# CHAPTER - I

# INTRODUCTION

## 1.1 Monetary System - Developments

In traditional economics the theory of money and the theory of output have been treated separately with little or no tendency toward integration. First Wicksell and then Keynes gave impetus to the movement to combine the theory of money with that of output as a whole In fact, changes in the stock of money needs to be very carefully watched and controlled, because such changes bring about a powerful influence on changes in money income, prices, output, employment, distribution of income and wealth, balance of payment, etc Therefore, any monetary authority having definite policy objectives with respect to these variables, cannot afford to be unconcerned about changes in the stock of money.

As per classical thinking, money was treated as a "veil", determining the nominal values of macroeconomic aggregates like output and yet not having any influence on the real economic activity Money was, thus, regarded as a reflector of economic activity rather than its regulator

Classical economists highlighted only the transaction function of money and treated money demand as an increasing function of output or real income only. While Keynes gave due importance to 'transaction' as well as the 'store of value' functions of money and presented money demand as an increasing function of output but a decreasing function of interest rate This broadening of the money demand function eliminated the classical dichotomy, and accorded a role for money in real economic activity The Keynesian revolution of the thirties in economic thinking remained unchallenged for over two decades Infact, it was considered like a supreme ideology by the policy makers of that period It was believed that money does not matter as fiscal policy can effectively manage the working of the system, so monetary policy has to play only subordinate role as a stabilisation force In the sixties, monetarism has emerged as a counter revolution to the Keynesian revolution, who assert that money alone matters the most in the macro behaviour of a market oriented economy[1]

Though the credit of advocating monetarism with all its sophistication and assertion goes to Milton Friedman, Clark warburton was actually the pioneer monetarist who challenged Keynes and stressed that money matters[2] He was the first economist to visualise that Keynes had grossly failed to perceive the analysing role of monetary change in analysing cyclical fluctuations in economic activity[3]

According to the monetarists, the role of money is much broader and goes deeper, as it is crucial determinant of the nominal income. In their opinion there is a direct and observable link between money supply and GNP. Therefore changes in the money supply is an important factor in the determination of the level of real output, employment and prices

No doubt there are well developed macroeconomic models to analyse the functioning of developed countries At times, in most of the theoretical models and empirical work, the models of advanced countries are used without modifying them as per the requirement This practice has often produced results and policy prescriptions which are at times unconducive with the structural and institutional set up of developing economics.

To promote development in the less developed countries, it was thought that aiming at expanding money supply and lower interest rates might be a good policy. This view prevailed for quite some time until the inflationary pressures resulting from it, itself become a serious problem and came in the way of the growth of LDCs. This made researchers to think that Keynesian economic policies were not suitable for less developed countries and once again they started testing the old fashioned quantity theory to find out appropriate solutions for the development of LDCs This view of money and monetary policy in LDCs has been strengthened in recent years by growing body of empirical and theoretical work in this field[4] Though Schumpeter had explained that money and credit are phenomenon of development[5], for a long time the nature of monetary policy remained indistinct and ill-defined, for two reasons. Firstly, monetary policy was viewed in a narrow sense as influencing aggregate spending through the regulation of interest rates, credit availability and credit allocation. Secondly, views on the role of money and monetary policy were dominated by the then prevailing perceptions of the growth process itself, and modern growth theory had not yet assigned a meaningful function of money. Since developments in this field have progressed slowly and still it is in the early stage, it has been difficult to find consensus regarding whether money is a causal, permissive or passive factor in the growth of developing economies. Empirical research work in the field of monetary economics and particularly regarding the role of money in the development of low income countries have began on large scale and many researchers have proved that money plays an important role in the development of these economies. However, money supply and money demand functions are basically different in developing from those in developed countries, though in certain respects they are influenced by institutional, political and economic factors unique to each country[6].

As far as money demand function is concerned, factors affecting demand for money are more or less the same in both developed as well as developing except the degree of monetization of the transactions as the economy begins to develop . As well the empirical work in developing countries has confirmed that demand for money in these economies is as stable through time as in the case of developed countries which provide strength to the effective use of monetary policies in these economies.

Regarding money supply, in case of developing countries base money is a major determinant of money stock Though the base money is influenced by many factors the primary factors are deficit financing of government expenditure and in some cases the excessive inflow of foreign exchange reserves

In most of the developing economies the monetary policy instruments are not that very effective as it is in case of developed ones, the reasons being less developed money and financial markets, limited use of open market operations policy as the government security market being insensitive, and rigid interest rates structure.

In the case of developing countries still a lot more empirical work in the field of monetary economies is the present day need. The basic money measurement or definition, problem is still an unsettled issue. Most of the conclusions are based on the findings of developed countries. Yet another highly significant issue, more pertaining to Jordan, is the relative in efficiency of monetary policy in case of small developing economy which are open to outside influences. There has already been some econometric model building for some LDCs which have provided a detailed insights into their policy problems. By and large, the general nonavailability of data and the poor quality of the available data hampers any meaningful econometric work in LDCs. Still, as the real world is so complicated and unpredictable, even simple exercises which help to understand the most important relationships could be of great value as these may through more light on the problems of these economies and thus improve our understanding of the functioning of these economies.

