Monetary Policy

What is monetary policy?
A policy formed by the central bank to control the supply of money around the economy.

What methods do they use?
- **Base rate:** the interest rate set by the central bank for lending to other banks. This influences the interest rates that commercial banks use to lend to customers. Commercial banks tend to place their interest rates above the base rate.

- **Reserve requirement:** the ratio of funds that the central bank requires commercial banks to hold in reserve compared to the deposits made by customers. This means that there is control over how much commercial banks are allowed to lend.

- **Quantitative easing:** the central bank creates money electronically to purchase government bonds. However, this is a controversial policy as similar policies have been used to services the government debts of countries in the past such as 1920s Germany and Zimbabwe. Also the money must later be withdrawn from the economy which can become very painful if the economy begins to rely too heavily on the policy.

- **Buying and selling government bonds:** the central bank may buy government bonds with its reserves in order to increase the supply of money, as it allows the government to spend more. However, selling the government bonds will do the reverse and reduce the money supply.

What is expansionary/inflationary monetary policy?

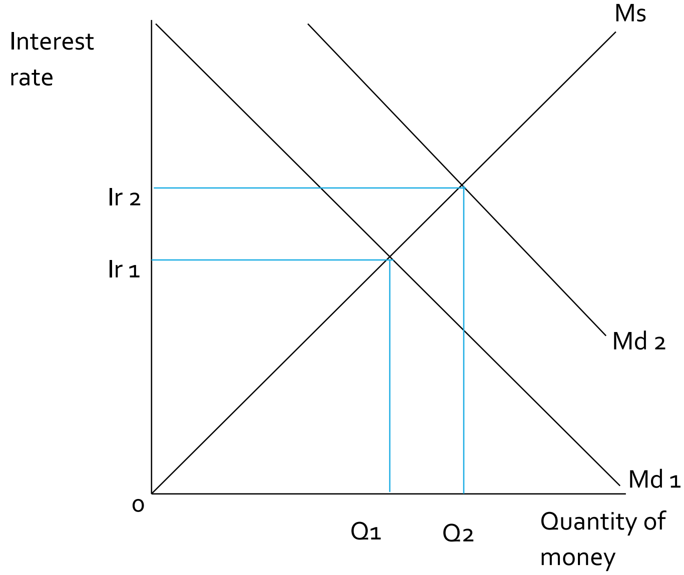
The central bank lowers interest rates and increases money supply in order to promote growth in the economy. This can also increase inflationary pressures.

What is contractionary/deflationary monetary policy?

The central bank increases interest rates and decreases money supply in order to reduce growth in the economy. This can also reduce inflationary pressures.

The role of interest rates

Interest rates: the cost of borrowing and the reward for saving.



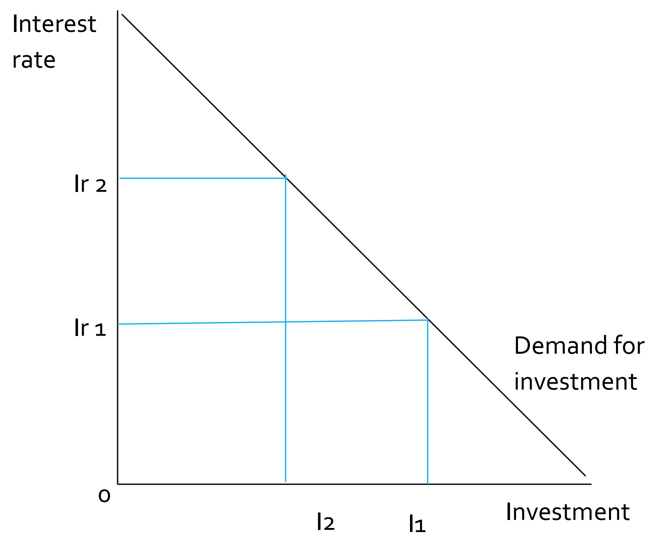
1. The money demanded increase from Md1 to Md2 – this may be due to people to an increase in spending rather than saving.
2. At IR1 there would be excess demand for money
3. The central bank decides to increase interest rates to Ir2 in order to reduce the excess and create a new equilibrium at Q2

What happens if interest rates increase?

