Monetary Policy

Central Banks

What are central banks?

- Important government banks
  - Banker to the government
  - Banker to other banks
  - Regulator of commercial banks
  - Carry out monetary policy

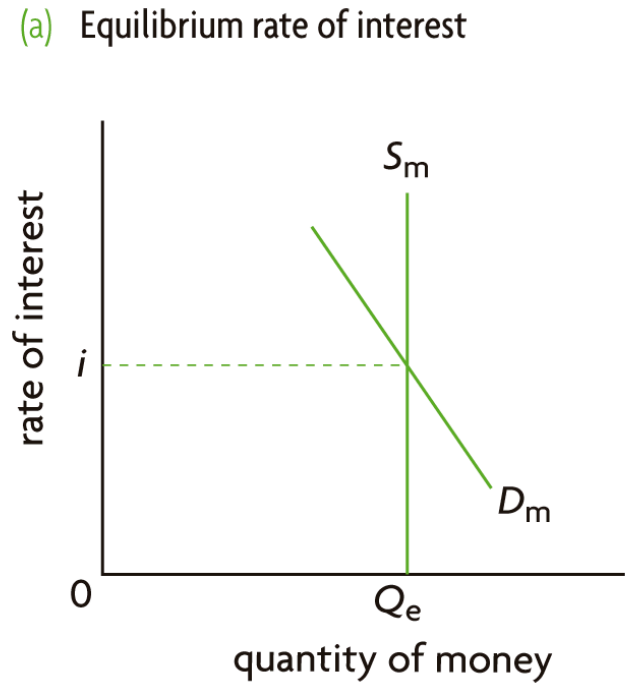
Monetary Policy

What is monetary policy?

- Action taken by the central bank to change the interest rate in order to move aggregate demand (AD).

How is the interest rate set?

Money Market

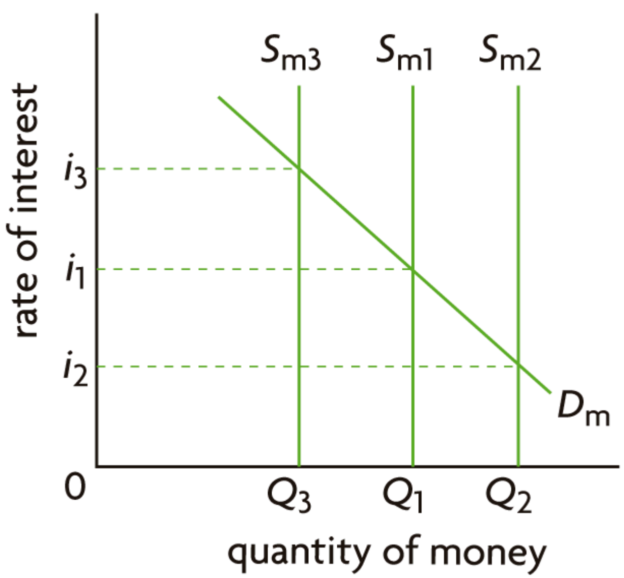


- The interest rate is set by the supply and demand for money.

How can the central bank change the interest rate?

By changing the money supply

(b) Changes in the supply of money cause changes in the equilibrium rate of interest



