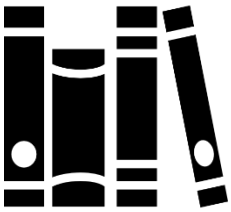
WEEK 9- EXPANSIONARY MONETARY POLICY VS RESTRICTIVE MONETARY POLICY

CONTENTS

1.0. INTRODUCTION

We will talk about expansionary and restrictive monetary policy in this unit. A deflationary gap, recession, or depression can be resolved through an expansionary (or soft) monetary policy. Restrictive (or dear) monetary policy, on the other hand, refers to a monetary strategy intended to reduce overall demand. It fills the gap left by inflation. As a result, we will talk about each one in turn to begin this presentation.

2.0. OBJECTIVES



At the end of this unit, you should be able to:

- ☐ Understand the meaning of expansionary monetary policy.
- ☐ Comprehend the meaning of restrictive monetary policy.

3.0. MAIN CONTENT

3.1. Expansionary Monetary Policy

A deflationary gap, recession, or depression can be resolved through an expansionary (or easy) monetary policy. *A deflationary gap* arises when business demand for investment items declines as well as consumer demand for goods and services. The central bank begins an expansionary monetary policy, which eases the conditions on the credit market and causes the aggregate demand to increase. The central bank stimulates the economy through encouraging consumer and commercial credit through selective lending in the money market, lowering the reserve requirements for member banks, and purchasing government assets on the open market.

What is expansionary monetary policy?

Expansionary monetary policy is a macroeconomic tool that a central bank uses to stimulate economic growth. A bank usually implements it during a contractionary

phase of the business cycle — when the gross domestic product (GDP) in a nation starts to decline.

A decline in GDP can have a variety of undesirable effects, including:

- Business bankruptcies and failures
- Unemployment
- A fall in the stock market
- A decline in the national currency's value

All these effects, if unchecked, can eventually lead to a recession or depression.

The overall goal of any expansionary policy is to encourage spending and borrowing. The theory is that when there's more money available to individuals and businesses at lower costs, it will result in the increased purchase of goods and services, stimulating growth.

When the economy is growing too fast and inflation is rising quicker than desired, a central bank will do the opposite: seek to slow down the economy through a contractionary monetary policy.

Expansionary monetary policy tools

The central bank's expansionary monetary policy often takes a three-pronged approach:

(i) Lowering interest rates

(ii) Reducing the reserve requirement (the amount of cash banks must keep on hand)

(iii) Buying back government securities

(i) Lowering interest rates

To increase the money supply — that is, the amount of cash and easily obtainable funds circulating throughout the country — the central bank reduces short-term interest rates. It can do so in two ways: reducing the central rate and the discount rate.

The central bank rate is the interest rate banks charge each other for extremely short-term loans. The central bank requires that banks keep a certain percentage of their deposits on hand every night to maintain a certain level of solvency. If banks are short on deposits to meet the requirement, they borrow from another, often overnight, at a rate the central bank sets. When the central bank lowers the rate, it becomes cheaper for banks to borrow money, leaving them with more funds to lend out to customers. Banks then also lower the rate they charge customers on loans.

The discount rate, which is higher than the central bank rate, is the interest the central bank charges financial institutions for borrowing. A bank goes to the central bank directly if it can't borrow from another bank. Reducing this rate also frees up a bank to loan more money, at less interest, to clients. The central bank can also try to help by extending the discount rate on loans not just overnight but for several months.

In both cases, customers now also have more money on hand to spend as a result of cheaper, easier loans, which they can use to purchase more goods and services, stimulating the economy. Businesses are also encouraged to borrow, using the funds to expand operations.

(ii) Reducing reserve requirements

Along with having to have a certain amount in deposits on hand every night, the central bank requires banks to always hold a certain amount of cash — money that must never be lent out. This "reserve requirement" is to ensure that banks can always give depositors their money if they need it and handle sudden large withdrawals — preventing a disastrous "run on the bank."

The central bank constantly monitors the sums the banks must keep in reserve. If it wants to encourage lending and spending, it can reduce the reserve requirement, which frees up funds for the bank. This extra money can then be lent out to customers, increasing the overall money supply.

(iii) Buying back government securities

As part of an expansionary monetary policy, the central bank will buy government securities — that is, Treasury bonds, bills, and notes. The central bank prints money to buy these securities from banks and other financial institutions.

Officially known as open market operations, this process adds more cash into banks, giving them more money to loan to individuals and businesses.

Example of expansionary monetary policy

The Great Recession of 2007-2009 is a prime example of an expansionary monetary policy used to curb an economy in free fall.

