presentation 16
monetary policy

Monetary policy

Monetary policy refers to the process whereby the monetary authority, the central bank, determines the size and rate of growth of the money supply, which in turn affects interest rates depending on the economic health of the economy.

In other words, the monetary policy is based on:

- the demand and supply for money relative to the (domestic) financial needs of consumers and business organizations
- the demand and supply of the domestic (national) currency in the transnational (foreign) markets

Financial actors

These include:

- Borrowers, individuals or organizations using funds on credit against a fixed or variable rate of interest, with or without a security. Borrowers are debtors for the duration of the credit. Thus:
    - Demand is made by borrowers
    - Supply is made by the financial sector

- Lenders, individuals, or organizations advancing cash to a borrower for a stated period. Lenders are creditors for the duration of the credit. Lenders to the financial sectors (investors) are depositors. Thus:

  - Demand is made by the financial sector
  - Supply is made by investors and other depositors (e.g. employers)

Demand of Money

The demand for money (withdrawals, credit, currency conversion) is made by borrowers according to:

- The needs for financial transactions – paying bills & purchase needs of domestic markets (transactions demand for money)
- The speculative purposes – purchase of bonds, derivatives and other financial products (speculative demand for money)
- Investment purposes of businesses - debt financing
- The purchase needs of foreign markets – imports

The demand for money (for deposits by domestic and foreign investors, employers) is made by the financial sector according to:

- The needs of the economy for financial transactions
- The savings the economy perceives given the (employment and financial) risks in the market (precautionary demand for money)
- The credit needs of borrowers
- Investment needs of the economy

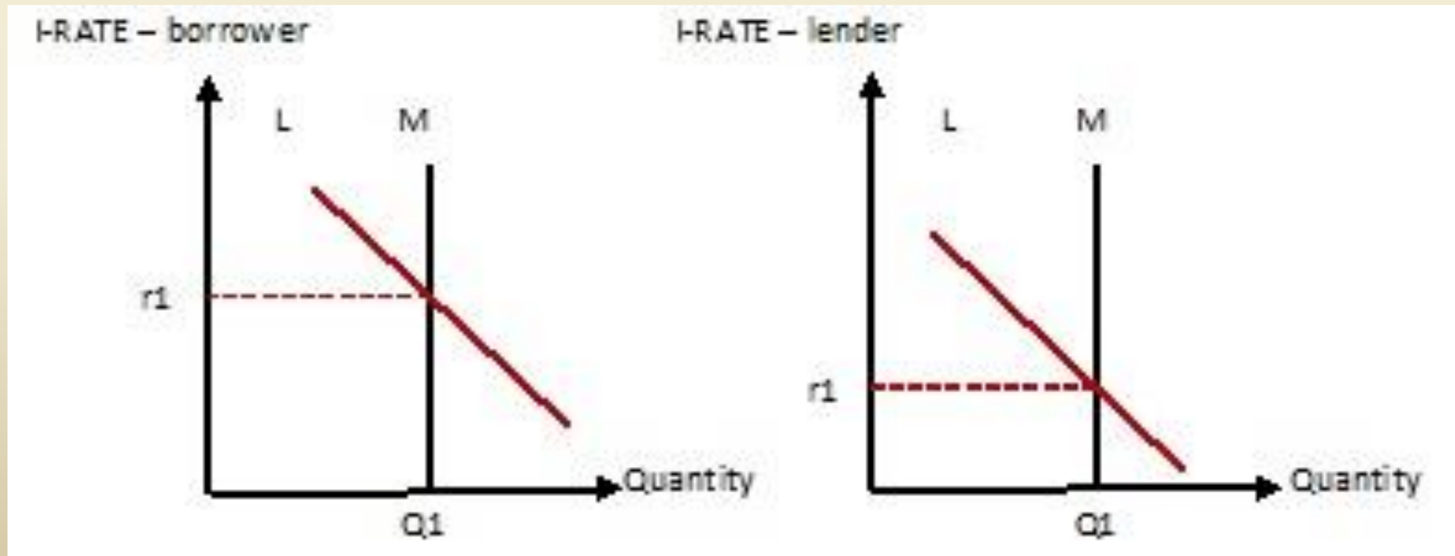
Supply of money

Given the demand for money by borrowers, the quantity of money to be supplied in the economy and the foreign markets is determined through establishing

