Monetary policy research paper example

Finance, Investment

Aggregate Demand and Supply Models

Interest rate is one of the economic factors affecting the aggregate demand and supply in the U. S . economy. It is defined as the price charged or paid for the use of a financial asset. Interest rates affect aggregate demand by influencing factors that determine the total goods and services produced in an economy at a particular price level (Colander, 2010). The largest component of Aggregate Demand that is affected most by changes in the rates of interest in the U . S. is consumption. When the rates of interest are high, it is extremely expensive to borrow money and spend it; this in turn leads to a decrease in consumptions, which leads to a decrease taken together Demand. When the rate of interest decreases, the effect is opposite (Pugel, 2007). The cost of borrowing is low and therefore people have a lot of money to spend so there is increased consumption and increased Aggregate Demand (Colander, 2010). Investment is also influenced by the rate of interest especially when we look at mortgages. Increased interest rate on the mortgage will make people not invest in that area because it is extremely expensive and so the aggregate demand will reduce because investment is also a significant contributor to aggregate demand (Carbaugh, 2010).

The U. S. government has made some recommendations on fiscal tools that are to be used to make sure that the economy is desirable and macroeconomic goals are attained. The two tools used in the fiscal policy are tax and government expenditure. During the recession period, the government recommends that the tax rate is cut down and the government expenditure is increased to simulate the economy (Carbaugh, 2010).

Reduction in tax leads to increased disposable income, which will lead to increased consumption and eventually the Aggregate Demand (Colander, 2010). Government Expenditure on the other hand has a positive relationship with Aggregate Demand so that an increase in Government Expenditure will lead to an increase in Aggregate Demand. The use of the two fiscal tools was seen in the years 2001, 2002, 2003 where the rate of interest was reduced and the Government Expenditure increased by 13%. This was after the U. S. economy had fallen into recession in the year 2001 (Colander, 2010).

According to Keynesian Economists, the fiscal tools are seen to be effective as they helped in fighting the recession in the U. S. in 2001. They therefore still support the reduction of tax and increase in government expenditure to fight recession and achieve the macroeconomic goals. Classical Economists however see these tools as unnecessary because according to them there are market mechanisms that correct these problems by bringing the economy to the natural level of Real Gross Domestic Product rather than having to reduce tax and increase Government Expenditure. An example of the mechanisms is the flexible adjustment of prices and wages (Colander, 2010). Classical Economists further felt like Keynes use of Tax and Government Expenditure had ignored some secondary effects that affected the market conditions. Government normally operates on a deficit. If it is therefore to simulate the economy by increasing it Expenditure it will have to borrow. The fact that the government borrows will lead to a high demand of funds, which will lead to increased interest rates. When interest rates are high, it is expensive to borrow, and therefore there is a decrease in investments, this is called crowding out. This therefore supports the classical view that the fiscal tools are unnecessary because in the end Aggregate Demand is mitigated (Colander, 2010).

Weekly Reflection

Factors Contributing To The Establishment Of General And Specific Interest Rates.

Federal Reserve Policy is one of the factors that contribute to the establishment of specific and general interest rates. The Federal Reserve Board has the mandate to control the volume of money in the economy. If the Board wants to simulate the economy it has to increase the money supply. This is achieved by buying and selling of short term securities, this would have an initial effect of reducing the short-term rates. The board can also lower rates of interest by pumping money into the economy through the buying of long-term securities (Colander, 2010). There is also the Federal Budget Surpluses or Deficits, which also affect the establishment of specific and general interest rates. The Federal Government normally operates on a deficit and so to cover this it has to borrow. Borrowing increases the demand for funds, which leads to increased interest rates. This is therefore a factor influencing the rates of interest.

International factors specifically global trade affect the establishment of the interest rates. If a country buys from other countries more than it sells outside it will end up with a trade deficit. For this reason, the Government has to borrow, this increases demand for funds and eventually interest. Operating a surplus has an opposite effect (Carbaugh, 2010).

If you study the business cycle keenly you will notice that during recession the decline in the short-term rates of interest is more rapid. This is mainly meant to simulate the economy by encouraging investments and increasing borrowing for consumption purposes (Colander, 2010).

Role of Federal Reserve System in Designing and Implementing U. S. monetary policies.

Monetary policies are undertaken by the Federal Reserve System to influence money supply in the economy to achieve macroeconomic goals. This is achieved by influencing the Federal Funds Rates and Federal Reserve Balance. Open Market Operations (OMO) is one of the main tools used by the Federal Reserve System. It involves buying and selling of securities to change the volume of money in the economy. Another tool is the reserve requirement, which is the minimum amount of money that a bank is allowed to hold, it is normally a percentage of the deposits. The increase or decrease of this ratio influences the economy by controlling the money supply held by the public (Colander, 2010). The Federal Reserve System sets the reserve requirement accordingly. It also extends credit through its discount window facility therefore still influencing the money supply.

Money Multiplier Effect and How It Facilitates Creation of Money

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