy and the financial market.

Structure of the Study

The study was divided into three sections. The first requirement dealt with the theoretical framework of the financial market, while the second requirement dealt with the theoretical framework of monetary policy. The third requirement came with the impact of monetary policy on the financial market, and the study concluded with a set of results and recommendations.

The first requirement: The theoretical and conceptual framework of the financial market

First: (The nature of the financial market)

1 - The concept of the financial market: The concept of the financial market differs according to the basic function it performs and the institutions that make up this market, and its mechanism is summarized in (transferring balances prepared for lending from units with a financial surplus to units with a financial deficit, i.e. transferring balances that can be loaned) (1).

Based on the above, financial markets can be defined as:

- The market in which different parties, individuals and institutions, deal in buying and selling securities consisting of stocks and bonds, and they may be organized or unorganized. The organized market is where the buying and selling of securities transactions takes place in a specific geographical location called (the stock exchange), while the unorganized market consists of traders and brokers who conduct their business and communicate with each other through means of communication. In this regard, stocks represent ownership certificates and bonds represent loan certificates.

- A regulatory framework under which securities are traded through which flows are financed.

2- The emergence of stock markets (2)

The origin of the stock exchange or stock market dates back to the late thirteenth century AD in the city of (Bruges) in Belgium, when the owners of trading and exchange houses who moved to it from Italy settled there and established their colonies there, and it became a place for merchants and businessmen to gather. In 1300 AD, the stock exchange of this city was established and continued to occupy the leading financial and commercial position among cities until 1485 AD, when the (Anvers) stock exchange was established in the city of (Antorp) and the name (stock exchange) goes back to the name of the (Vander Buerse) family until the exchange movement developed to take the name of this family. There are those who attribute the word stock exchange to the French language, which means (money bag), as its origin goes back to a hotel in the Belgian city of Bruges, whose facade was decorated with a picture of a logo consisting of three money bags where money changers and merchants met. The process of forming stock markets known as stock exchanges went through a development phase in the sixteenth and seventeenth centuries to become organized markets for the movement and trading of capital. The first stock exchange was in France in 1724, in Britain at the beginning of the nineteenth century, and in America in 1821 on Wall Street.

In general, the stages that stock markets went through until they reached what they are now can be listed:

1 - The emergence of commodity exchanges: They are the oldest types of stock exchanges. A commodity exchange emerged in Paris around 1304, followed by a stock exchange in Amsterdam in 1608 AD, as they were markets for future sales. 2- Trading some securities: It began in France when some securities such as bills of exchange were traded during the thirteenth century AD, and the trading process was organized by creating the profession of brokerage in exchange, which was created by King Philip the Blond, and a type of dealing in credit bonds was unified in England in 1688, and the East India Company traded shares.

3- Separation of trading in securities from the commodity exchange: Here, the traders dealing in securities went outside the commodity exchange to its edges in the approaches and nearby cafes where trading takes place outside the commodity exchange.

4- The emergence of stock exchanges: This stage coincided with the industrial revolution and the start of work on large projects that individuals cannot finance, and with industrial expansion, rising income levels, broad economic growth and the expansion of trading in securities, all these factors encouraged the emergence of organized securities markets with advanced methods of dealing, which became independent in their structures and systems.

The oldest financial markets in the world are the London, Paris, New York and Tokyo Stock Exchanges.

-Development of financial markets (1)

A quick look at the stages that the development of financial markets went through with all their implications of monetary and capital markets until they became this widespread form, as follows:

A- The first stage: This stage prevailed in the presence of a large number of private commercial banks, in addition to banking operations and individuals' orientation towards investing in projects due to their savings.

B- The second stage: In which the spread of central banks in the world began and their organization of the work of commercial banks in countries.

C- The third stage: The emergence of specialized banks such as agricultural, industrial and real estate banks, which work to grant medium- and long-term loans and issue long- and medium-term bonds to cover the shortage of funds in financing various projects.

