Central banks are the national authorities responsible for providing currency and implementing monetary policy. Monetary policy is a set of actions through which the monetary authority determines the conditions under which it supplies the money that circulates in the economy. Monetary policy therefore has an effect on short-term interest rates.

Setting monetary policy goals has been a defining issue for economists and public opinion since the consolidation of central banks as the entities responsible for providing the economies with domestic currency and for implementing monetary policy. Parallel with academic progress and experience in this matter, the understanding of monetary policy has advanced significantly over the last few decades.

Currently, it is clear that in both academic circles and among the world’s monetary authorities, monetary policy’s best contribution to sustained growth is to foster price stability. For that reason, in recent years, the central banks of many countries, including Mexico, have reoriented their monetary policy objectives, setting price stability as their main goal. This goal has been formalized, in most cases, by establishing low-level inflation targets.

The central bank does not control prices directly because these are determined by the supply and demand of many goods and services. Nevertheless, through monetary policy the central bank can influence the price-determination process and thus attain its inflation target.

The latter suggests the extreme need for the monetary authority to identify the effects that its actions have on the general economy and, particularly, on the price-determination process. The study of the channels by which these effects take place is known as the monetary policy transmission mechanism. Flow Chart 1 details this mechanism in general terms.
In general terms, central banks conduct monetary policy by affecting the conditions under which they satisfy the economy’s liquidity needs. This stage can be defined as the first stage of the transmission mechanism. The monetary authority provides liquidity to money market participants via changes in some items of the central bank balance or some measures that can influence interest rates more directly.

The second stage of the transmission mechanism consists of four channels under which short-term interest rates can influence aggregate demand and supply and, therefore, prices.

a) Interest rate channel

Medium and long-term interest rates depend, among other factors, on expectations for short-term interest rates in the future. When the central bank induces changes in short-term interest rates, they affect the entire interest rate curve. Nominal interest rates for different time horizons also depend on inflation.
expectations for those time periods (higher inflation expectations lead to higher nominal interest rates). In general terms, real interest rate increases act as a disincentive to expenditure in an economy. On the one hand, when the cost of capital to finance projects increases, investment decreases. On the other hand, when real interest rates increase, the opportunity cost of consumption does also, and therefore, consumption tends to slow. Both elements affect aggregate demand and, eventually, inflation.

b) Credit channel

When interest rates increase, credit available for investment and consumption decreases. On the one hand, interest rate increases also raise the cost of credit, and the demand for credit diminishes; on the other, the supply of credit can decline, because higher real interest rates may increase the risk of portfolio recovery, and financial intermediaries typically react to this risk by tightening credit. The decline in consumption and investment leads to a decline in aggregate demand and, consequently, to lower inflation.

c) Exchange rate channel

The increase in interest rates can make domestic financial assets more attractive to investors than foreign financial assets. This situation can trigger an appreciation of the nominal exchange rate, thus reallocating expenditure in the economy. The latter takes place because this exchange rate adjustment tends to diminish the price of imports and raise the price of exports, which tends to slow aggregate demand and eventually reduce inflation. When the exchange rate appreciates, the cost of imported inputs declines, and thus firms’ costs in general. These developments have a favorable effect on inflation.

d) Other asset-price channel

An interest rate increase tends to make bonds more attractive for investors and reduces the demand for equity, making the value of these and other assets decrease. In a situation where the market value of firms decreases, these firms can face lower capacity to access financing, therefore hindering the consolidation of new investment projects. The latter also slows aggregate demand and therefore reduces in inflation.

e) Expectations channel
Monetary policy decisions affect expectations for the future performance of the economy and, in particular, of prices. Economic agents determine their prices based on these expectations. Inflation expectations affect interest rates and these, in turn, affect aggregate supply and demand through the channels mentioned previously. Illustrating the role of inflation expectations in the economy, firms’ previsions regarding costs and future revenues are key to determining the prices and levels of production of goods and services offered.

Finally, the different channels through which the effects of monetary policy are transmitted to the economy are complementary because they operate simultaneously. There are additional channels through which monetary policy influences inflation; however, those mentioned above are the most important.