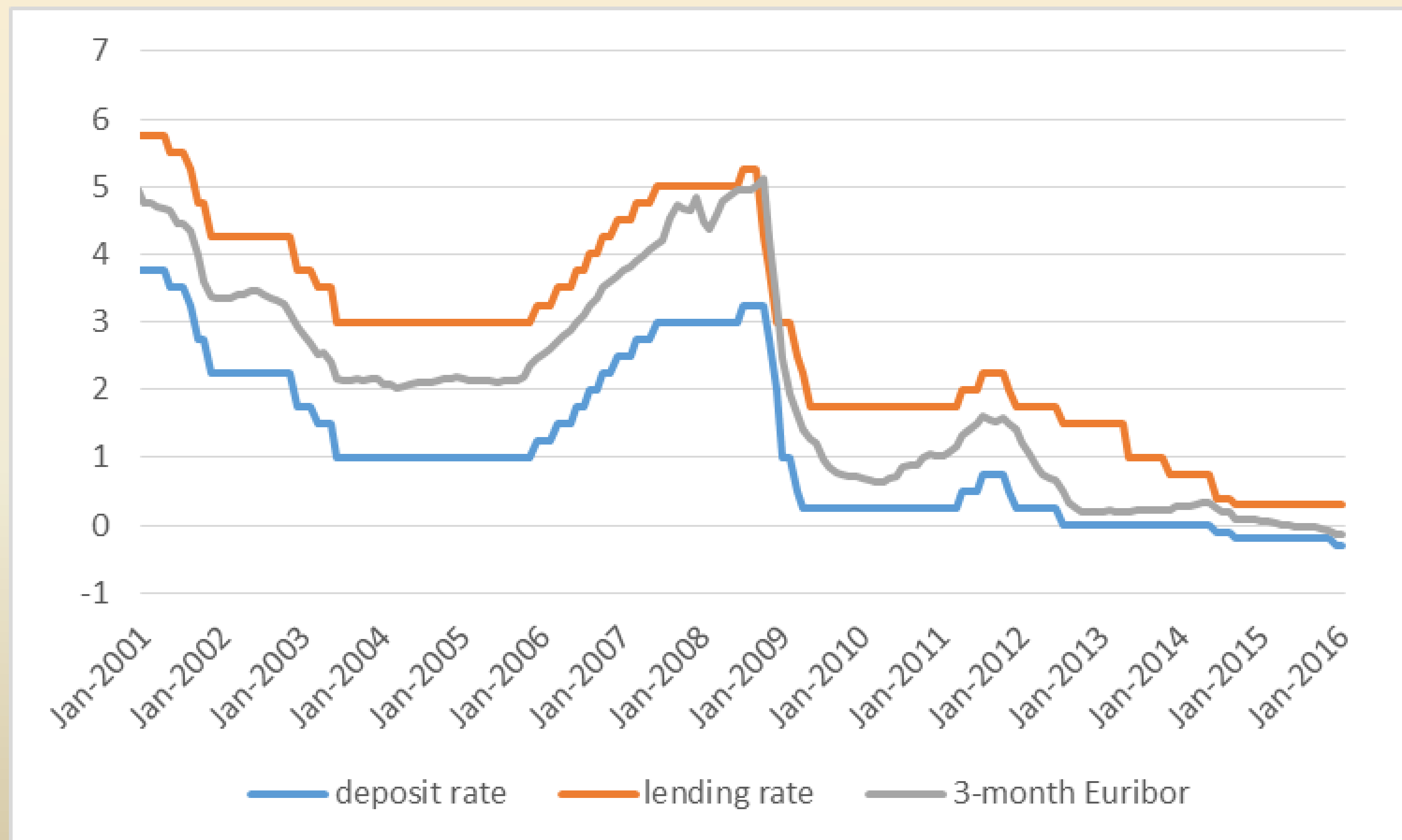
- The quantity of tangible money (i.e. existing and real money) available
- The quantity of credit (i.e. balance sheet money) to be available

Rate of interest

The interaction between demand (L) and supply for money (M) determines a rate of interest (r) for money, which is also the main revenue for a bank (amongst other sources). The value of r is different for borrowers and lenders given that borrowing entails a risk for payment default.

