Monetary Policy

Monetary policy refers to the policy of the government to use the interest rate and money supply to manage aggregate demand in an economy in order to achieve macroeconomic objectives. It can be an expansionary monetary policy or a contractionary monetary policy.

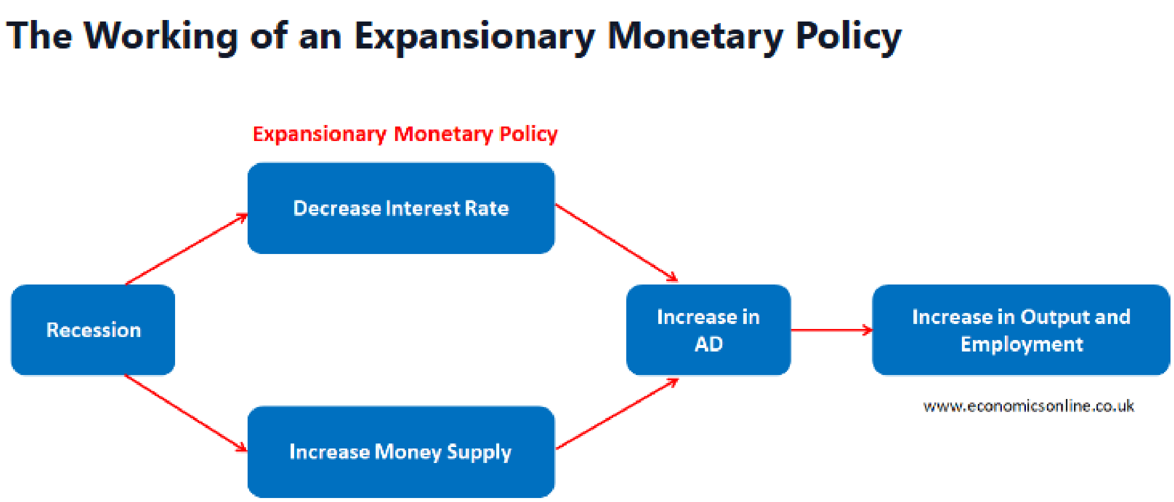
What is an Expansionary Monetary Policy?

Expansionary monetary policy refers to the policy of the government to decrease the interest rate and increase the money supply in order to increase aggregate demand in an economy to increase output and employment levels.

<u>Tools for an Expansionary Monetary Policy</u>

Increasing Money Supply

Decreasing interest rate

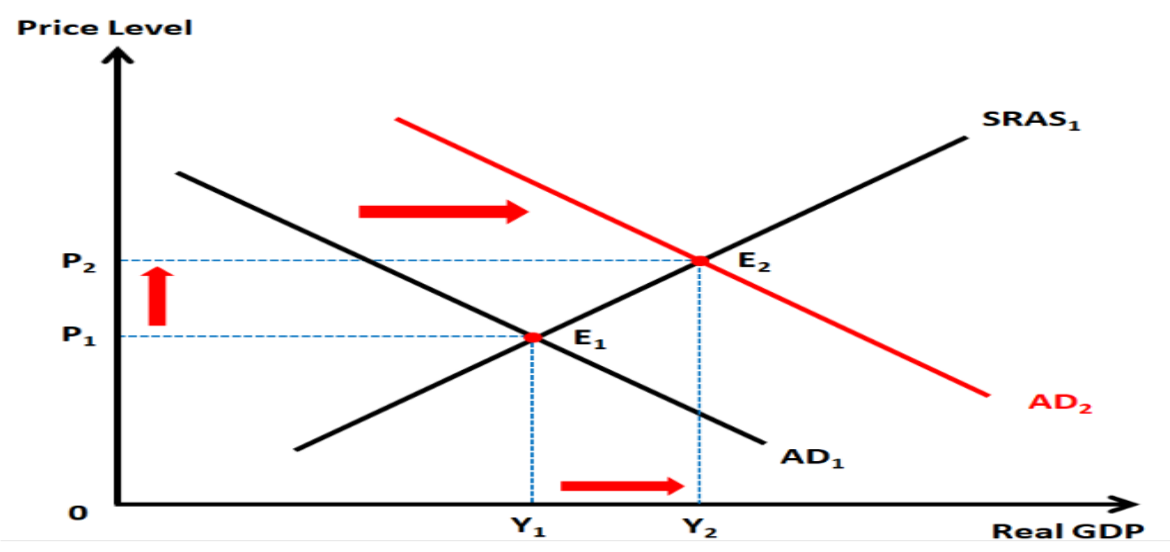


When a central bank decreases the discount rate and increases the money supply, it can increase aggregate demand

Due to the lower interest rate, loans will become cheaper for individuals and firms and they will increase their consumption (C) and investment (I). The households will save less and spend more. Firms will also have an incentive to invest more as they are expecting higher consumption by households. This will increase the aggregate demand.

The central bank can increase money supply in many ways including the purchases of government bonds, open market operations, printing more money or encouraging commercial banks to increase lending by decreasing the reserve requirements. Due to an increase in the money supply, individuals and firms will have more money which may lead to an increase in consumption and investment. As a result, the aggregate demand will increase.

Graph of Expansionary Monetary Policy



In the above graph, the Real GDP is taken on the horizontal axis (x-axis) while the price level is taken on the vertical axis (y-axis). The initial equilibrium is at E1 which is point of intersection of aggregate demand curve AD1 and short run aggregate supply curve SRAS1. The initial price level is P1 and the initial output level is Y1. When interest rate is decreased and money supply is increased, the aggregate demand curve is shifted towards right from AD1 to AD2. The new equilibrium point is E1. The real GDP is increased from Y1 to Y2 showing economic growth and a fall in unemployment. The general price level is increased from P1 to P2 showing a resulting inflation which is a side-effect of an expansionary monetary policy.

The Effects of Expansionary Monetary Policy on Macroeconomic Objectives

The above graph illustrates the impact of expansionary monetary policy on the following macroeconomic objectives of government.

Effect on Economic Growth

Economic growth in a country will increase as a result of using an effective expansionary monetary policy. In the above graph, the real GDP is increased from Y1 to Y2 indicating economic growth.

Effect on Unemployment

The unemployment in a country will decrease as a result of using an effective expansionary monetary policy. In the above graph, the increase in real GDP from Y1 to Y2 indicates a fall in unemployment.

Effect on Inflation

The inflation rate will increase as a result of using an expansionary monetary policy. In the above graph, the increase in price level from P1 to P2 indicates inflation. This is a negative effect of using an expansionary monetary policy. Central banks should keep check and balance on inflation and try to adjust their policies to maintain price stability.

Contractionary Monetary Policy

Contractionary monetary policy aims to slow down the economic growth of a country and control inflation by decreasing borrowing and spending, increasing interest rates, decreasing money supply and by limiting access to credit.

Contractionary monetary policy is typically used when inflation becomes a concern and needs to be controlled.

Conclusion

In conclusion, expansionary monetary policy refers to the use of reduction in interest rate and an increase in money supply to increase aggregate demand in an economy. This policy can serve as a useful tool to achieve economic growth and tackle recession. However, this policy has some drawbacks such as inflationary pressure, asset price bubbles, unequal distribution of income, and the risk of future instability. Governments should keep a close check on inflation rates when using an expansionary monetary policy and take corrective measures if inflation becomes a matter of concern.