D- The fourth stage: The expansion of monetary markets in countries and the expansion in the issuance of short-term government bonds (treasury bills) in addition to medium- and long-term ones and the spread of the issuance of securities and certificates of deposit and the integration of expansion in secondary markets and advanced monetary markets.

E- Financial globalization and the integration of local financial markets with global ones and international financial markets and the development of the local banking system and its connection to the global system and the high mobility and large flows of money between countries with ease and speed.

Second (Development of financial markets and their role in economic activity)

1- Factors that helped the emergence and development of financial markets (1)

Many factors helped the emergence and development of financial and monetary markets and increased their importance, we mention their essence as follows:

A- The availability of a greater amount of national and individual incomes, which allowed a greater amount of savings as a result of the state of development in developed countries, and as a result of the tangible increase in incomes in developing countries, despite their relative and limited development, and this ultimately led to a greater need to use these savings that were achieved to a greater extent in order to achieve a corresponding return, and this is done by using them in financial and monetary markets.

B- The limited areas of use of financial resources, whether in developed or developing countries, despite the difference in the reasons for this limitation, which necessitated the search for additional areas for the use of these financial resources in the financial and monetary markets, because developed countries have a large, diverse and wide range of productive projects and infrastructure facilities (roads, transportation, electricity, water, etc.), and therefore they do not need a large amount of financial resources for use in these areas, and for this reason there is a surplus of money that exceeds its need, and this surplus is directed towards developing countries through financial markets, while the limited use of financial resources in developing countries, despite their urgent need for such resources, is linked to their weak ability to use them in the broad areas they need, whether in financing the establishment of productive projects or infrastructure projects, which leads to the direction of resources towards non-productive (marginal) areas and the weakness of their direction towards productive areas, especially those most important for satisfying the needs of individuals, or meeting the requirements of the development process. Therefore, financial and monetary markets can provide an alternative to use instead of using them in unproductive and unnecessary areas.

C- The large and huge sizes of projects at the present time, especially the contribution of them, which is usually accompanied by the wide use of advanced technology with capital intensity, are all factors that lead to the need for such projects for huge financial resources, some of which depend on the financial resources available in the financial and monetary markets, and thus this matter contributes to expanding the work of these markets and their development.

D- Increasing the number of intermediary financial institutions, and increasing the degree of their diversity and sizes, which undertake the task of mediation between savers and investors, and the huge financial resources available to them contribute to expanding the work of the financial and monetary markets through their huge transactions in these markets through buying and selling operations (demand and supply), which includes expanding the supply and demand of papers in the financial and monetary markets in a way that helps to develop these markets to a tangible degree. E - The development of the means, tools and services provided by these markets in a manner that is increasing and diversifying to a large extent and continuously, so that these markets provide savers with many areas to use their savings by investing their savings in them, which encourages dealing in these markets and thus contributes to expanding this dealing and thus developing their work.

F - The interconnectedness of the economies of the countries of the world in general, and the increase in economic relations between them, among which and perhaps the most important in bringing about development in the work of financial and monetary markets is what is related to liberalizing the movement of capital and its transfer between countries by canceling the restrictions that limit this movement and in a way that contributes to extensive dealings in the markets from outside the borders of the countries in which these markets exist, so that these dealings are added to the local dealings in them in a way that leads to bringing about significant development in the work of financial and monetary markets as a result, especially within the framework of the trends towards globalization and liberalization of the economy, which have increased clearly in recent years.

Y - Concentration and internationalization (?) of the activity of financial institutions, such that it has become possible for them to obtain huge, even very huge, financial resources through concentration resulting from the expansion and development of their operations, or as a result of merging some of them with others. Internationalization has also made it possible for these financial institutions, and many of them giants, to obtain resources from many countries and use them in several countries as a result of internationalizing their activity, i.e. practicing their activity in more than one country, whether it is related to obtaining financial resources or using these financial resources, such that all of this has led to the availability of enormous financial capabilities that enable them to move huge amounts of money between countries and to deal with them in the financial and monetary markets in these countries, which has contributed significantly to the expansion and development of the work of the financial and monetary markets. 2- The role of financial markets in economic activity (1)

The stock market represents a link between most of the influential economic centers such as banks, companies, savers, investors, etc., which qualifies it to provide a general indicator of price trends and savings and investment rates (macroeconomic indicators). It also contributes to studies that aim to identify fruitful economic activities and provide opinion and advice to the relevant authorities to achieve coordination and integration between investment activities, monetary and financial policies, and the movement of capital, which helps in achieving economic stability.

