The BIG ideas!

webnote 250

Syllabus 2.5

I.b Syllabus 2.5: Macroeconomic Objectives:

Monetary Policy

Syllabus 120-123

- 250: Powerpoint summary
- 251: Policy Conflicts
- 252: How Monetary Policy works
- 253: Monetary Policy and Circular Flow
- Sample Exam Question – see slide 4

Big Idea 1

Big Idea 2

Big Idea 3

Big Idea 4

Key terms

- **2.5 - Monetary Policy**

- interest rate
- time lag
- monetary policy
- commercial bank
- regulator
- central bank
- expansionary monetary policy
- tight/contractionary policy

Notes :

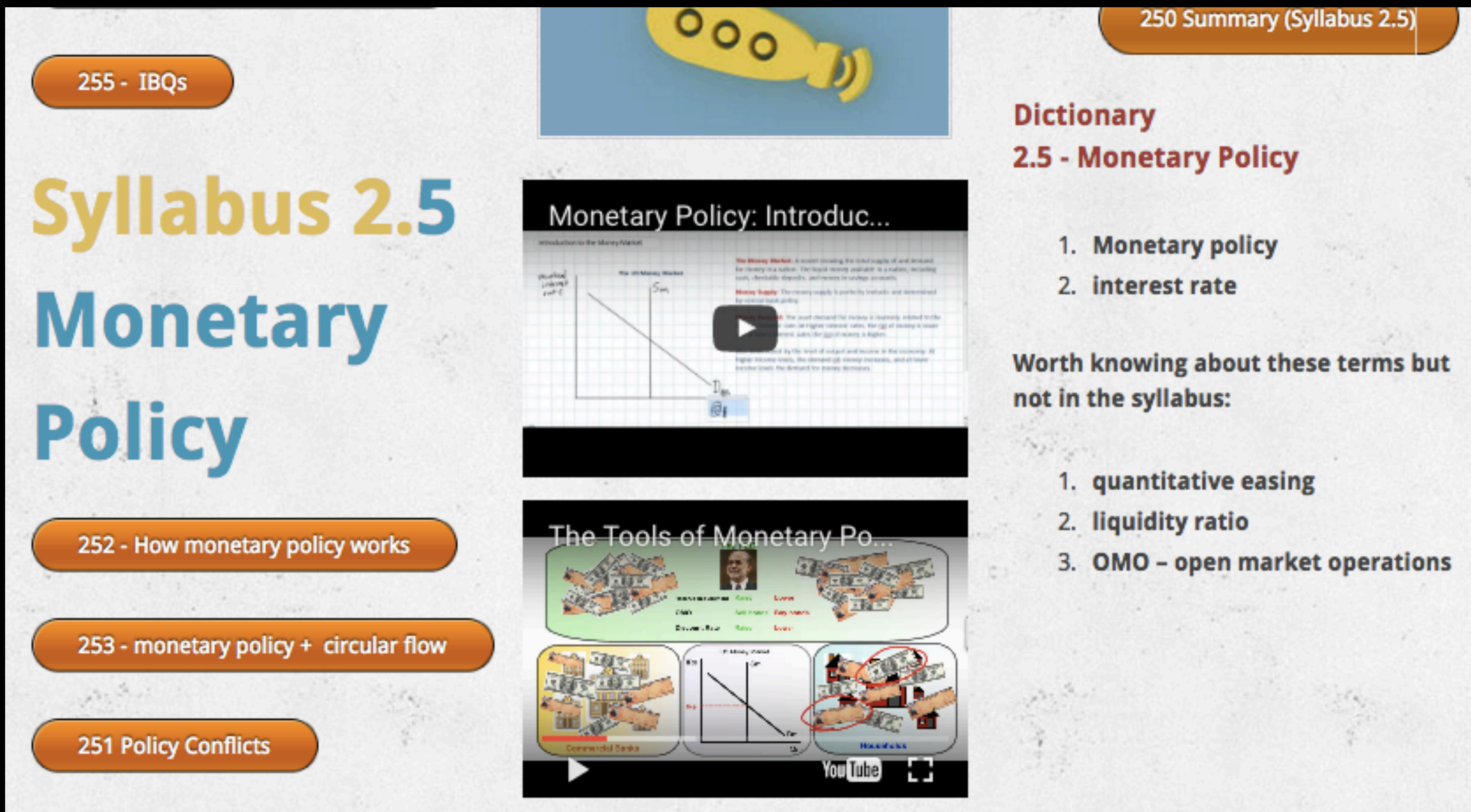
- explicit or implicit rate of inflation

and rational expectations

- syllabus also refers to possible

policy conflict in prioritizing inflation control (Item 123 in syllabus)

Use Big Questions 2.5+ webnotes



syllabus 123

- 123 (weight = 5)
- Evaluate the effectiveness

of monetary policy through

consideration of factors

including the independence of the central bank, the ability to adjust interest rates incrementally, to ability to implement changes in interest rates relatively quickly, time lags, limited effecetiveness in increasing aggregate demand if the economy is deep in recession and conflict among government economic objectives.

