13.12: Monetary Policy and Aggregate Demand

Learning Objectives

- Explain and show how monetary policy impacts aggregate demand

Monetary Policy and Aggregate Demand

Monetary policy affects interest rates and the available quantity of loanable funds, which in turn affects several components of aggregate demand. Tight or contractionary monetary policy that leads to higher interest rates and a reduced quantity of loanable funds will reduce two components of aggregate demand. Business investment will decline because it is less attractive for firms to borrow money, and even firms that have money will notice that, with higher interest rates, it is relatively more attractive to put those funds in a financial investment than to make an investment in physical capital. In addition, higher interest rates will discourage consumer borrowing for big-ticket items like houses and cars. Conversely, loose or expansionary monetary policy that leads to lower interest rates and a higher quantity of loanable funds will tend to increase business investment and consumer borrowing for big-ticket items.

Watch It

Watch this video for a clear example of how changes in interest rates can impact investment, which in turn affect consumption, which can shift aggregate demand.

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If the economy is suffering a recession and high unemployment, with output below potential GDP, expansionary monetary policy can help the economy return to potential GDP. Figure 1(a) illustrates this situation. This example uses a short-run upward-sloping Keynesian aggregate supply curve (AS). The original equilibrium during a recession of Er occurs at an output level of 600. An expansionary monetary policy will reduce interest rates and stimulate investment and consumption spending, causing the original aggregate demand curve (AD_0) to shift right to AD_1, so that the new equilibrium (Ep) occurs at the potential GDP level of 700.

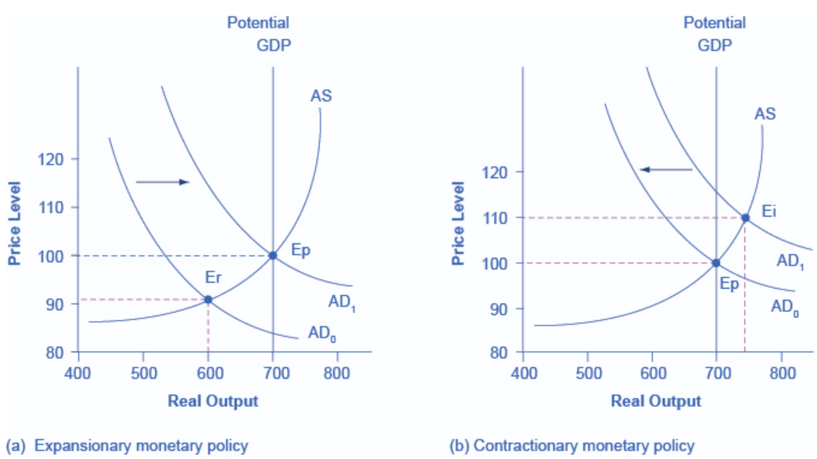

Figure 1. Expansionary or Contractionary Monetary Policy. (a) The economy is originally in a recession with the equilibrium output and price level shown at Er. Expansionary monetary policy will reduce interest rates and shift aggregate demand to the right from AD_0 to AD_1, leading to the new equilibrium (Ep) at the potential GDP level of output with a relatively small rise in the price level. (b) The economy is originally producing above the potential GDP level of output at the equilibrium Ei and is experiencing pressures for an inflationary rise in the price level. Contractionary monetary policy will shift aggregate demand to the left from AD_0 to AD_1, thus leading to a new equilibrium (Ep) at the potential GDP level of output.

Conversely, if an economy is producing at a quantity of output above its potential GDP, a contractionary monetary policy can reduce the inflationary pressures for a rising price level. In Figure 1(b), the original equilibrium (Ei) occurs at an output of 750, which is above potential GDP. A contractionary monetary policy will raise interest rates, discourage borrowing for investment and consumption spending, and cause the original demand curve (AD_0) to shift left to AD_1, so that the new equilibrium (Ep) occurs at the potential GDP level of 700.

These examples suggest that monetary policy should be **countercyclical** that is, it should act to counterbalance the business cycles of economic downturns and upswings. Monetary policy should be loosened when a recession has caused unemployment to increase and tightened when inflation threatens. Of course, countercyclical policy does pose a danger of overreaction. If loose monetary policy seeking to end a recession goes too far, it may push aggregate demand so far to the right that it triggers inflation. If tight monetary policy seeking to reduce inflation goes too far, it may push aggregate demand so far to the left that a recession begins. Figure 2(a) summarizes the chain of effects that connect loose and tight monetary policy to changes in output and the price level.

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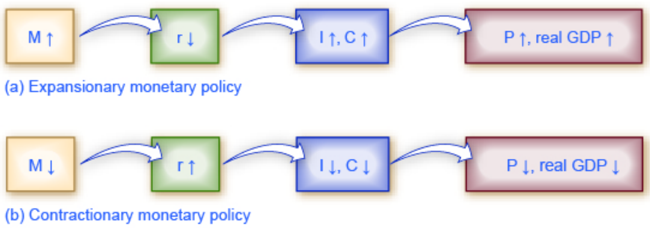

Figure 2.The Pathways of Monetary Policy. (a) In expansionary monetary policy the central bank causes the supply of money and loanable funds to increase, which lowers the interest rate, stimulating additional borrowing for investment and consumption, and shifting aggregate demand right. The result is a higher price level and, at least in the short run, higher real GDP. (b) In contractionary monetary policy, the central bank causes the supply of money and credit in the economy to decrease, which raises the interest rate, discouraging borrowing for investment and consumption, and shifting aggregate demand left. The result is a lower price level and, at least in the short run, lower real GDP.

Watch It

Watch this video to take yet another look at the way that monetary policy can, through a reaction chain, affect aggregate demand.

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Try It

These questions allow you to get as much practice as you need, as you can click the link at the top of the first question ("Try another version of these questions") to get a new set of questions. Practice until you feel comfortable doing the questions.

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Glossary

[glossary-page][glossary-term]countercyclical:[/glossary-term]
[glossary-definition]moving in the opposite direction of the business cycle of economic downturns and upswings[/glossary-definition]
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