

THE EFFECTIVENESS OF TIGHT MONETARY POLICIES IN REDUCING OVERALL INFLATION

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Abstract: *The rise in global inflation during the post-pandemic period has led to a significant shift in monetary policy orientation, marked by a rapid transition from accommodative measures to restrictive policies. This article analyzes the effectiveness of these policies in reducing inflation, using a qualitative and comparative approach based on secondary data.*

The analysis focuses on the major developed economies and the strategies adopted by the Federal Reserve, the European Central Bank, and the Bank of England. The results highlight a significant correlation between the tightening of monetary conditions and the reduction of inflation during the 2022–2024 period, but also underscore the limitations of these policies in the face of supply shocks.

The study shows that the effectiveness of restrictive monetary policies depends on the nature of inflation and the structural characteristics of the economies. The findings suggest that monetary policy remains an essential tool, but is insufficient in the absence of complementary policies.

Key words inflation, monetary policy, interest rates, central banks, global economy, disinflation

JEL Classification Codes: E52, E31, E58, F41

1. INTRODUCTION

In recent years, inflation has returned to the forefront of economic attention, following a long period during which low inflation rates seemed almost a permanent feature of developed economies. The post-pandemic context, however, has radically changed this outlook, bringing to the fore a combination of factors that have generated significant inflationary pressures globally.

The rapid rebound in demand following the period of restrictions, expansionary fiscal measures, supply chain bottlenecks, and the sharp rise in energy prices have collectively contributed to accelerating inflation at a pace that was difficult to anticipate. In this context, central banks were forced to rapidly reconfigure their strategy, shifting from accommodative monetary policies to restrictive measures within a relatively short period of time.

Institutions such as the Federal Reserve and the European Central Bank adopted monetary tightening policies by raising interest rates and reducing liquidity, with the aim of curbing aggregate demand and bringing inflation back to levels considered sustainable. We consider this shift in direction to have been one of the fastest and most sweeping in recent decades, raising important questions about the effectiveness and consequences of these interventions.



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In this context, one question seems to take center stage: to what extent do restrictive monetary policies succeed in reducing inflation, especially when it is driven not only by domestic factors but also by external shocks? The answer is not straightforward, as the effectiveness of these policies depends on a number of factors, including the nature of inflation, the structural characteristics of the economy, and how the monetary transmission mechanism operates.

Based on these considerations, in this article we aim to analyze the effectiveness of restrictive monetary policies in reducing overall inflation through a comparative analysis of the major developed economies. The analysis examines not only the results achieved but also the limitations of these policies, highlighting the conditions under which they are more or less effective. Through this approach, we hope that the study will contribute to a more nuanced understanding of the role of monetary policy in the current context, characterized by uncertainty and increasingly strong economic interdependencies.

2. RESEARCH METHODOLOGY

The research is based on a qualitative methodology, utilizing: a comparative analysis of economies (the U.S., the eurozone, the UK, and Japan), a descriptive analysis of inflation and interest rate trends, and the interpretation of secondary data from official sources. The data used in the analysis comes from: the International Monetary Fund, the World Bank, and the European Central Bank. The methodology allowed us to identify the relationships between monetary policy and inflation, as it is suitable for both conceptual and applied analysis.

3. INFLATION TRENDS AND THE EFFECTIVENESS OF RESTRICTIVE MONETARY POLICY: A COMPARATIVE ANALYSIS (2019–2024)

An empirical analysis of inflation trends and monetary policy rates over the 2019–2024 period provides a clear picture of how advanced economies navigated the transition from stability to high inflationary pressures and, subsequently, to the disinflation process. Beyond the numbers, what becomes relevant is the dynamics of the relationship between monetary policy decisions and the economy’s actual response.

