Introduction to the Irish economy: Monetary Policy

Monetary Policy refers to actions that central banks take to influence the cost and availability of money in the economy. Central banks set monetary policy by controlling the interest rate for the banking system and the quantity of money and credit available in the economy.[1]

Why is Monetary Policy Important?

Monetary policy affects how much prices are rising - called the rate of inflation.[2] The primary objective of many central banks is to ensure price stability to support growth in the economy. Price stability means a low to moderate inflation rate that does not rapidly erode the value of purchasing power over time. This means that consumers can effectively buy as much as possible with their money tomorrow as they can today. Monetary policy is the only policy tool central banks have to try to control inflation and maintain price stability. While central banks can increase interest rates to try reduce inflationary pressures from demand in an economy, they cannot directly influence the supply of goods and services or labour in an economy.

Who Sets Monetary Policy for Ireland?

The European Central Bank ('ECB') sets monetary policy for Ireland as we are a member of the euro area using the Euro currency, known as 'the Eurosystem.' The primary goal of the ECB is to maintain price stability by targeting an inflation rate of 2% over the medium term.[3]

The ECB sets three key interest rates. These are:

- The interest rate on the main refinancing operations ('MRO'), which provide the bulk of liquidity to the Eurozone Banking System;
- The rate on the deposit facility, which banks use to make overnight deposits with the Eurosystem, and;
- The rate on the marginal lending facility, which offers overnight credit to banks from the Eurosystem.

Other Monetary Policy tools - Quantitative Easing and Forward Guidance

Since the financial crisis, the ECB expanded its suite of policy instruments. The new tools included:

- Offering banks as many central bank loans as needed against a fixed rate;
- Negative interest rates;
- Offering long-term loans to banks at very favourable rates on the condition that these were loaned on to the people and businesses in the broader economy;
- Purchasing substantial amounts of private and public assets; and
- Providing information to signal future monetary policy - known as 'forward guidance'.

1 By contrast, fiscal policy refers to decisions made by governments about taxation and spending.
2 In the euro area, the Harmonised Index of Consumer Prices (HICP) is used to measure consumer inflation.
3 European Central Bank (ECB), *Introduction to Monetary Policy*.

Quantitative tightening now refers to a reversal of these policies to reduce the central bank balance sheet, also known as balance sheet normalisation.

Monetary Policy in Action

Expansionary monetary policy is when a central bank pursues monetary policies aimed at stimulating the economy. This can be achieved through reducing interest rates and through 'Open Market Operations' where a central bank buys Government bonds to increase the quantity of money (liquidity) in the economy. Central banks can also reduce the reserve requirements for banks so that they can lend more money into the economy. Central banks such as the Federal Reserve[4] and the ECB[5] use expansionary monetary policies during recessions and periods of weak economic growth to try stimulate the economy.

Contractionary monetary policy is the opposite of an expansionary monetary policy and is used to try to slow down an overheating economy. Contractionary monetary policy involves increasing interest rates and/or 'quantitative tightening', which can include reducing government bond purchases on secondary markets and curtailing the money supply. Central banks can also raise the reserve requirements for banks, so they must hold more money in reserve and therefore have less to lend into the economy.

How Contractionary Monetary Policy and Inflation Interact

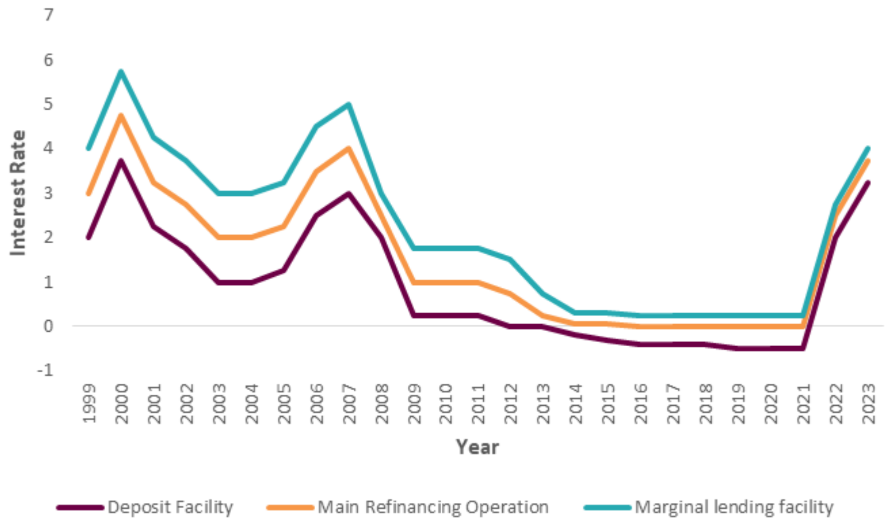
In periods of high inflation, central banks can increase interest rates to reduce and stabilise inflation by limiting the amount of money circulating in the economy. If central banks increase interest rates, it makes it more expensive for banks to borrow from central banks. Banks then in turn, increase the interest rate they charge on both new loans and variable loans. This makes it more expensive for consumers to borrow money and makes it more costly for businesses to invest in new machinery and expansion plans. This can lead to reduced demand and cause businesses to slow down or postpone expansions. Less hiring will mean fewer job opportunities, and consumers may become more cautious with spending. In addition to the increased cost of borrowing, higher interest rates (if passed onto consumers) will mean a higher rate of return on deposits. Some consumers may take advantage of higher interest rates on their savings and reduce their consumption. This will contribute to the reduction in demand and slow down inflationary economic activity.

After a long period of expansionary monetary policies, global central banks are now tightening financial conditions. Of the world's ten largest economies[6], eight have increased interest rates recently. Interest rates have been increased in the USA, Germany (as a member of the euro area), the UK, India, France (as a member of the euro area), Italy (as a member of the euro area), Canada and Brazil since the beginning of 2022. China and Japan have not yet increased interest rates.

The European Central Bank has begun a process of increasing interest rates in an effort to tame higher than normal inflation. The euro area's annual inflation rate (HICP) was 6.9% in March 2023, down from 8.5% in February but still considerably higher than the ECB's target rate of 2%.[7]

4 Federal Reserve, *Monetary Policy Principles and Practice. Monetary Policy: What Are Its Goals? How Does It Work?*
5 European Central Bank (ECB), *Introduction to Monetary Policy*.
6 International Monetary Fund (IMF), *World Economic Outlook Database: April 2023 Edition.*
7 Eurostat, *Press Release*.

Figure 1: ECB Key Interest Rates 2014-2023 (March 2023)[8]



At its recent meeting on May 4, the ECB Governing Council decided to slow the pace of interest rate increases to 25 basis points (0.25%) from 50 basis points (0.50%) previously. While headline inflation has declined over recent months, underlying price pressures remain strong. Monetary policy changes can have a variable impact on the real economy, and may take some time to have a full effect. This means, the full impact of the past rate increases may not have materialised yet.

The next monetary policy decision at the ECB will be taken by its Governing Council on June 15, 2023. Immediately following the monetary policy setting meeting, the ECB will issue a press release providing details of the decision. At the press conference following immediately afterwards, the President will outline the reasons for the actions taken.

8 ECB, *Key ECB interest rates*.