Money Supply

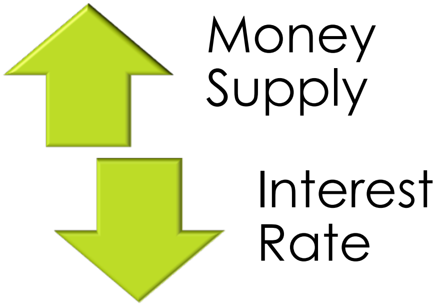
Interest Rate

Money Supply

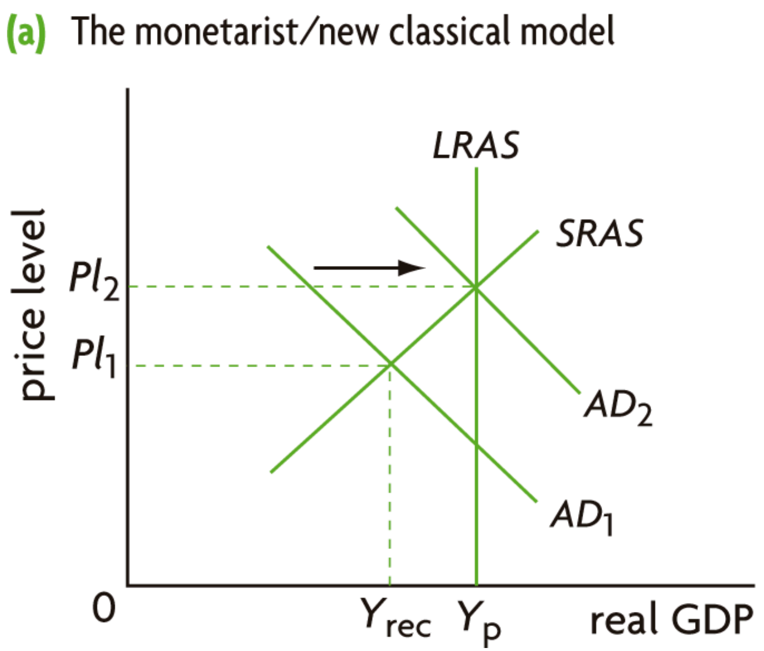
Interest Rate

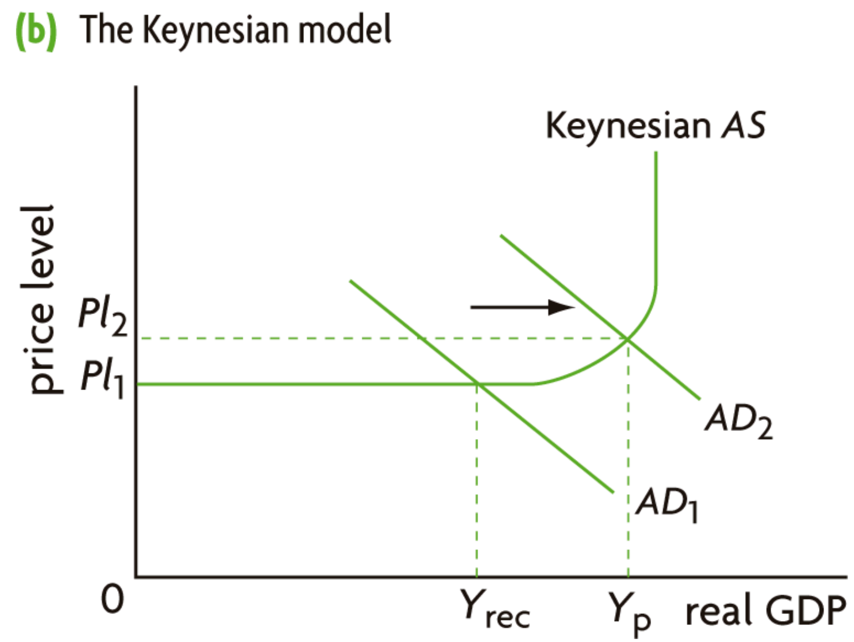
Expansionary Monetary Policy

- Increase the money supply to decrease the interest rate
- This will make borrowing money cheaper and move the AD curve to the right