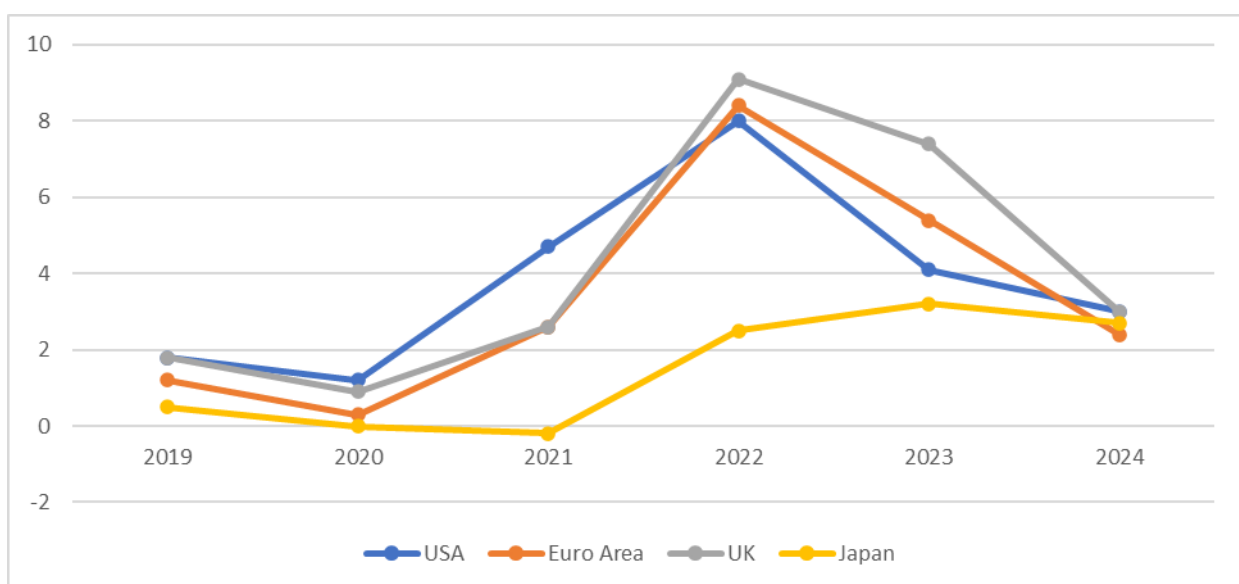


Figure no 1. The evolution of inflation during the period 2019-2024 (%)
 Source: realized by the authors using WEO database (IMF) and World Bank

Table no 1. The evolution of Monetary policy Rates during the period 2019-2024 (%)

Year	Federal Reserve	European Central Bank	Bank of England	Bank of Japan
2019	1.75	0.50	0.75	-0.10
2020	0.25	0.50	0.10	-0.10
2021	0.25	0.50	0.25	-0.10
2022	4.50	2.50	3.50	-0.10
2023	5.50	4.50	5.25	-0.10
2024	5.25	4.00	5.25	0.00

Source: made by the author using the banks sites

During 2019–2020, the economies under review were characterized by low inflation and an accommodative monetary policy stance. In 2020, amid the pandemic shock, the decline in aggregate demand led to a widespread drop in inflation, prompting central banks to adopt unprecedented stimulus measures. Interest rates were cut to record lows, and liquidity was significantly expanded to support economic activity.

We can see that the shift in trend becomes evident in 2021, when inflation begins to rise rapidly, initially in the Federal Reserve and subsequently in other economies as well. This rise largely reflects the accumulation of imbalances between supply and demand, driven by the rapid economic recovery and persistent supply chain constraints. At this stage, the reaction of central banks has been relatively cautious, amid the perception that inflation is temporary.

We consider that the year 2022 marks a turning point, both in terms of inflation levels and the direction of monetary policy. The sharp rise in prices, exacerbated by energy shocks and the geopolitical context, has prompted a rapid shift in strategy. The Federal Reserve, the European Central Bank, and the Bank of England have initiated cycles of interest rate hikes at an accelerated pace, signaling a clear priority on price stability.

Starting in 2023, the effects of these measures begin to become visible. Inflation enters a downward trajectory in all the economies analyzed, although the pace of this adjustment varies. In the United States, the decline in inflation is relatively rapid, suggesting greater effectiveness of monetary policy in controlling demand. In the euro area, the disinflation process is slower, reflecting the persistent influence of external factors, particularly energy prices. In the United Kingdom, inflation remains higher for a longer period, indicating the existence of internal rigidities, particularly in the labor market.

The Bank of Japan presents a distinct case, where the dynamics of inflation and monetary policy differ significantly. Historically low inflation rates have led to a much more cautious approach, and the process of monetary normalization has been significantly delayed compared to other developed economies.

Overall, we can observe that the data highlight a clear relationship between tighter monetary conditions and lower inflation, but this relationship is not uniform. The differences observed across economies suggest that the effectiveness of monetary policy is influenced not only by the intensity of the measures adopted but also by the economic context in which they are implemented.

Thus, the empirical analysis confirms that restrictive monetary policies contribute to reducing inflation, but at the same time we consider that it emphasizes that their results are mediated by structural factors and the nature of the shocks that generated inflationary pressures.

4. DISCUSSION

We believe that the results obtained should be interpreted in the context of the structural characteristics of the economies under analysis.

First, the effectiveness of restrictive monetary policies is greater in the case of demand-driven inflation. In contrast, in the context of supply shocks, the impact of these policies is limited.

Second, there is a significant time lag between the implementation of measures and their effects on inflation. This complicates the decision-making process of central banks and may lead to risks of over-tightening.