Ib question May 2013 - HP1

Macroeconomics

- 3. (a) Using a diagram, describe how expansionary monetary policy might be used to close a deflationary (recessionary) gap. [10 marks]
- (b) Discuss why, in contrast to the monetarist/new classical model, an economy can remain stuck in a deflationary (recessionary) gap according to the Keynesian model.

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Webnote 250

Syllabus reference: items 120 +123

Big Idea

1

Why is Monetary Policy a key market based macroeconmic policy? (See also slide 9)

- **Some key points**

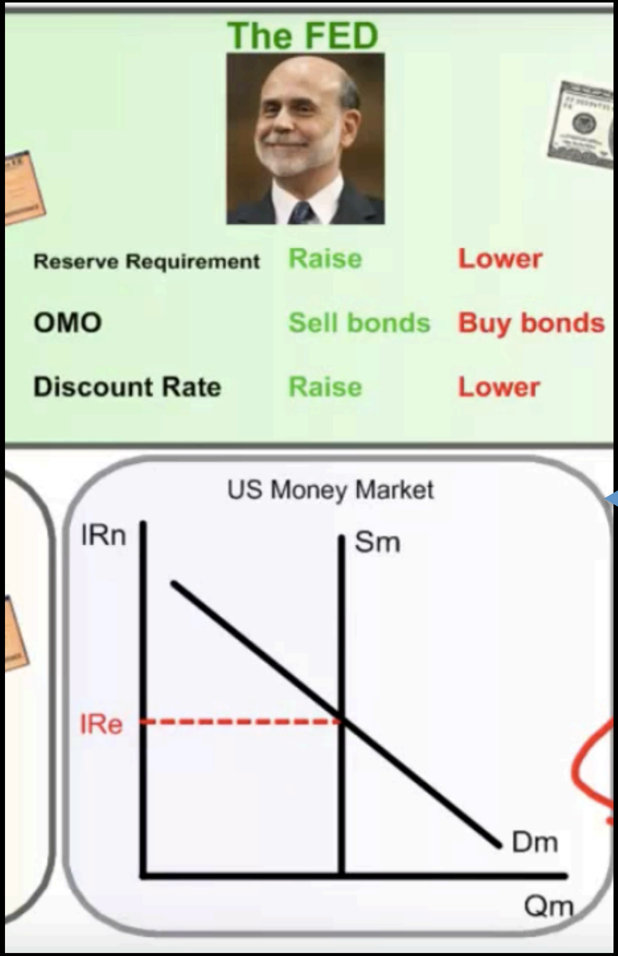
1. **Key government policy to manage a macroeconomy**
2. **Key government policy to improve spending in the short/long run run and therefore a key anti recession policy and one that attacks unemployment, inflation and growth issues. Pay particular attention to the 'time lag' as monetary policy interventions take time to impact the economy**
3. **Typically described as a 'monetarist' policy tool as it is of key importance for supply siders. Remember demand and supply side economists do not "own" fiscal and monetary policy. They share the use of these policies to manage the macroeconomy**

Big Idea 2

Know how the government bank (e.g.Federal Reserve) uses 'Open market operations' to control money supply

Take a look at Welker here:

https://www.youtube.com/watch?v=rcPEkmstDek&t=671s



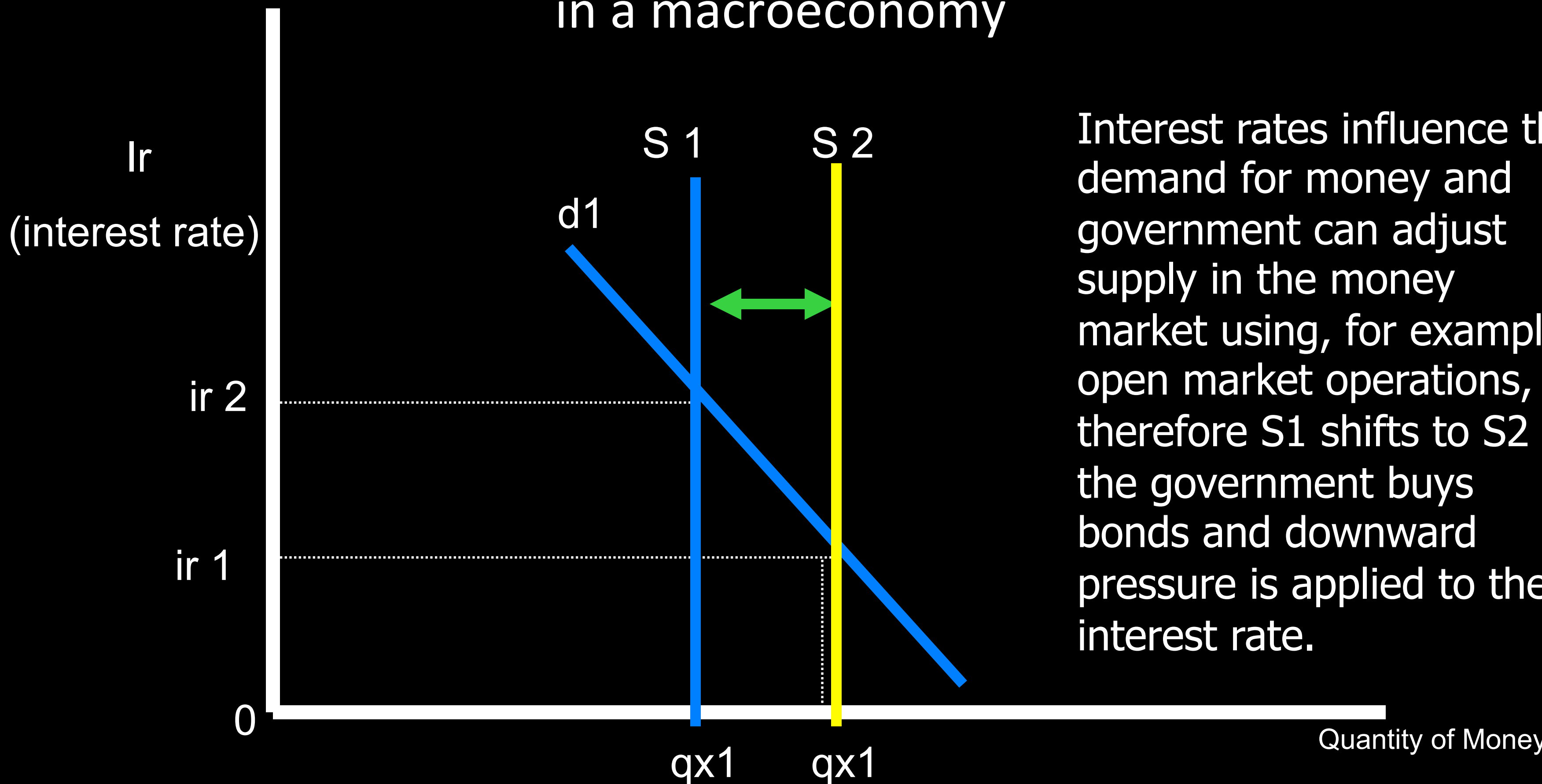
[See webnote 252](#)

[How to control the money supply](#) ?

- Open market operations whereby government buys and sells treasury bills and bonds
- Liquidity ratios i.e. amount of funds held as a % of deposits
- Increase or decrease the public sector borrowing requirement (PSBR)
- Special directives (advice)
  Eg China Jan 2010 – government gave instructions to bank to cut lending
- See interest rates below

Monetary Policy: Money Supply

Diagram A: Money market showing supply and demand of money in a macroeconomy



Interest rates influence the demand for money and government can adjust supply in the money market using, for example, open market operations, therefore S1 shifts to S2 if the government buys bonds and downward pressure is applied to the interest rate.