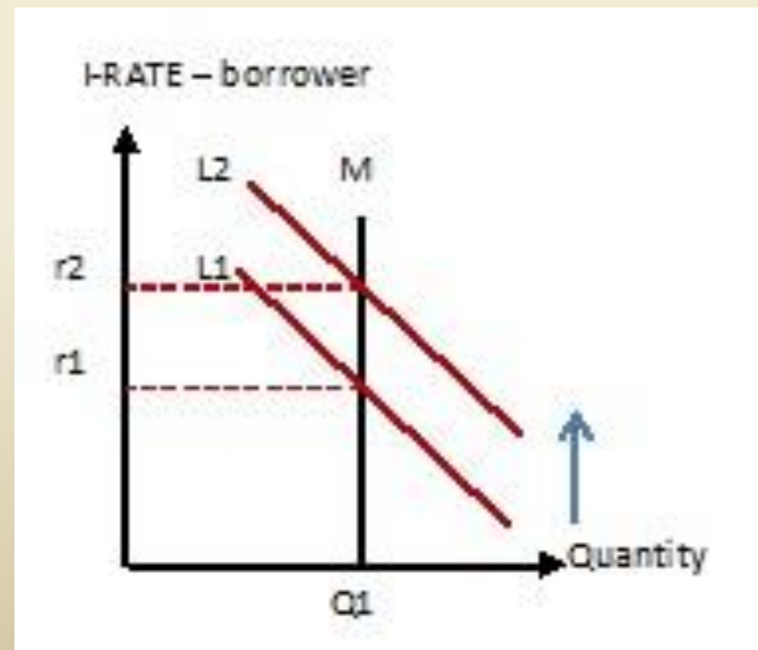


deposit vs lending rates e.g. CH

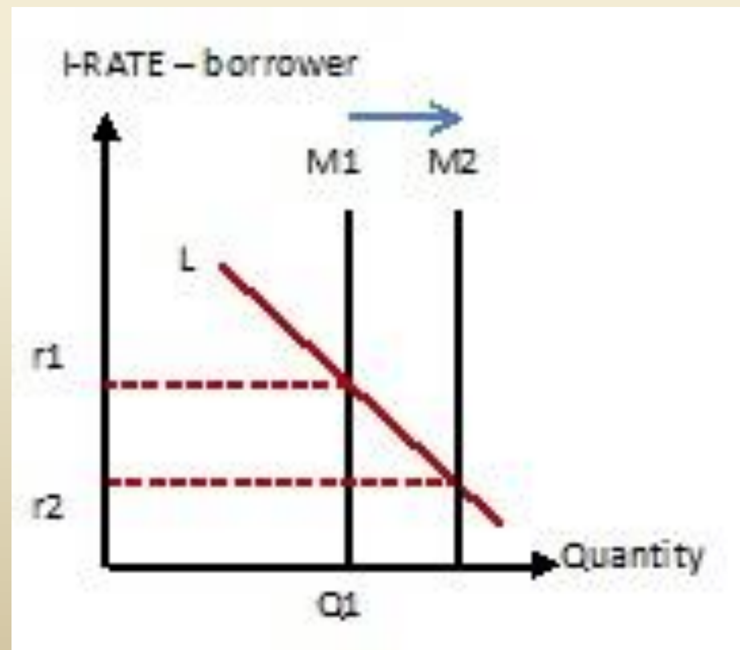


Note that the variables (M) and (r) are controllable but not (L):

