l'éco en bref

What is monetary policy?

Key facts

Monetary policy is one of the components of economic policy, but it is not the only one – fiscal policy and "structural" policies are also important levers. Monetary policy is the responsibility of central banks, which must both support economic prosperity by acting on the currency, and ensure monetary and financial stability, but without intervening in the areas of legislation, public investment, taxation and the organisation of labour, which are the responsibility of government.

In the euro area, the primary objective is price stability, which is defined as medium-term inflation "below, but close to, 2%". Monetary policy aims to ensure that the growth of money in the economy is neither too fast nor too slow compared with the growth in goods and services.

If monetary policy is too "accommodative" the danger is that inflation becomes too high, which is harmful for the whole of the economy: excessive inflation leads over time to a fall in the value of the currency (with the same amount of money one can purchase fewer goods and services) and makes anticipating prices and investment and purchasing decisions more difficult. In addition, it leads to an imbalance in the distribution of wealth between borrowers and savers.

Conversely, monetary policy should not be too restrictive either, so as not to promote deflation, which encourages people to postpone purchases, thereby causing a fall in consumption, slower growth and higher unemployment.

Thus, central banks seek to durably maintain inflation at a low and stable level. They have several means to achieve this objective, the main ones being: explaining their medium-term strategy so that the public has confidence in it and anticipates future developments correctly; and varying the key interest rates, which are the rates at which they lend to commercial banks (see "Understanding monetary policy"). By varying these rates, central banks vary the cost of money, and this influences price developments and the economic situation.

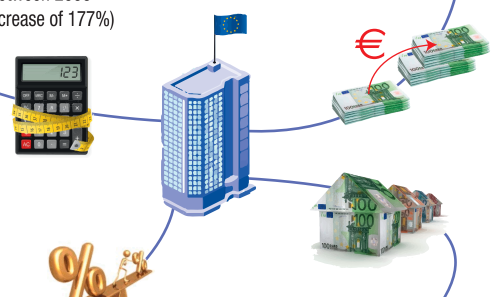
A brief history

- 44 BC: Julius Caesar was the first person to have himself depicted on a coin in his lifetime, a mark of his sovereignty. This began a practice adopted by many kings and emperors after him.
- 1355: Nicolas Oresme wrote his *Traité des monnaies*, a work that was a precursor to political economics. He laid the foundations for what would later be Jean Bodin's theory and advised the king against making any change to the value of the currency so as not to affect confidence in it.
- 1568: publication of the *Réponse au paradoxe de M. de Malestroit* by Jean Bodin. In it he asserted that it was the arrival in France of large quantities of precious metals from the New World that was the cause of the rise in prices that had been observed. This argument led much later to the quantity theory of money and in its wake to a whole school of thought: monetarism.
- 1668: creation of the first central bank, the Bank of Sweden.
- Early 19th century: theoretical debate in the United Kingdom between the Banking School and the Currency School. Whereas according to the "banking principle", the quantity of currency in circulation should satisfy demand from economic agents, proponents of the "currency principle", notably David Ricardo, thought that excessive monetary growth caused inflation, and that therefore the Bank of England should only issue currency equivalent to the quantity of gold it holds.
- 1800: creation of the Banque de France by Napoleon.
- 1844: passing of the Banking Act in England, which imposed the "currency principle".
- 1913: creation of the US Federal Reserve (the Fed).
- 1923: hyperinflation in Germany, with annual inflation above 16 million per cent.
- 1992: signature of the Maastricht Treaty. Independence of euro area central banks.
- 1999: introduction of the euro and implementation of the single monetary policy by the European System of Central Banks.

