How central banks use monetary policy to manage inflation

Speech :

When we talk about monetary policy, we mean the actions taken by a central bank (like the Federal Reserve, the European Central Bank, or Bangladesh Bank) to control the money supply, credit, and interest rates in order to achieve key economic goals — mainly price stability (low inflation), economic growth, and employment.
And “Inflation” simply means the purchasing power of our money.

There are **two main types of monetary policy**, plus the key **tools** used under each:

🟦 1. Expansionary Monetary Policy

🟥 2. Contractionary Monetary Policy

Monetary Policy Tools -

1. Interest Rate Policy

2. Money Supply Control

3. Reserve Requirements

4. Open Market Operations (OMO)

5. Exchange Rate Policy

6. Credit Control Measures

Interest Rate

When central banks raise interest rates, it's big news. Bankers judging that the only way they can try to pull down inflation is to carry on raising interest rates. We're going to see rising rates. Rising interest rates that will make the cost of borrowing go up. It can send ripples across the whole economy. It can sink consumer confidence, result in fewer jobs and lower wages, and cause stock prices to fall. If they go too far too fast, it can tip economies into recession. So why do central banks raise interest rates?

Let's start with the basics. If you borrow money, you'll have to pay back a little extra to make it worthwhile for the lender. Well, I think we can make you this loan. You have a good reputation. We know you're reliable. I'm glad you think so. This is the interest rate. So if you are taking out a loan, you want the interest rate to be as low as possible, so you don't have to pay that much back.

On the flip side, if you want to save money, then a high interest rate means you can earn more on your savings. See it as a reward for leaving money in your account. But the size of your reward depends on the circumstances. There's no single interest rate in the economy. You've got thousands of banks setting their own commercial rates. That's all influenced, though, by the interest rate that the central bank sets. A central bank is like a bank for banks. Just like you and your savings account, banks also earn interest when they leave money with a central bank. Commercial banks have these things called reserves. So that's a bit like their cash on hand. Commercial banks lend those excess reserves to each other at an interest rate, and they also can deposit their excess reserves at the central bank. And when they do that, they can earn an interest rate. Ordinary people can't access the interest rate on the excess reserves, but it still affects them. And that's the idea.

When central banks raise interest rates, they're trying to control inflation — how fast prices rise for everyone. They were $1.29, now they're $1.39, and that's in the space of four weeks. Central banks like the Fed or the Bank of England or the European Central Bank are all trying to hit an inflation target of 2%. Interest rates are a really powerful tool that they have to do that. If inflation is seen as too high, that's when banks raise interest rates. The change spreads through the financial system and slows down the rate of inflation. Here's how. A rise in interest rates from a central bank means that a commercial bank will earn more on their reserves. They might make more from keeping their money in a central bank than lending it out. So if they do lend it out, they'll raise their interest rates to make it worth their while. How that affects consumers depends on the economy.

Lower spending will translate into lower inflation. And it's not just consumers who will tighten the purse strings. When interest rates rise, then businesses will find it more expensive to borrow and invest. That generally means less economic activity. It might mean fewer jobs are created. Fewer jobs and lower wages could mean less money for households. And consumer confidence might suffer, which also means less spending. People are grappling with a decline in real wages, meaning their money buys less, When interest rates rise, that will tend to slow down spending, investment, and generally depress economic activity. Overall, that will make businesses more reluctant to raise their prices, and that will tend to pull back inflation. It sounds straightforward, right? But the trick is judging how far to go. In 1981, the Federal Reserve, America's central bank, allowed interest rates to rise to a whopping 19%. The move curbed inflation, but it led to widespread economic pain.

The idea is that if it can show that it is credible, that it will always act to get inflation back down to 2%, then maybe it won't have to raise interest rates and then lower them in this kind of seesaw fashion. Raising interest rates can slow an economy right down. The trouble is, the brake pedal has a delay. It can take as long as two years to see the full results from interest rate changes. Central banks know this, so when they set interest rates, they're actually trying to read the road ahead. But predicting the future isn't easy. Slowing down the economy is not fun. But it's worth it.

It's worth it to get low and steady inflation so that in the long run, you don't have to think about it.

Money Supply (M1, M2, M3)

The central bank controls how much money is available in the economy, and this has a big impact on our daily lives.
We measure money in three levels: M1 is the cash we use every day, M2 adds our savings accounts, and M3 includes bigger, long-term deposits.

If the central bank increases the amount of money in the system, people and businesses have more to spend, which helps the economy grow.
But if there is too much money, prices can rise too fast.
So sometimes the central bank reduces the money supply to slow things down and keep inflation under control.

In simple terms, they increase money when the economy needs a boost and reduce it when prices get too high.

Reserve Requirements (CRR & SLR)

Banks don't get to use all the money we deposit.
The central bank requires them to keep a certain portion aside for safety.
This is called reserve requirements.

There are two types:
- CRR is the cash banks must keep with the central bank.
- SLR is the money banks must hold in the form of safe investments like government bonds.

If the central bank increases these requirements, banks have less money to lend. This slows down borrowing and helps control inflation.
But if the central bank lowers the requirements, banks can lend more, which boosts spending and supports economic growth.

In simple terms, reserve requirements act like a safety lock that also helps control how much money flows through the economy.

Open Market Operations (OMO)

Open Market Operations, or OMO, are one of the main tools the central bank uses to control the flow of money in the economy.
It works very simply: the central bank buys or sells government securities.

When the central bank *buys* these securities, it gives money to banks.
This increases the amount of money available, making it easier for people and businesses to borrow and spend.

When the central bank *sells* these securities, it takes money out of the banking system.
This reduces the amount of money available, helping slow down spending and control inflation.

In simple terms, OMO is like turning a tap on or off — buying opens the tap to add more money into the economy, and selling closes the tap to reduce money flow.

Rebel Bitcoin

Today, I want to talk about why many people call Bitcoin a rebel against inflation. We all know inflation — it's when the prices of things keep rising, and the money in our pockets buys less and less. This happens because governments can print more money whenever they need to.

But Bitcoin is different.

Bitcoin has a fixed limit of 21 million coins, which means no one can print more. This limited supply makes Bitcoin scarce and protects it from losing value the way regular money does. It is also decentralized, meaning no government or bank controls it. No one can change its rules or create more coins.

Because of this, many people see Bitcoin as a safe place to store their money — especially in countries where inflation is very high. When local currencies fall, Bitcoin gives people another option to protect their savings.

Data Source 1: (Raw numeric data)
https://www.worlddata.info/asia/bangladesh/inflation-rates.php

Data Source 2: (Raw numeric data)
https://www.bddata.org/db/Prices_of_selected_consumer_goods

Rice Price in Bangladesh 1980-2020