MONETARY POLICY

Monetary policy: The use of interest rates and the money supply to control aggregate demand in the economy.
Money supply: The amount of money circulating in the economy. This includes all notes and coins in the economy plus any money held in bank accounts.
Interest rates: The cost of borrowing money or the reward for lending/saving money. An interest rate is normally expressed as a % of the total borrowed/lent/saved.
Base rate: The rate of interest set by government or regional central banks for lending to other banks, which in turn influences all other rates in the economy.
Mortgage: Legal arrangement where you borrow money from a financial institution in order to buy land or a house, and you pay back the money over a period of years; if you do not make your regular payments, the lender normally has the right to take the property and sell it in order to get their money back. The land/property is put up as collateral (security).

The Role of Central Banks

In many countries, interest rates are set by a central bank. Central banks play an important role in the economy by:
- implementing the government's monetary policy and regulating the banking system.
- acting as a lender of last resort to commercial banks
- controlling inflation and stabilising a nation's currency
- setting interest rates (base rates).

Impact of Interest Rate Changes on Macroeconomic Objectives

Inflation

Monetarists believe that inflation is caused by the money supply growing too quickly, and that interest rates can be used to slow it down. When interest rates are higher, borrowing is likely to fall as it will be more expensive to pay money back. The money supply will grow less quickly which will help to reduce aggregate demand in the economy and limit price increases, decreasing inflation.

Unemployment

A decrease in interest rates is likely to increase consumer and business borrowing. This, in turn, will increase aggregate demand, leading to an increase in production of goods and services. Businesses will need to recruit more employees to meet the demand, so unemployment will fall. Hence, a government might loosen the monetary policy (i.e. lower interest rates) to reduce unemployment.

Economic growth

Governments can use monetary policy to encourage an economy out of a recession. If base rates are set very low, this will encourage businesses and consumers to borrow more because it will be cheaper for them to repay the loan than it might be if rates go up.

The current balance

A government could use monetary policy to adjust the current account balance. For example, to reduce a deficit, a government might decide to use contractionary monetary policy by raising interest rates. This would lower aggregate demand and less would be spent on imports. However, raising interest rates may also result in the appreciation of the exchange rate. This would make exports more expensive and imports cheaper and worsen the current balance. The overall effect of higher interest rates on the current account depends on whether:

- Demand for imports is income elastic or not; since higher interest rates would mean lower disposable income, then demand for imports would fall proportionately more and current account balance would improve.
- The link between interest rates and exchange rates are strong or not. If the link is strong, higher interest rates will raise exchange rates. Exports will become more expensive and imports will become cheaper. The current balance would worsen.
- Demand for imports and exports are price elastic or not; if they are both price elastic and the exchange rate appreciates when interest rates rise, imports will be cheaper and exports will be dearer. This would worsen the current account.

The Mechanism by which Interest Rate Changes Affect Consumers & Firms

Consumers

When interest rates fall:

- demand for loans from households will rise. Consumers are likely to borrow money to buy goods, such as cars, furniture and holidays, because borrowing is cheaper.
- mortgage payments of consumers will fall. This means they will have more disposable income, which will also increase aggregate demand.
- savers will be rewarded less for saving their money. This might encourage people to spend rather than save.

When interest rates rise:

- consumers try to reduce borrowing because it becomes expensive. As a result, demand for goods using borrowed money will fall.
- mortgage payments will rise. People will have less disposable income to spend and will have to cut some of their expenditure or reduce their saving. This dampens inflationary pressure.

Firms

When interest rates fall:

- this will help to increase the profits of businesses, as their costs, which include borrowed money, such as mortgages, loans and overdrafts to fund their business activity, will be lower.
- business confidence levels will rise, and this will stimulate more investment. This is because since a large proportion of business investment is funded through borrowing, lower interest rates mean that the returns on investment are likely to be higher.
- the exchange rate is likely to fall. If it falls, the prices of exports become cheaper and demand for them will rise. Firms will benefit because they will sell more goods and services. Also, the price of imports will rise, which means domestic consumer and firms will buy fewer. An increase in exports and a fall in imports will increase aggregate demand, improving the balance on the current account.

When interest rates rise:

- costs will rise, profits will be lowered, business confidence will be reduced and entrepreneurs will be more cautious. As a result, investment is likely to fall.

The use of Asset Purchasing by Central Banks

One way to control the money supply is by using a method called quantitative easing. **Quantitative easing:** Buying financial assets, such as government bonds, from commercial banks, which results in a flow of money from the central bank to commercial banks.

- This extra cash can be used by commercial banks as a basis for making new loans to consumers and businesses. When more loans are granted, aggregate demand will increase. However, one possible problem with quantitative easing is that it can be inflationary. This is because the money used by the government does not exist - it is created electronically. The government buys financial assets from commercial banks and increases the cash balances in their accounts without actually giving them any cash.