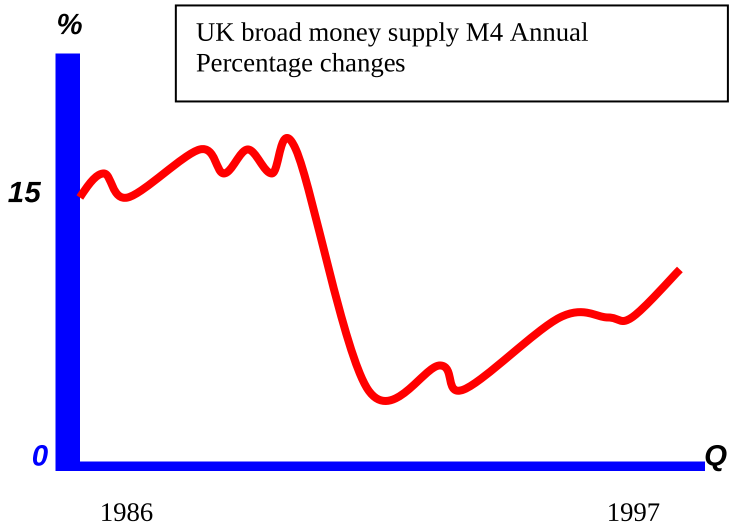
Webnote 252- syllabus weight 4

Syllabus Reference 3.5: Unemployment and Inflation

Cross Reference: see also webnote 319 re quantity theory of money + 317 re investment

Monetary policy syllabus weight: 4

- **Adjustments to money supply and interest rates to manage the economy**



Interest rates affect investment
See 317

Money Supply

Narrow ↔ Broad

Mo M1 M2 M3 M4 M5

Money supply:
Mo: e.g. notes and coins

M4: e.g includes domestic and foreign sector deposits in Financial institutions

Monetary Policy

Government Bank

e.g Bank of England, Bundesbank

Functions:

1. regulates financial system: licenses to deposit takers
2. issuer of legal tender
3. acts as banker to commercial banks 'lender of last resort'
4. banker to the government. Manages national debt;buys and sells bonds and government securities
5. carries out exchange rate policy

Webnote 252- syllabus weight 4

A) How to control the money supply ?

- Government (ecb in eurozone) control 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

B) Interest Rates influence Consumpton:

Impact on Consumption

1. Higher rates affect the cost of borrowing
2. If rates rise then the disposable income of households falls
3. If rates rise the cost of borrowing on credit cards rises
4. If rates rise the cost of bank overdrafts rises
5. If rates rise the cost of loans increases

1-5 will cause AD to fall and AD will shift inward toward the origin.

Economy contracts.

Note: real interest rate is nominal adjusted for inflation
Nominal = 10% inflation = 4%
Then the real rate of interest = 6%

Reading:
- McGee 377

What determines the interest rate?

C) Interest Rates influence investment:

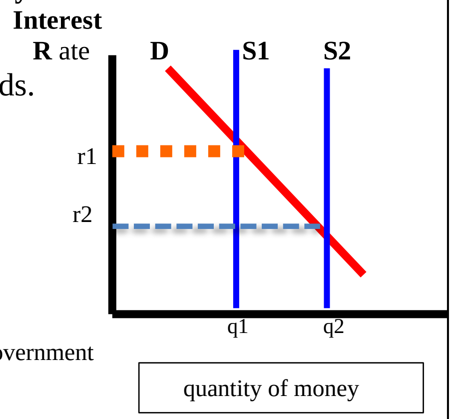
Impact on Investment

Investment is dependant on 4 factors:

1. rate of interest
2. past changes in N.I.
3. business expectations
4. rate of profitability

see webnote 317

Interest Rates Determined by: Supply and demand for loanable funds



Supply and demand for loanable funds.

Supply:

1. Government Bank:
   Ability of banks to lend
   i.e. degree of regulation and market conditions important here
2. S-avings (including foreign)
3. Adjusting the interest rates (base rate) or using open market operations the government can control the quantity of money

Demand:

1. H- (ousehold) buys durables and non durable goods
2. F- irms- investment
3. G-overnment- borrowing