Third, the costs associated with restrictive policies are not negligible. Reducing inflation is accompanied by a slowdown in economic growth and an increase in the cost of borrowing.

Therefore, we believe that the effectiveness of monetary policy must be assessed not only in terms of reducing inflation, but also in relation to its impact on overall economic stability.

5. IMPLICATIONS AND LIMITATIONS OF RESTRICTIVE MONETARY POLICIES

An analysis of the results obtained between 2019 and 2024 suggests several important implications for how monetary policy should be understood and implemented in the current context.

First, it is clear that restrictive monetary policies remain the central tool in the fight against inflation. The coordinated responses of institutions such as the Federal Reserve or the European Central Bank show us that raising interest rates remains the most direct and effective way to curb aggregate demand and stabilize inflation expectations. In this regard, recent experience confirms the validity of the classic monetary transmission mechanism, even in a global context that is far more complex than in the past.

At the same time, we believe that the results increasingly highlight that monetary policy cannot act effectively in isolation. The reduction in inflation was not driven exclusively by rising interest rates, but also by factors such as the normalization of supply chains or the stabilization of energy prices. This suggests that the effectiveness of monetary policy depends on the existence of a broader macroeconomic framework, in which fiscal policies and structural interventions play a complementary role. In the absence of such coordination, monetary policy risks being either insufficient or becoming excessively restrictive.

We believe another important implication concerns the role of expectations. In many cases, the rapid response of central banks had not only a direct effect on the cost of credit but also a psychological effect on economic agents. The stabilization of inflation expectations contributed significantly to the disinflation process, which confirms the importance of communication and institutional credibility.

On the other hand, the analysis also highlights a number of structural limitations of restrictive monetary policies.

The most important of these relates to the nature of recent inflation. Unlike classic episodes of demand-driven inflation, inflation during the period under review had a strong supply component. Rising energy prices, logistical disruptions, and geopolitical tensions cannot be directly controlled through monetary instruments. Under these conditions, we believe that raising interest rates acts rather indirectly and, at times, insufficiently on the source of the problem.

Second, we must take into account the lag in the effects of monetary policy. Decisions made by central banks take a significant amount of time to impact the economy, typically between 12 and 18 months. This lag creates difficulties in calibrating interventions and can lead

to the risk of an overreaction. In other words, there are situations where inflation begins to fall, but monetary policy remains restrictive, unnecessarily amplifying economic costs.

Furthermore, the costs associated with these policies are not negligible. The reduction in inflation has been accompanied by a slowdown in economic growth, an increase in the cost of borrowing, and, in some cases, pressure on the labor market. This trade-off between price stability and economic growth remains one of the most sensitive dilemmas of monetary policy.

Last but not least, the analysis highlights the fact that the effectiveness of monetary policy is deeply dependent on the specific characteristics of each economy. The differences observed between the U.S., the euro area, and Japan show that there is no one-size-fits-all solution. Factors such as the energy mix, labor market rigidity, or the degree of economic openness significantly influence the outcomes of monetary policy.

In conclusion, we believe that restrictive monetary policies have proven useful in reducing inflation, but recent experience clearly shows that they cannot be considered a sufficient tool in isolation. Their effectiveness depends on the context, coordination with other policies, and the ability of central banks to manage the delicate balance between price stability and overall economic stability.

6. TIGHT MONETARY POLICY AND THE RISK OF RECESSION

One of the most debated and, at the same time, difficult-to-manage effects of restrictive monetary policy is the risk of an economic slowdown or even a recession. In theory, the role of these policies is relatively clear: by raising interest rates and tightening liquidity, central banks reduce inflationary pressures. In practice, however, we believe this process involves a delicate balance, as the mechanisms that help reduce inflation are the same ones that can negatively impact economic growth.

At the mechanism level, we believe that things work in a relatively straightforward way, but with ripple effects. Higher interest rates make credit more expensive, which discourages debt-financed consumption and reduces firms' appetite for investment. At the same time, the value of financial and real estate assets may be affected, which negatively impacts households' perceived wealth and, consequently, their consumption behavior. All these channels contribute to dampening aggregate demand, but if they are too strong, they can lead to a sharp slowdown in economic activity.

Recent experience shows that the responses of institutions such as the Federal Reserve or the Bank of England have been deliberate and firm, precisely to avoid the risk of inflation becoming persistent. Rapid increases in interest rates were intended to send a strong signal to the markets and anchor inflation expectations. However, these measures have gradually begun to take effect in the real economy, leading to a slowdown in lending, a decline in investment, and a moderation in consumption.