The stock markets promote development by providing the necessary capital to finance economic projects through the owners of these projects offering their shares in the stock market, which represent entities with a financial deficit, in order to obtain the necessary financing from entities with financial surpluses. And obtaining an efficient allocation of capital for productive investments at a relatively lower cost.

The financial markets contribute to helping increase production levels and raise the level of employment or employment, and thus achieve better levels of income at the individual and national levels.

The government can also implement its economic policy, especially monetary policy, through the stock market, by using monetary policy tools, specifically the open market tool for buying and selling securities. Therefore, financial markets are the main engine for driving economic growth, due to their great importance in converting negative savings into positive savings that benefit the local economy and the capital owner alike, as financial markets have the ability to force hoarders to transfer their frozen money to the investment market, in addition to the fact that stock profits will encourage individuals to abandon some inherited consumer habits in exchange for obtaining additional profits on their money.

These markets work to achieve an effective balance between the forces of supply and demand for money and allow complete freedom to conduct all exchanges between dealers, as the importance of this market increases in countries characterized by economic freedom and where the economy depends on individual and collective initiative.

Second requirement

The conceptual and theoretical framework of monetary policy

First: Monetary policy (concept, objectives, tools)

1. The concept of monetary policy (monetary policy concept)

1- They are the procedures and measures followed by the central bank to influence the supply of money, credit and the exchange rate in order to achieve the goal of monetary stability in the country.

2- They are the contractionary or expansionary policies carried out by the monetary authority to influence economic activity by influencing the volume of credit and money supply using open market policies and changing the rediscount rate and changing interest rates on loans.

2- Monetary policy objectives (3): (monetary policy coals) Monetary policy aims within the framework of macroeconomic policy to achieve the desired overall objectives called the Kaldor square (magic square), which are increasing GDP growth rates, reducing unemployment rates, achieving balance in the balance of payments, and achieving stability in the general price level. These objectives vary between developing and developed countries (*) due to the difference in growth rates and institutional differences in them, and the objectives associated with each stage, as the nature of the stage plays a role in achieving these objectives. The following figure represents the Kaldor square (N-Caldor) for monetary policy objectives.

A- Achieving price stability: (Realization of price stability)

The goal of stabilizing the general level of prices is a necessary condition for the smooth running of the economy. Usually, price fluctuations fundamentally affect the structure of the existing economic system, and therefore, rising prices increase the risks of investment and economic growth. Some attribute the decline in economic growth in the countries of the South American continent to the high inflation rates that these countries suffer from (4). In most cases, those in charge of monetary policy in developed countries are interested in the policy of targeting inflation (Inflation Targets) as an intermediate and primary goal to influence other macroeconomic variables (5). It is worth noting that the importance of price stability (*) appears in providing a fertile and suitable economic environment to attract direct foreign investment (Direct investment) and indirect investment (indirect investment), which helps stimulate investment among producers and thus accumulate capital and increase economic growth (1).

B- Achieving a high level of employment: Realization of full employment)

This goal is considered one of the most important final goals for two reasons: First: The increase in unemployment rates leads to social problems, so citizens suffer from real financial problems. The second reason: The low level of employment causes economic activity to lose its basic production factors, represented by the unused labor force, which is an influential productive element in the economy. Treating the unemployment problem and achieving natural unemployment rates (Natural rate of Employment) (*), which usually range between (4.5-6)%, must be in line with the procedures of the monetary authority to stimulate economic activity and activate the wheel of investment, thus increasing the level of employment, in addition to raising the level of total demand and maintaining the growth rate of the gross domestic product in a way that matches the growth rate of the money supply (2(.