Expansionary Monetary Policy

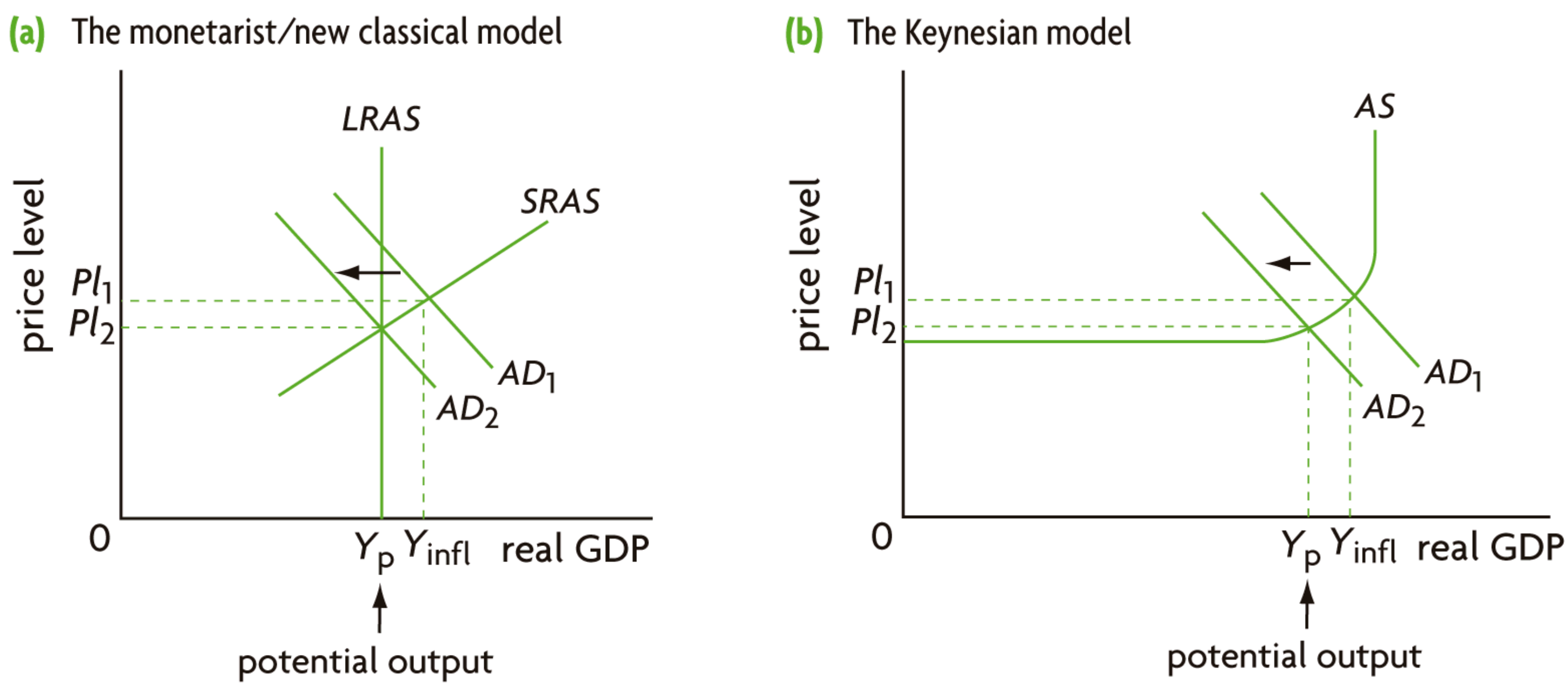




Contractionary Monetary Policy

- Decrease the money supply to increase the interest rate
- This will make borrowing money more expensive and move the AD curve to the left

Contractionary Monetary Policy



Expansionary Policy (Unemployment)

Type of Policy	Measures	Effects
Fiscal Policy	Increase Government Spending	Increase AD
	Decrease personal income taxes	Increase AD
	Decrease business taxes	Increase AD
Monetary Policy	Increase money supply – decrease interest rate	
	• Increase consumption	Increase AD
	• Increase investment	Increase AD

Contractionary Policy (Inflation)

Type of Policy	Measures	Effects
Fiscal Policy	Decrease Government Spending	Decrease AD
	Increase personal income taxes	Decrease AD
	Increase business taxes	Decrease AD
Monetary Policy	Decrease money supply – increase interest rate	
	• Decrease consumption	Decrease AD
	• Decrease investment	Decrease AD