## 1.2 The Present Study

This study on "Monetary System in Jordan - Experiences during 1964-95" intends to study the Jordanian Economy in general and the functioning of its monetary system in particular. The Jordanian economy though is a small one, it is an open system. This economy is influenced by the international events and more specifically by the events of the middle east and Arab world to a great extent The influence of these factors on the economic front is quiet significant.

The present study centres mainly around the question of highlighting important issues surrounding Jordanian macroeconomic policies and to provide empirical evidence on these issues using secondary data during the period of thirty two years i e 1964-1995.

The analysis and examination of all the issues pertaining to monetary policies are not possible here, however, this study attempts to examine major issues which have bearing on formulation, conduct and conceptual aspect of monetary policy and its impact on other macro economic variables.

Monetary policy is considered to be a powerful stabilisation tool It's significance lies in its effects on output, price level and other macroeconomic variables Viewed this way, the main question that comes to mind is what are the theoretical foundation of monetary policy ? At theoretical level what is the link between money stock and other macro variables that is sought to be established ?

At the policy level, at least in the Jordanian context, money stock rather than interest rate is considered to be an important monetary policy variable Therefore, the relevant issue here is, what causes macroeconomic instability ? Is it primarily caused by imbalance in money market, if so, then the pertinent question is that how monetary imbalances arises? Is demand for money function unstable ? Is it because behaviour of money supply is uncertain and fluctuating ? If demand for money function can be found to be a stable function of few variables, can money stock be controlled and predicted with some accuracy ? A more relevant question is, to what extent the use of money multiplier approach is a good guide to monetary policy formulation in Jordan ? Does it have any operational significance ? It, as an alternative, one examines the factors affecting the money stock by the fact that different factors exert varying degrees of influence on money stock at different time periods. Now all these have sizeable implications for the conduct and formulation of monetary policy What needs to be studied in detail is whether the structural composition of money stock has changed drastically ? What changes have taken place over time ? If the effect of money stock changes cannot be split into prices and output effects then to what extent money stock variations can explain variations in current money income which is the product of price and real output ? Keeping in mind the above mentioned highly pertinent questions pertaining to the monetary system, the researcher has made an attempt to test following hypothesis in the context of the Jordanian economy. The major hypothesis tested in the chapters that follow are .

1. It is hypothesised that government's operations have stronger influence over the monetary changes in the economy.
2. With the development of financial market instruments in Jordan, financial deepening has taken place.
3. The volume of credit money in Jordan is less sensitive to monetary policy instruments
4. It is also hypothesised that the monetary expansion has relatively stronger impact on general price level than on output growth.
5. It is hypothesised that money stock is determined through the process of market adjustment rather than the alternative belief that it is a result of mechanical application of money multiplier

These hypothesis are tested in the subsequent chapters. The brief methodology and data source are presented in the next section.

## 1.3 Data Sources and Methodology

The present study. thus seeks to examine the behaviour of many crucial monetary, fiscal and real variables in the Jordanian economy The statistical information (data) used for this purpose is mainly collected from the following publications

1. Central Bank of Jordan.
   - (i) Annual reports
   - (ii) Monthly Statistical Bulletin
   - (iii) Yearly Statistical Series.

2. International Financial Statistics (I F.S)

3 Economic and Social Development Plans of Jordan.

Since the analysis of Jordan's monetary sector involves many variables, we have used various known statistical techniques. The data on price behaviour in Jordan is hard to get. There is no published data on national income deflator Even in case of whole sale prices (WPI) the data is available only from 1975. The data on Consumer Price Index (CPI) is available from 1967 The present study is for the period starting from 1964 Hence the scholar had to extend the CPI series upto 1964 making use of data from other sources In the absence of any other price deflator the scholar had to depend up CPI knowing fully well the limitations of this index This could be considered as one of the limitations of this study In this study wherever nominal values had to be expressed in real terms CPI has been used as a deflator The study uses for its analysis simple ratios, growth rates in addition to the techniques such as correlation and regression analysis To test for the results, where ever required $t$ - statistic, $F$ - statistic have been used To test for the causality between the money & prices and money & real output in the Jordanian economy the Grangers causality test and modified Sims causality tests have been made use of. The following section presents the chapter scheme

## 1.4 Scheme of the Work

The study is divided in to seven chapters The order of presentation of issues is as follows

Chapter I gives an introduction of the thesis It also presents the hypothesis to be tested along with brief and the chapter scheme.

Chapter II provides an introduction of Jordanian economy The structure of the economy, national income, its growth, employment structure and international trade is discussed in this chapter

Chapter III provides a brief sketch of the Jordanian monetary structure, History of the Central Bank of Jordan (CBJ) and its role in the Jordanian monetary management is presented in detail.

Chapter IV examines the demand for money in Jordan. Where in it has been tried to examine empirically the demand for liquid financial assets as well as to identify crucial factors influencing the money demand function

Chapter V provides an analysis of money supply mechanism in Jordan The study analyses the factors affecting reserve money and the relative contribution of external and internal factors in it

Chapter VI provides an analysis of relative behaviour of the money supply in Jordan and its effect on output and prices The causal relationship between money and prices and money and output is examined

Chapter VII presents findings of the study and discusses the policy implications

**References**

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