C- Achieving stability in financial markets: Realization stability of financial market

There is no doubt that the state of instability in financial markets affects their effectiveness in matching savers and investors, i.e. a decline in the exploitation of financial resources due to the difficulty of obtaining the capital necessary to finance capital investments, and thus the stability of Financial market institutions and providing a fertile environment for them makes the process of transferring capital proceed with high efficiency (3).

D- Achieving stability in the balance of payments (Realization of A stable balance of payment

Monetary policy can address the imbalance in the balance of payments. When a deficit occurs, the monetary authority raises the rediscount rate, which contributes to the inflow of short-term capital into the country, which works to balance the balance of payments. The other direction comes through changing internal prices, which will decrease, leading to an increase in the volume of exports, which leads to the same result, or the two directions may come together to remove the deficit from the balance of payments (1).

E- Realization of high rates of economic growth: Monetary policy, through the control it exercises over the volume of bank credit and its cost, increases economic growth (*), and the monetary authority can make changes in the volume of total reserves of local commercial banks. Expansionary monetary policy can maintain a low interest rate, which increases demand for credit and investment and achieves economic growth (2). Second: Channels of transmission of the effects of monetary policy to economic activity

1- Interest rate channel: This channel is considered the most important channel of transmission of the effects of monetary policy to the real sector, and (Keynes) is the first to address this channel)4. When the monetary authority decides to make a change in the money supply, the first channel that transmits the effect of this change to economic activity is the interest rate channel. When assuming a certain flexibility of investment and a certain marginal adequacy of invested capital, and when following an expansionary monetary policy by increasing the money supply, this will lead to a decrease in the nominal interest rate, and in light of the assumption of stable prices, the real interest rate will decrease accordingly (*), which will lead to a decrease in the cost of capital and an increase in investment activity and an increase in the pace of aggregate demand and thus production and use.

2- Exchange price channel: Interest in this channel has increased with the expansion of global economic exchange in light of the rising trend towards internationalization of the economy (*). The role of the exchange rate channel is highlighted in transmitting the impact of monetary policy to economic activity through the value of the local currency and through the interest rate. Changes in exchange rates are reflected in changes in aggregate demand and supply. The monetary authority’s action to reduce the money supply will lead to an increase in the real interest rate within the local economic activity relative to its counterpart abroad, which results in a movement of foreign capital flows inward. These flows will increase the demand for the local currency, leading to an increase in its real value, which negatively affects the quantity of exports (it becomes more expensive than foreign goods) and the country’s current account position and its reflection on the decline in GDP growth (1).

3- The asset price channel The impact of monetary policy is transmitted through this channel through two channels: the Tobin investment channel and the wealth effect channel on consumer spending. Through q-Tobin (*), expansionary monetary policy works to raise stock prices, which makes investment more attractive and thus increases aggregate demand. The process of raising stock prices also necessitates an increase in wealth, leading to an increase in consumer spending and thus increases aggregate demand. Also,

4- Credit channel: The role of this channel is highlighted through the impact of monetary policy on output and through rationalizing spending, and it is divided into two channels, the first: Bank Lending channel, and the second: Balance sheet channel (3), the first channel goes to that the decrease in the money supply leads to a reduction in the size of deposits, which reduces the ability of banks to provide loans or financing for projects and companies, as this works to reduce investments in these companies, especially small ones that depend mainly and mainly on bank financing, and thus results in a decrease in the growth rate of output, and the opposite happens in the case of an increase in the money supply (4), as for the second channel, it plays its role through moral risks and negative selection risks, when following a contractionary monetary policy, the risks of neglect and poor selection of borrowers increase, as the decrease in the money supply reduces the net value of companies, and thus reduces the guarantees that must be provided by the company when borrowing, which results in not providing Loans to these companies, especially small ones, from financing banks, and thus negatively affect their investments and cause a decline in the growth of output (5), and the transfer of the effect can be represented in the two channels as in the diagram:

Second: Traditional tools of monetary policy (Monetary policy tools)

