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Editorial

# The Effect of Monetary Policy on Aggregate Demand

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## DESCRIPTION

Interest rates and the amount of loanable money available are influenced by monetary policy, which in turn influences numerous components of aggregate demand. Two components of aggregate demand will be lowered if monetary policy is tight or contractionary, resulting in higher interest rates and a smaller pool of loanable funds. Business investment will fall as it becomes less appealing for businesses to borrow money, and even businesses that already have money will discover that, with rising interest rates, it is more appealing to put those funds in a financial investment rather than a physical capital investment. Furthermore, increased interest rates will deter consumers from borrowing for large-ticket purchases such as houses and cars. Conversely, loose or expansionary monetary policy that hints to lower interest rates and a higher quantity of loanable funds will tend to surge business investment and consumer borrowing for big-ticket items.

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. This example uses a short-run upward-sloping Keynesian aggregate supply curve (SRAS). The original equilibrium during a recession of E0 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 to shift right to AD1, so that the new equilibrium occurs at the potential GDP level of 700.

A contractionary monetary policy, on the other hand, can lower inflationary pressures for a rising price level if an economy is producing at a quantity of production over its potential GDP. The initial equilibrium is reached at a production level of 750, which is higher than potential GDP. A contractionary monetary policy raises interest rates, discourages borrowing for investment and consumer expenditure, and causes the original demand curve to move left to AD1, resulting in a new equilibrium (E1) at 700.

These instances show that monetary policy should be countercyclical, in the sense that it should act to balance out economic downturns and upswings. When unemployment rises as a result of a recession, monetary policy should be loosened; when inflation threatens, it should be tightened. Of course, there is a risk of overreaction with countercyclical policy. If monetary policy is excessively loose to terminate a recession, aggregate demand may be pushed too far to the right, triggering inflation. If monetary policy tightens too much in an attempt to lower inflation, aggregate demand may shift so far to the left that a recession occurs. The chain of consequences connecting loose and tight monetary policy to changes in output and price level is summarised. A central bank may engage in expansionary monetary policy by purchasing treasury notes, lowering interest rates on bank loans, or lowering the reserve requirement. All of these measures expand the money supply, lowering interest rates. This encourages banks to lend and businesses to take out loans. Through employment, debt-financed corporate expansion can have a favourable impact on consumer spending and investment, hence raising aggregate demand.

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