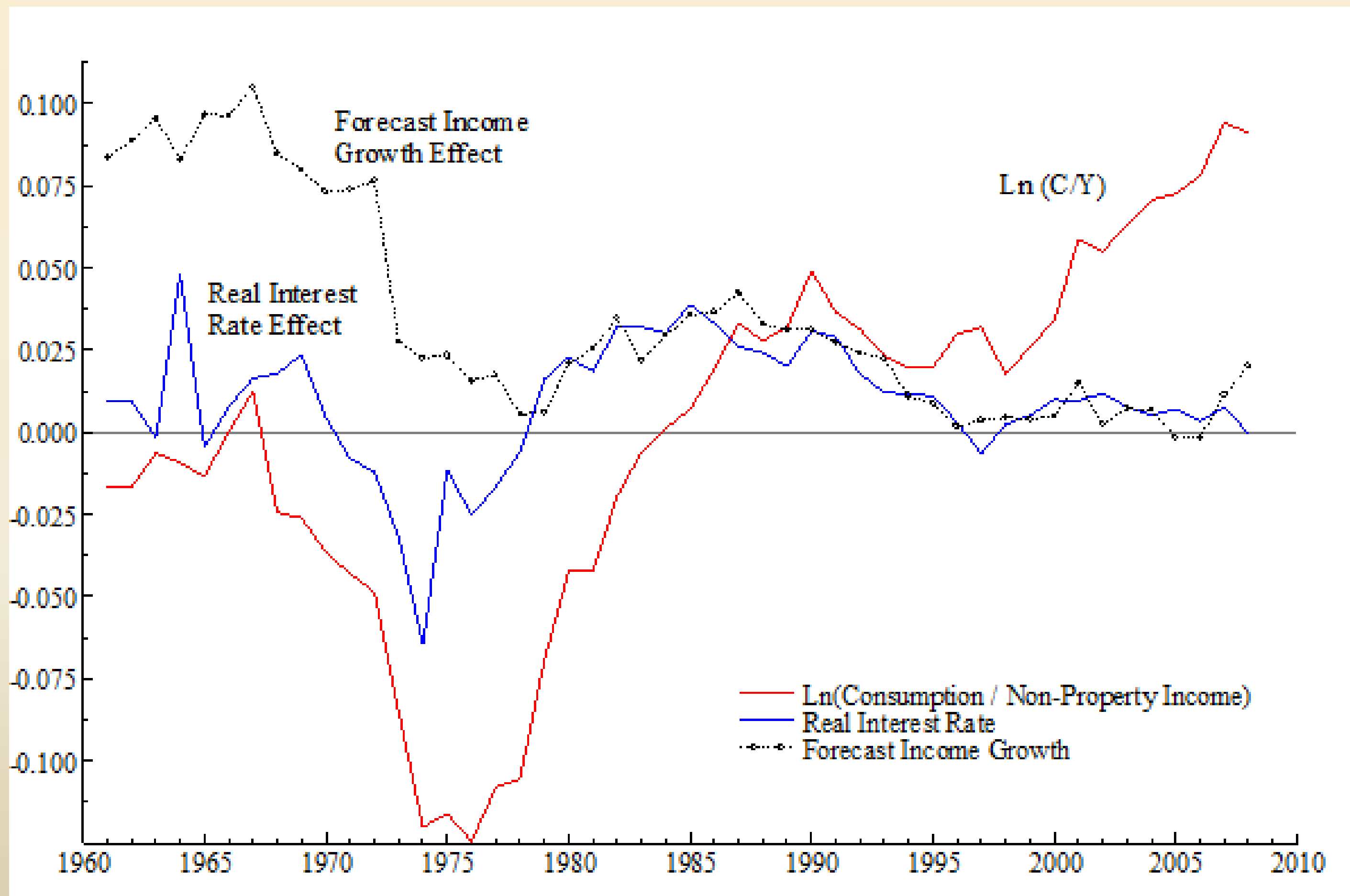
- If L increases, because of growth or demographics, there is a upward pressure on the interest rate, which, if decided, becomes an added cost to borrowers; it may even slow consumption