Savers: people become more inclined to save money, rather than spending it so consumption decreases.

Borrowers: borrowing becomes more expensive, so people will delay purchases if they would have to borrow in order to pay for the products. Therefore, fewer borrowers means lower levels of consumption.

Firms: it is more difficult to find funds in order to pay for expansion, so firms reduce their investment spending which leads to a fall in aggregate demand.



Mortgage owners: flexible mortgage rates increase with an increase in interest rates, this reduces their discretionary income (income available once taxes and current bills have been paid for) and means that individuals have less money to spend on goods and services, so consumption decreases.

Government: the government also borrows money to pay for its spending, so an increase in interest rates may cause them to fall into greater debt. In order to deal with this the government may increase taxes and reduce its spending, such as on healthcare, education or pensions, which in turn will lead to a fall in aggregate demand and economic growth of the country.

Questions

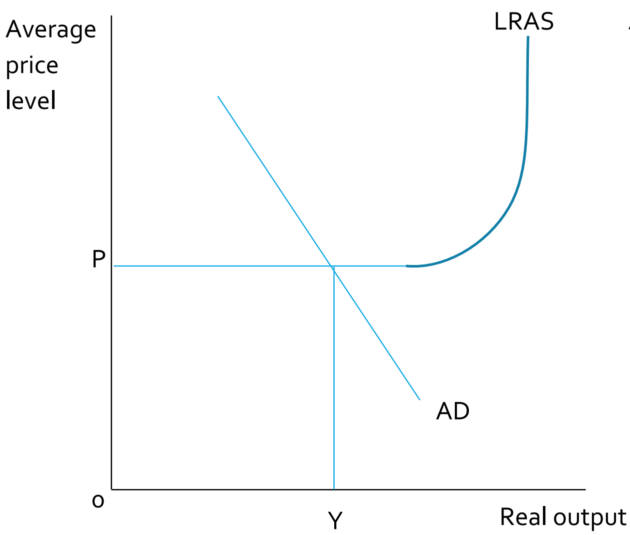
What would happen to the savers, borrowers, firms, mortgage owners and government if the central bank reduce the base rate?

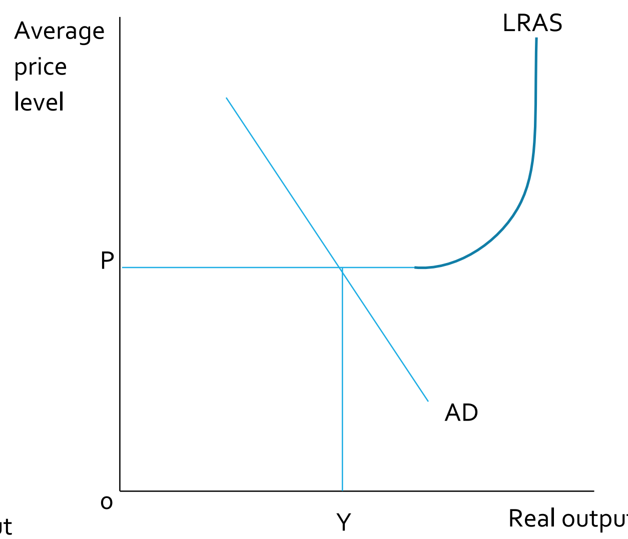
How does an increase in the reserve requirement lead to a contraction in the economy?

How does an increase in quantitative easing increase aggregate demand in the economy?

How would the sale of government bonds by the central bank lead to a reduction in consumption?

These are Keynesian LRAS and AD curves, show what would happen if the government followed an expansionary monetary policy and if they followed a contractionary monetary policy?





Evaluation of Monetary Policy

- The central bank is usually independent from political motives
- Interest rates can be increased/decreased incrementally, to maintain confidence and stability in the economy
- The interest rates can be changed relatively quickly as the monetary policy committee tends to meet monthly
- There are still some time lags as some mortgages are on fixed rates, so it takes more time to change these, and consumers may not immediately notice the change in interest rates, so they will not react for a while.
- The impact of an increase in aggregate demand on economic growth depends on the current state of the economy and whether a Keynesian or monetarist graph is used.
- Interest rates cannot be lowered below zero and decreasing interest rates when they are already low tends to have little effect.