A1. Legal reserve ratio: This tool is one of the tools or means that central banks resort to in order to influence the ability of commercial banks to grant loans and create deposits, and the central bank usually resorts to using it to influence the money supply by imposing a percentage of the total bank deposits for the purpose of keeping them as a credit balance in the central bank as a legal reserve (2)

2- Discount rate: We mean by it the interest that the central bank obtains from commercial banks in exchange for these banks discounting the securities it has in order to obtain the necessary liquidity for the purpose of granting loans to individuals and companies (2), and the purpose of this policy is to influence the granting of credit, as raising the discount rate reduces the ability of banks to grant credit, while reducing it sends clear indications of the expansion in granting Credit, and commercial banks transfer this burden by raising interest rates on bank loans, which results in an increase in the cost of credit and thus a contraction in its volume. However, in the case of economic recession, the monetary authority resorts to following an expansionary policy by reducing the discount rate, which results in commercial banks reducing interest rates on bank loans, which leads to an expansion in the volume of credit.

In addition to the above, there are many channels that the monetary authority can use to influence the financial market, the most important of which are the rediscount rate, open market operations, and the legal reserve ratio. The central bank can influence financial investments through these channels. The effects of the monetary authority's use of the discount rate tool in the financial market extend through the monetary and capital market to change the lending provisions to commercial banks from the central bank, i.e. influencing the size of commercial banks' reserves. As for open market operations, the second tool through which the impact of monetary policy on market activity can reach the buying and selling of short-, medium-, and long-term government securities and through influencing the price and interest rate channel, in addition to the cash reserves channel. As for the third tool (the legal reserve ratio), the central bank can control that ratio, which prompts commercial banks to resort to the financial market to display their securities. Thus, the previously mentioned analysis focuses on indirect quantitative monetary policy tools because the direct qualitative tools of monetary policy hinder the activity of the financial market for several reasons (2). The effectiveness of monetary policy, especially the quantitative one, depends on regular financial markets as the scope of work of these tools changes. Therefore, these markets must be highly efficient and effective to implement these tools, i.e. they must have great capacity and be able to absorb vast quantities of government bonds offered by the central bank through open market operations, as well as its ability to implement the bank rate policy. The impact of the financial market on the implementation of monetary policy is as follows: (3)

1- The bank rate is one of the interest rate structures that must be determined in the financial market, especially the money market, as deciding the bank rate depends on changes affecting the supply and demand sides of liquidity in the money market.

2—The effectiveness of the bank rate requires a strong relationship between it and other interest rates in the financial market, as changes in the bank rate depend on changes in interest rates in the market. This requires the existence of an efficient financial market.

3—The existence of a developed (short-term) financial market in which credit instruments are rediscounted by the central bank facilitates the implementation of monetary policy procedures.

4- The success of the open market policy depends on a large, active and highly effective bond market, as previously mentioned. Thus, the development of the financial market makes monetary policy tools (quantitative) more effective and influential in all macroeconomic variables by providing the optimal scope for their application and extending their impact towards the intended objectives of their use.

RESULTS

1- Monetary policy is one of the influential factors and essential channels for transferring financial surpluses in the financial market.

2- Financial markets have become the proper mirror for judging the extent of the development of the financial domain in countries, especially in developing countries.

3-Financial markets are one of the main determinants of the effectiveness of monetary policy in a country.

4- Open market policies are the most essential tool in transferring the financial impact of financial markets.

5-Capital markets represent one of the important channels for accumulating and managing wealth and are the most important institution that affects the economy's ups and downs.

Recommendations

1- Since financial markets are part of the economy and a true mirror of the economy, monetary decision-makers must evaluate the negatives in their decisions towards financial market indicators.

2- The necessity of adopting policies for economic and financial terminology to reflect on the development of financial markets, which have become a significant component of the structure of the economies of developing and developed countries.

3-Establishing active and effective centers within the financial markets that allow investors and traders to view all monetary decisions issued by the central bank.

4- Conduct more research on this topic and the Iraq Stock Exchange to develop scientific results that reflect the impact of monetary policy on financial market indicators.

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