Essay topic: What is the effect of monetary policy on real economic activity?

Monetary policy is the macroeconomic tool employed by the country’s government or central bank through managing interest rates and money supply with the purpose of controlling inflation, consumption, liquidity and growth in the economy (Principles of Macroeconomics, 2016). Conventional monetary policy is an instrument that influences interest rates and involves liquidity providing open-market operations, standing facilities and minimum reserve requirements (Principles of Macroeconomics, 2016). Unconventionalmonetary tools include using balance sheet operations such as quantitative and credit easing, emergency lending, negative interest rates policies and forward guidance (Principles of Macroeconomics, 2016). This essay will compare different theories and empirical evidence on whether the monetary authority is able to make a difference to real economic variables by altering the monetary base. The essay will discuss the effects of conventional and unconventionalmonetary policies on real economic activity and how the monetary policies, implemented by the central bank, are transmitted to the economy through the monetary transmission mechanism.

According to the classical economic theory of the neutrality of money, changes in the money supply only affect nominal variables such as prices, wages and exchange rates but not real economic variables – employment, real consumption and real output (Mankiw, 2016). This idea is related to the classical dichotomy and it implies that the central bank does not affect the real economic activity in the long-run through an increase in the stock of money, thus the policy will merely cause prices and wages to rise (Mankiw, 2016). The neutrality assumption implies that an increase in the quantity of money will give rise to a proportionate increase in prices but will have no effect on real economic output (Twinoburyo and Odhiambo, 2018).

On the other hand, Robert Lucas in his islands model stated that if economic agents were able to anticipate changes in the monetary policy, the change in the money stock would have no real impact on output and employment - the money neutrality would hold in short and long term (Walsh, 2017). However, individuals and firms cannot perfectly forecast the level of expected inflation and variations in the money supply, hence the central bank can manipulate short-term nominal interest rates to influence the real interest rate andreal activity in the economy (Walsh, 2017). Austrian economists argue that when the central bank expands money and credit, the money created increases demand for some goods and services, driving their prices up relative to the general price level (Moreira et al., 2016). The relative inflationary price changes entail wealth and income redistribution between first and late receivers of issued currency (Moreira et al., 2016). After the money has spread out in the economy, permanent redistribution of wealth and income will continue to persist, which proves that money is non-neutral in the long term (Moreira et al., 2016). The empirical findings suggest that changes to the monetary base directly distort relative prices, which in turn indirectly influence the inflation rate, real investment, employment rate and real potential output (Moreira et al., 2016).

The standard framework of the monetary transmission mechanism shows inconsistency with the Phillips curve concept, according to which low interest rates lead to higher inflation because increased real activity puts an upward pressure on the cost or real resources (Lacker, 2016). The monetary policy does not cause inflationary variations though its actions on the real economic activity, as it has a simultaneous impact on both inflation and real activity in the economy (Lacker, 2016). Lacker (2016) argues, however, that monetary policy tools aimed at stabilising inflation will only have modest, limited and temporary effect on the real economic activity and growth.

Monetary policy decisions influence the real economy through the monetary transmission mechanism, which involves the number of channels (ECB, 2017). The traditional interest rate channelimplies that a policy-induced change in interest rates has a direct impact on moneymarket interest rates and it indirectly affects lending and savings rates (ECB, 2017). Adoption of the monetary policy can affect the production process in the economy through changes in interest rates (Amen et al., 2011). When the central bank decides to increase nominal shortterm interest rates, the cost of capital and real interest rates in the longer term will rise, making firms cut down on investment and labour (ECB, 2017). Higher savings and decline in consumption will weaken the demand, putting a downward pressure on the price level (ECB, 2017). The policy decision to decrease interest rates will have an opposite effect on real economic activity and will result in the increase in demand, GDP growth and higher inflation rates (ECB, 2017).

When nominal domestic interest rates go up the incentive to invest into domestic currency arises, causing the home currency’s appreciation towards the foreign exchange rates through the exchange rate channel (ECB, 2017). Domestically produced goods become more expensive than foreign products so the country will see the fall in net exports, contraction of domestic output and growth, decreased inflation (ECB, 2017). Conversely, when interest rates fall, demand for the domestic currency shrinks, hence depreciation of the exchange rate occurs and export volumes increase (Atkin and Cava, 2017). Depreciation in the exchange rate will raise import prices and make domestic producers who strongly rely on imported materials, indirectly pass the rise in prices to consumers in the form of higher inflation (Atkin and Cava, 2017).