We believe that a key factor in understanding this process is the time lag in the transmission of monetary policy. Unlike other economic policies, the effects of monetary policy decisions are not immediate. Typically, the full impact on the economy becomes apparent after a period of 12 to 18 months. This lag significantly complicates the decision-making process, as central banks must act based on expectations regarding future developments, not just on current data.

From our perspective, this context poses a significant risk: that monetary policy may become excessively restrictive. If central banks continue to raise interest rates at a time when inflation is already beginning to decline, the cumulative effects of the measures taken could lead to a stronger economic contraction than is necessary. This situation is difficult to avoid, precisely because of the lag between decision and effect, and explains why many central banks adopt a more cautious approach in later stages.

Another relevant point, in our view, is that the impact of monetary policy is not evenly distributed across the economy. Sectors sensitive to the cost of credit, such as construction or the real estate market, react much more quickly and strongly to rising interest rates. In contrast, other sectors may be affected indirectly or with a delay. Furthermore, households with variable-rate loans immediately feel the rise in costs, which can lead to a significant reduction in consumption. These differences can amplify economic imbalances and generate social effects that are not necessarily visible in aggregate macroeconomic indicators.

Furthermore, we must take into account the interaction between monetary policy and the broader economic context. In situations where the economy is already fragile and inflation is largely driven by external factors, such as energy prices, the restrictive effects of monetary policy can have a disproportionate impact on economic growth without directly addressing the cause of inflation. In such cases, monetary policy risks addressing the symptoms rather than the causes.

In the academic literature and recent practice, we have observed the emergence of the concept of a “soft landing,” meaning the reduction of inflation without triggering a severe recession. This objective reflects central banks’ efforts to calibrate policies in a way that maintains a balance between price stability and the support of economic activity. However, achieving this balance is difficult and depends on a number of factors that cannot be fully controlled, including external developments or market reactions.

Taken as a whole, it becomes clear that restrictive monetary policy involves an inevitable trade-off. On the one hand, it is indispensable for reducing inflation and maintaining the credibility of central banks. On the other hand, it generates economic costs that cannot be ignored. For this reason, the assessment of monetary policy effectiveness should not be limited to an analysis of inflation, but should also include the impact on economic growth, investment, and overall well-being.

From our perspective, the risk of recession is not an unintended consequence of restrictive monetary policy, but an inherent consequence of the mechanism through which it operates. The major challenge for central banks lies in managing this risk so that reducing inflation does not come at an excessive economic cost.

7. CONCLUSIONS

An analysis covering the period 2019–2024 highlights the fact that restrictive monetary policies have played a key role in the process of reducing inflation globally. The relationship between tighter monetary conditions and the downward trend in inflation is evident in most developed economies, which broadly confirms the effectiveness of this classic economic policy tool.

However, a closer look at the data and the macroeconomic context reveals that this effectiveness is neither uniform nor complete. In economies such as the United States, where the demand component of inflation was more pronounced, the Federal Reserve’s swift response led to relatively rapid disinflation. In contrast, in the eurozone, where price increases were heavily influenced by energy shocks, the European Central Bank’s interventions had a slower and less direct effect on inflation.

This difference should not be interpreted as a lack of effectiveness of monetary policy, but rather as a reflection of its structural limitations. Monetary policy works best when inflation is driven by excess demand, but becomes considerably less effective in the face of external or structural factors over which it has no direct control. From this perspective, recent experience provides a strong argument in favor of a more nuanced approach that takes into account the nature of inflation, not just its level.

From our perspective, another relevant aspect concerns the time lag between the adoption of measures and the emergence of their effects. The disinflation observed in 2023–2024 is not

solely the result of recent decisions, but largely reflects the cumulative effects of measures adopted previously. This underscores the difficulty of the decision-making process in monetary policy and the need for a prudent approach that avoids both delayed reactions and excessive interventions.

At the same time, we believe that the costs associated with these policies cannot be ignored. The reduction in inflation has been accompanied by a slowdown in economic growth and an increase in the cost of financing, which confirms the existence of a real trade-off between price stability and economic dynamics. In this context, the effectiveness of monetary policy should not be assessed solely in terms of inflation, but also in relation to its impact on the economy as a whole. Looking ahead, the results suggest that monetary policy will continue to be a central tool in managing inflation, but not a sufficient one on its own. Recent experience shows us that price stability depends increasingly on the interaction between monetary, fiscal, and structural policies. In the absence of such coordination, central banks' ability to control inflation can be significantly limited.

In conclusion, we believe that restrictive monetary policies have demonstrated their usefulness, but also their limitations. They remain indispensable, but their effectiveness depends on the economic context, the nature of the shocks, and how they are integrated into a broader economic policy framework.

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