‘Quatitative Easing’ example of open market operations

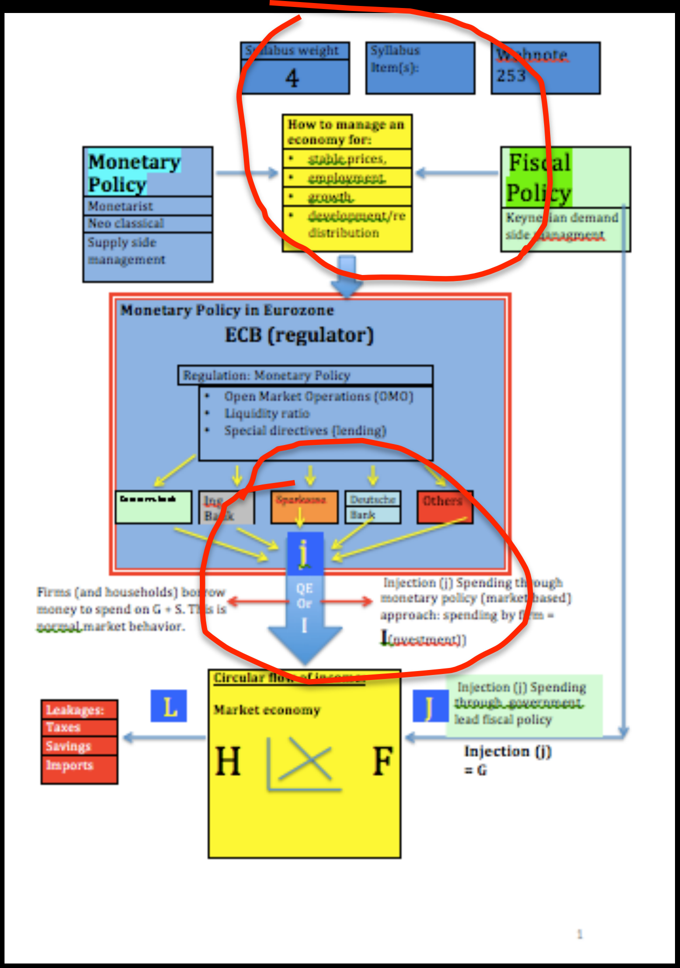
- Government can directly adjust interest rates e.g. ECB and decision to borrow/spend lies with C+F but this depends on the level of confidence in the economy
- OR Government buys government + private bonds(Ms)↑
- OR Government sells government + private bonds(Ms)↓
- This has the effect of injecting /leaking money into the economy but the Firm is making the **decision** to buy or sell in response to the government action
- This impacts interest rates in the economy

Monetary policy works via market system

Big Idea 3

See webnote 253

Why is monetary policy a market system for resource allocation? This is because the household and the firm in particular are deciding on how to use the borrowed money, how to spend it and in the case of the firm: what to produce?



Monetary policy is primarily a market based tool for managing the macroeconomy because it involves the consumer or the producer taking the risk and borrowing money from the banks in order to carry out spending in the economy. Household carries out consumption spending and the firm carries out investment spending.

NB

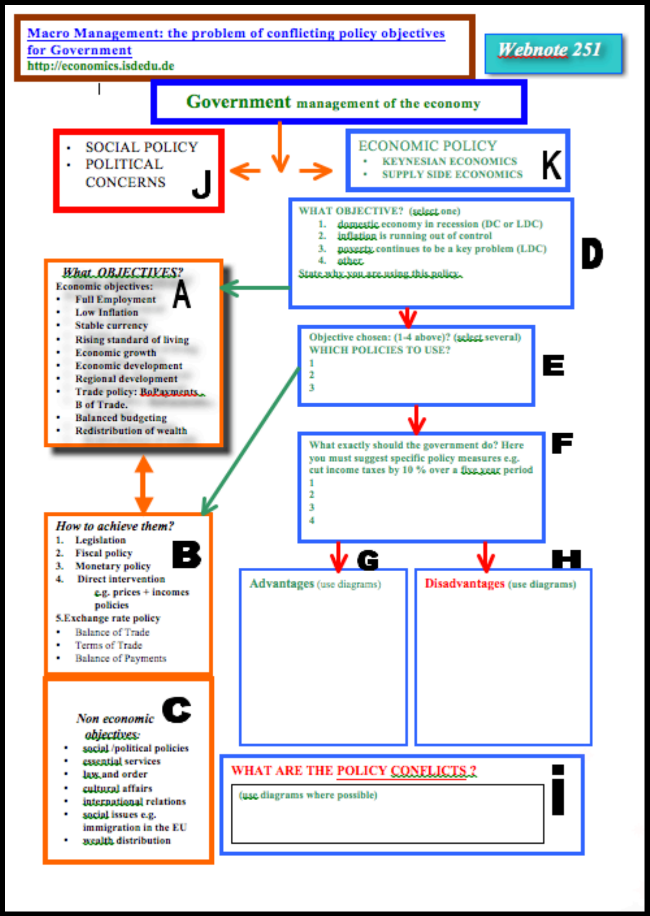
Big Idea 4

Monetary policy can cause policy conflicts affecting the whole macroeconmy

For macroeconomic policy know the possibility of a policy conflict e.g. if a government wants to reduce inflation it will have to contract the economy and spending will fall along with prices. Then growth and employment may fall. This is the

policy conflict

Policy conflict



See syllabus item 123

Weakness of monetary policy: Monetary policy (unlike fisccal) targets the whole economy. Interest rate chages affect all stakeholders