The theoretical implications of the wealth channel are associated with changes in asset prices in response to the policy decision implemented by the monetary authority (ECB, 2017). Monetary tightening increases interest rates, which means that investors can receive higher return from new debt instruments compared to existing debt or equity yield (ECB, 2017). This dampens demand for stocks and the equilibrium in the securities market will be restored once the stock prices fall (ECB, 2017). The decrease in the price per share will adversely affect firms, and they may cut back on their investment decisions leading to subdued demand (ECB, 2017). However, decreased interest rates stimulate demand for assets, making the prices go up (Atkin and Cava, 2017). The fall in interest rates implies the higher discounted value of the asset’s future cash flows (Atkin and Cava, 2017). In this scenario households’ and firms’ wealth will increase, encouraging more spending in the economy (Atkin and Cava, 2017).

Higher interest rates cause a decline in asset prices through the balance sheet channel, reducing the net worth of borrowers and the value of the assets of lenders (ECB, 2017). The value of households’ and businesses’ net assets fall, they may face tighter credit conditions to borrow as the value of the collateral goes down (ECB 2017). Investment and consumption will decline, which will hinderreal economic activity (ECB, 2017). On the contrary, reduction in interest rates expands the borrowing capacity of households and firms due to the subsequent increase in asset prices (Atkin and Cava, 2017). Higher asset prices mean higher value for the collateral the banks can lend against, resulting in increased consumption and investment spending (Atkin and Cava, 2017).

The lending channelrelated to the effect of monetary policy on the supply of credit and the amount of loans that can be issued by the banks (Apergis et al., 2012). Assuming there is a hike in interest rates, banks may face a difficulty in refinancing themselves and will tighten new lending (Apergis, et al., 2012). Households and firms will have to decrease consumption and defer investment, contracting the growth of the real economy (Apergis, 2012). The opposite implications will manifest if the central bank intends to lower interest rates by expanding the monetary base and thereby allowing its member bank to increase lending (Apergis, 2012). A reformulation of the lending channel is proposed by Disyatat (2010), who states that more consideration should be given to the impact of the monetary policy rule on the banks’ balance sheet strength and system risk. The more relevant components of the channel though which the monetary policy shocks are transmitted to the real economy are suggested by the economist – changes in the health of financial intermediaries including leverage and asset quality as well as risk perception by the banking sector (Disyatat, 2010).

Twinoburyo and Odhiambo (2018) explored theoretical and empirical literature on the influence of monetary policy on the economic growth. The researchers concluded that monetary policy positively contributes to the economic growth mostly in financially developed countries with independent central banks (Twinoburyo and Odhiambo, 2018). The effectiveness of the monetary policy is lower in developing countries whose financial markets tend to be less developed and weakly integrated into global markets (Twinoburyo and Odhiambo, 2018). Positive monetary policy shocks matter for the economic activity and growth in the short and long-run (Twinoburyo and Odhiambo, 2018).

The Federal Reserve is a real-world example of the monetary policymaker in the U.S., which utilised traditional and unconventional monetary measures to fight a recession during the global financial crisis in 2007-2009 (Mishkin and White, 2014). The Fed’s first response to the economic disaster was to reduce the spread between discount rates and the federal funds rate, until interest rates became close to zero (Mishkin and White, 2014). The Fed created new lending facilities to provide liquidity to financial institutions and introduced the TAF auctions that encouraged banks’ borrowing at a competitive rate (Mishkin and White, 2014).

The U.S. central bank adopted the non-conventional monetary policies of Large-scale Asset Purchases and Government Sponsored Entities Purchase Program with the aim of lowering the interest rates for certain types of credit and residential mortgages (Mishkin and White, 2014). Another unconventional monetary tool the Fed employed was quantitative easing which aided the recovery of financial markets while the federal funds rate hit zero (Mishkin and White, 2014). Fed pursued to revive the economy and announced the large-scale purchasing program of long-term Treasury securities in November 2010 (Mishkin and White, 2014). The Fed also administered the Supervisory Capital Assessment Program, requiring the stress test for financial institutions, which resulted in improvement of market confidence, stabilization of the financial system and encouraged the assessed banks to recapitalize (Acharyal and Seru, 2013).

The Federal Reserve has played a key role in maintaining monetary stability since the financial crisis, which is critical for the country’s economic growth (Lacker, 2016).

It can be inferred that neutrality of money does not hold in the long run and the central bank, commercial banks or government are able to affect the real economic activity by managing interest rates and altering the money supply. Traditional and non-traditional monetary policy decisions are transmitted to the real economy through the theoretical transmission channels. The Federal Reserve is the U.S. policymaker which used the conventional monetary tools supplemented by the non-conventional methods to boost the economic activity and pull the economy out of the recession during the financial crisis. The effect of the monetary policy is empirically concluded to have a more efficient outcome in financially developed economies compared to the underdeveloped countries.

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