Syllabus weight

4

Syllabus Item(s):

Webnote 253

How to manage an economy for:

- stable prices,
- employment,
- growth
- development/re distribution

Monetary Policy

Monetarist

Neo classical

Supply side management

Fiscal Policy

Keynesian demand side managment

Flow B: Monetary

banks influence spending via expansionary or contractionary monetary policy to solve one or more of the government objectives:

1. Inflation
2. Growth
3. Unemployment

Follow yellow text boxes

Monetary Policy in Eurozone

ECB (regulator)

Regulation: Monetary Policy

- **Open Market Operations (OMO)**
- **Liquidity ratio**
- **Adjusting minimum lending rate (base rate)**
- **Special directives (lending)**

Commerzbank

Ing Bank

Sparkasse

Deutsche Bank

Others

j

QE Or I

Flow A: Fiscal

Government influences spending via fiscal policy. Follow green /red arrows

Injection (j) Spending through monetary policy measures This is a (market based) approach: e.g. spending by firm = **I**(nvestment). Decision is made by Firm (or household) to spend depending on how they react to the change. This is then expansionary monetary policy.
Note it can also have a leakage effect when interest rates go up then savings increase.

L

Leakages:

Taxes

Savings

Imports

Circular flow of income:

Mixed Market economy

H

F

Injections:

Government

Investment

Exports

j

Injections: (j) Spending or transfers through government lead fiscal policy

How does monetary policy affect Firms (and households)? They borrow money to spend on G + S. This is normal market behavior. Of course both firms and houeholds can also save money causing the economy to contract.

Webnote 253

Syllabus weight 4

Syllabus Item(s):

Open Market Operations (OMO): Open Market Operations (OMO): Demand side management of macroeconomy

Expansionary Monetary Policy

OMO: Using QE by bond buying (quantitative easing. Why?
To increase money supply and keep downward pressure on interest rates

Government buys government and private firm bonds in financial markets in an effort to increase the money supply in the macroeconomy keeping interest rates low and therefore stimulating the incentive to borrow and spend.

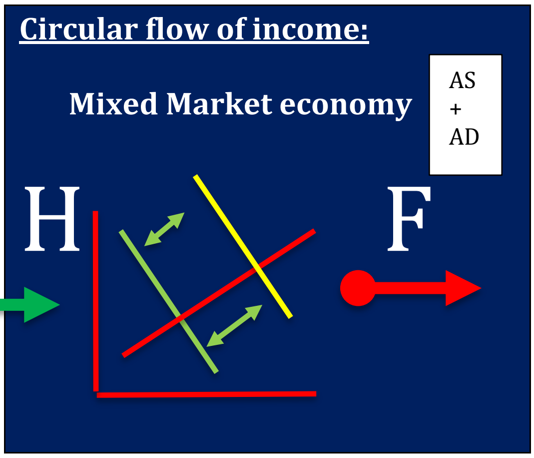
This increase in the money supply is channeled through the banking sector in the expectation that households + firms will borrow at lower interest rates.

Great Recession:

This approach was used by ECB pumping up to 60 billion euro per month into the financial markets. When banking sector refused to lend to business firms then government increased purchase of private bonds in an effort to stimulate spending and expand the economy with more growth and more employment. Overall objective was to keep interest rates low to increase the incentives for investment spending by firms + consumption spending by Households.

Monetary Policy:

a market-based approach to macroeconomic management using open market operations (OMO)



Note: nice combination of diagrams here is the money supply diagram highlighting how interest rates are determined and combining this with showing shift changes in AS/AD to show the economy contracting or expanding.
Note Carefully: This is Demand Side management of the economy i.e. shift AD

Open Market Operations (OMO):

Contractionary Monetary Policy

OMO: bond selling into markets to reduce money supply
But also using the minimum lending rate or base interest rate

Government can sell government and private firm bonds in financial markets in an effort to decrease the money supply in the macroeconomy therefore reducing the incentive to borrow and spend.

This decrease in the money supply is channeled through the banking sector in the expectation that households + firms will reduce borrowing at higher interest rates e.g. recent increases in interest rates will slow down household spending as loans are now more expensive. Households with high borrowings for purchasing property that are on variable mortgages will now have less disposable income as their current loan costs are higher.

This will give downward downward pressure to inflation but increase unemployment and reduce growth contracting the economy.

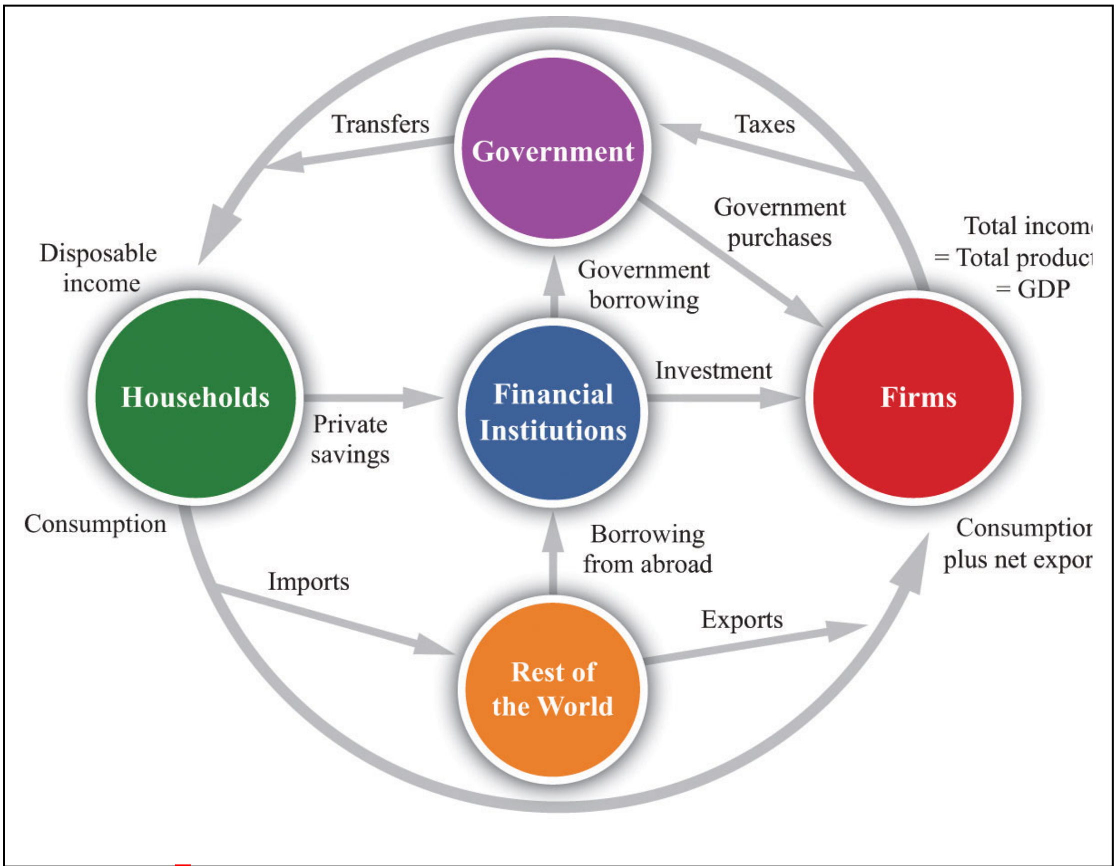
Webnote 253

Syllabus weight

4

Syllabus Item(s):

Alternative Macro circular flow of income: showing importance of Monetary sector to whole economy



Leakages:

S: savings
T: taxes
M: imports

Injections:

G: government
I: investment
X: exports