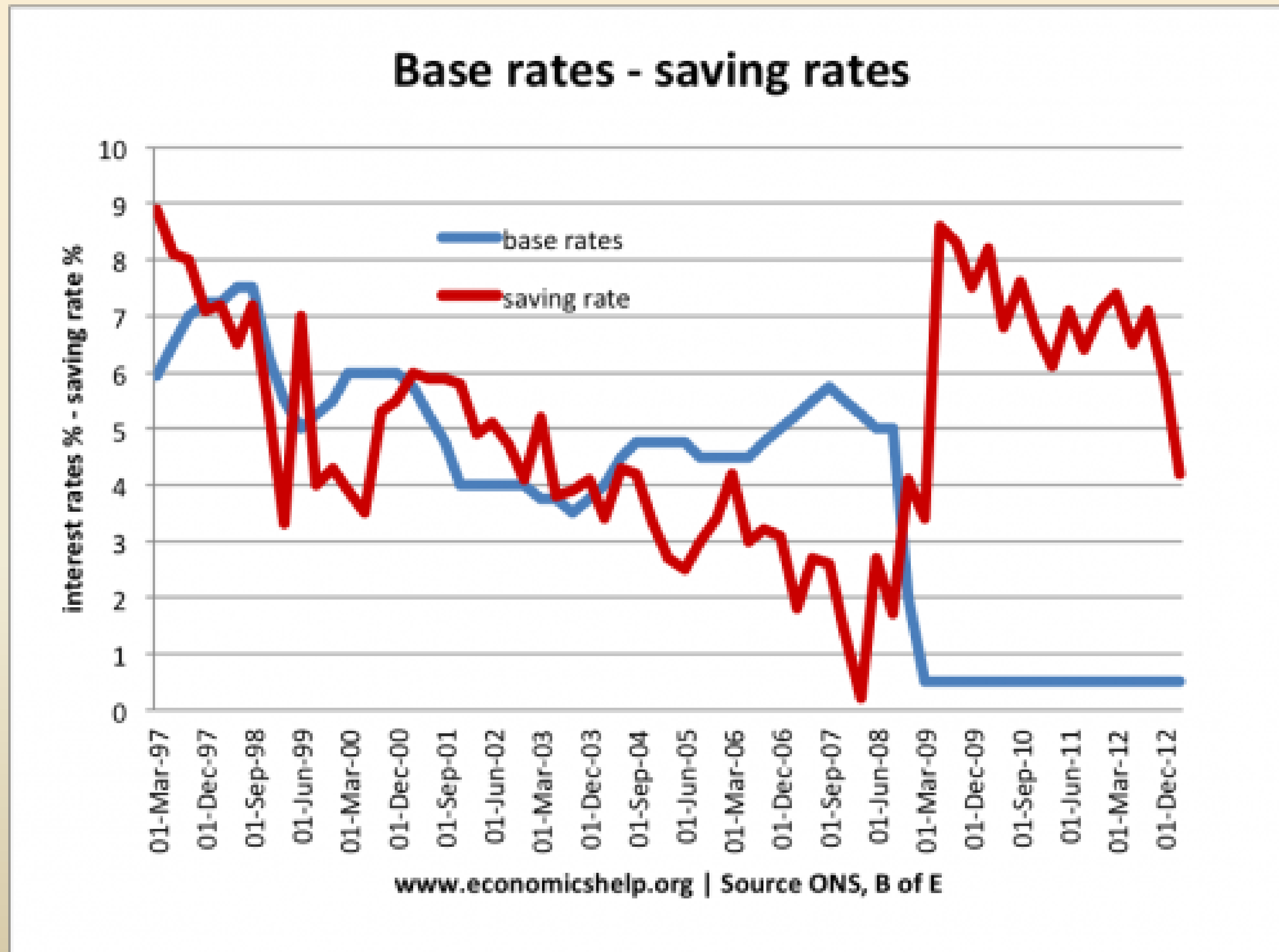
- If M increases following a decision made my the central bank, which explains the fact that it is perfectly inelastic as such decisions occur, at specific times, there is a downward pressure on the interest rate, which, if decided, reduces the cost for borrowing money; it may even stimulate consumption – no guarantees!



i-rate vs consumption



i-rate vs savings



Real rate of interest

It is important to take into account the real i-rate since important inflation may have opposite effects to those described above

- If L ↑ then i-rate ↑ but if inflation is of the same amount, i-rate ↑ will have a detrimental effect on the economy
- If M↑ then i-rate ↓ but if inflation is of the same amount, i-rate ↓ will have no effect on the economy