Key figures

1,834 *billion euro*
Increase in the size of the Eurosystem's consolidated balance sheet between 2006 and 2016 (an increase of 177%)

0%
Inflation rate in the euro area in 2015



0%
Interest rate on the main refinancing operations (main policy rate) in the euro area, set by the ECB's Governing Council since 10 March 2016

6,366
Number of monetary financial institutions (MFIs) in the euro area in 2015

Understanding monetary policy

Monetary policy: from key interest rates to the financing of the economy

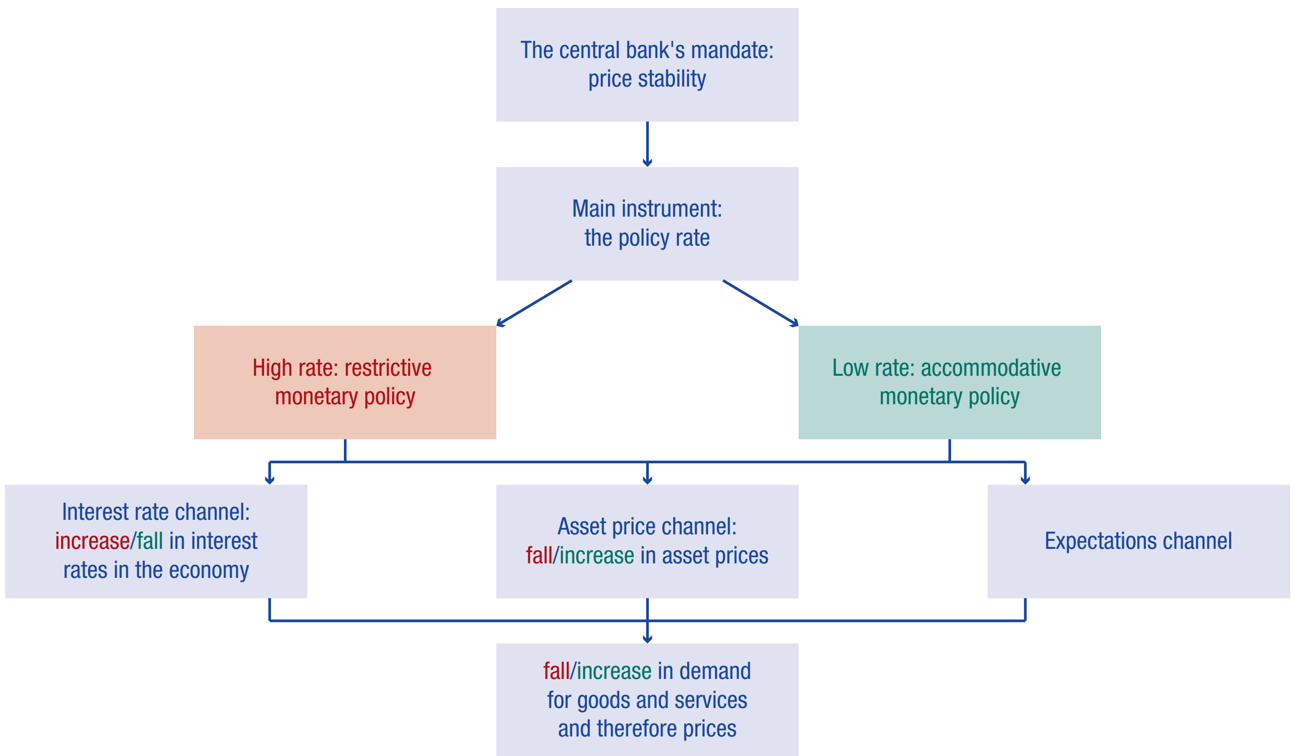
The Eurosystem brings together the national central banks of the 19 countries that belong to the euro area and the European Central Bank (ECB). This institutional framework is responsible for steering the euro area's monetary policy, with priority given to ensuring price stability.

Its main instruments are its key interest rates. In particular, the Eurosystem decides the level of the interest rates on the loans made by central banks to commercial banks (the price of "central bank money"). This policy rate, whose level is determined by the Eurosystem in accordance with the economic situation in the euro area, influences the cost of commercial banks' lending to the economy. It has a major impact on money creation (see sheet entitled "Who creates money?"), as it serves as a point of reference for other interest rates in the economy. If it rises suddenly or is very high, demand for loans slows. Conversely, if it falls significantly or is very low, this encourages firms and households (economic agents) to borrow more from their bank and therefore to create more money.

Key interest rates produce their effects on the real economy after implementation lags, and act via a number of transmission channels. Some of these channels play a decisive role:

- *The interest rate channel:* the interest rate is the price at which economic agents take on a debt to finance their economic activities. A fall in interest rates encourages agents to take out a loan.
- *The asset price channel:* a fall in interest rates increases the price of assets (for example financial securities) on the markets. Agents who own assets see their wealth increase, which boosts their purchasing power accordingly.
- *The expectations channel:* the central bank's actions must be clear and credible so as to enable economic agents to anticipate future key rate developments correctly.

The transmission of monetary policy



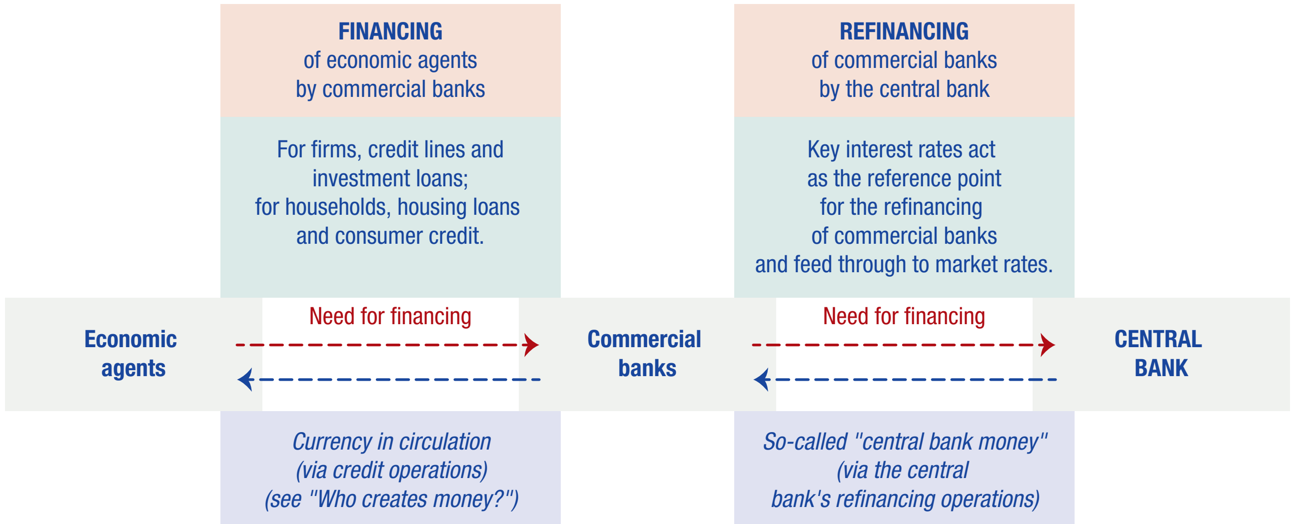
Source: Banque de France.

Monetary policy and you

Since the creation of the euro area in January 1999, the European institutions in charge of monetary policy have shown pragmatism. The measures adopted transcend ideological divides and are the result of compromise, as effective monetary policy cannot limit itself to following the prescriptions of a single doctrine; it is constantly tested in a complex and changing environment. The so-called "non-standard" measures taken by the Eurosystem since 2008 to ensure financial stability, maintain the cohesion of the euro area and give stimulus to the European economy illustrate its capacity to adapt in the face of an unprecedented crisis (see sheet entitled "Non-standard monetary policy").

- The single currency has acted as a shield, particularly for those European citizens in countries that would have found it difficult to obtain financing on the financial markets and who could have suffered, in the absence of the euro, from a devalued national currency and therefore from a fall in their purchasing power.
- The Eurosystem has overcome the potential difficulties linked to the enlargement from 11 to 19 member countries. It rises on a daily basis to the challenge of cooperation between countries in divergent economic situations. The Eurosystem produces common solutions, demonstrating through this capacity for coordination the reality of the European project.
- In only a few years, through its decisions, the Eurosystem has succeeded in establishing its credibility and proving its independence. It has shown that it is free in its actions, provided that these contribute to meeting the objectives set for it by its mandate.

The circuit of the financing of the economy



Source: Banque de France.

To learn more

Suggested viewing

- ➜ Monetary policy
- ➜ The Eurosystem (ECB website)
- ➜ The Transmission of Monetary Policy – Whiteboard

Useful links

- ➜ Monetary policy, Banque de France website
- ➜ Monetary policy, ECB website