For most of 2007, the fed funds rate was fairly stable at 5.25%. When troubling signs in the housing market first started to appear, the Fed reduced the rate to 4.75% in September 2007. Once the housing market collapsed, and the recession began in December 2007, the rate decreased to 4.25%.

The Fed also lessened the gap between the discount rate and the fed funds rate and extended the period for discount-rate loans.

The Fed continued to drop the rate for a year, up until December 2008 when the fed funds rate hit 0%. But, because the recession was so severe, the decrease in the fed funds rate and the discount rate to zero was not enough to combat it.

The Federal Reserve then entered into *quantitative easing*, which is an irregular method of open market operations. Quantitative easing is implemented when the Fed funds rate cannot be lowered any further.

It bought longer-term government securities than it usually would — 20- and 30-year bonds. In addition, it also expanded the types of securities it could buy, such as mortgage-backed securities (MBS).

The Fed's quantitative easing is considered to be one of the main reasons why the Great Recession lasted only two years, and the economy recovered, albeit slowly.

The Fed's balance sheet increased from $882 billion in December 2007 to $4.5 trillion in May 2017. As a percent of GDP, this was an increase from 6% to 24%.

As for the fed funds rate, it stayed at 0% until 2015, at which time the Fed raised the rate to 0.5%.

Expansionary monetary policy case of Kenya

When the CBK's monetary policy Committee wants to expand the money supply in Kenya, it can combine three different actions:

1. Make open market purchases of securities (also known as Open Market Operations).
2. Reduce the CBK Monetary Policy Rate (MPR)
3. Reduced Reserve Requirements

Each of these has a direct effect on interest rates. The price of the securities increases as a result of CBK purchases made on the open market. Since the MPR is a rate of interest, lowering it has the same effect as lowering interest rates. Banks will be able to invest more money if the CBK decides to reduce reserve requirements instead of raising them. Interest rates must decrease as a result because this drives up the cost of investments like bonds. Any method the CBK chooses to increase the money supply will result in falling interest rates and rising bond prices.

The exchange market will be impacted by rising bond prices. Investors will sell these bonds in exchange for other bonds as bond prices rise. It costs less to finance capital projects when interest rates are lower. Therefore, if everything else is equal, lower

interest rates result in higher investment rates. When the Federal level policy-making group meets, they carefully examine the present and projected economic situations. Forecasts about the anticipated course of the economy over the next year or so will be given to the members of the monetary policy committee.

Let's examine the scenario Kenya faced in early 2016. During the previous years, the Kenyan economy had been expanding at an increasingly rapid rate. The fact that food prices have been high since July 2016 contributed significantly to the first half of 2016's overall high inflation rate. From 6.5 percent in 2015, the annual average inflation rate slightly climbed to 6.6 percent in 2016. Overall inflation did, however, stay within the government's goal range of 5% ± 2.5% during the year.

Due to elevated food inflation, which added 5.6 percentage points to the overall CPI in January 2017, overall inflation increased to 7.0 percent from 6.4 percent in December 2016. Given the drought conditions in the first quarter of 2017, it was anticipated that food inflation would continue to have a short-term negative impact on overall inflation. High energy prices and pressure on fuel inflation could result from the recovery in world oil prices. In order to be effective, the committee prefers to plan ahead for economic issues as opposed to responding to the situation as it is.

In terms of interest rates, the short-term rates have decreased during the past 12 months. As market liquidity conditions improved, the weighted average interbank rate declined from an average of 11.24 percent in 2015 to 4.8 percent in 2016. Over the same time period under examination, the rates for 91-day and 182-day Treasury bills also reduced, with the 91-day rate falling to 8.6 percent from 10.9 percent and the 182-day rate rising to 10.9 percent from 12.2 percent.

Comparing 2016 to 2015, the average loan interest rate offered by commercial banks stayed constant at 16.58 percent. The loan categories labeled "Over 5 years" and "Overdraft" accounted for the majority of the slight rise. The average lending rate did, however, noticeably drop from 17.71 percent in August 2016 to 13.69 percent in December 2016, partly due to the implementation of the interest rate limiting law, which went into force in mid-September 2016. The average commercial bank deposit rate rose from 6.93% in 2015 to 7.1% in 2016. The savings category, which rose from 1.53 percent to 2.92 percent by 16 basis points, reflected the increase.

How does the central bank use expansionary monetary policy to stimulate growth during an economic downturn?

Expansionary monetary policy's aim is to make it easier for individuals and companies to borrow and spend money — actions that all stimulate the economy.

Modern, capitalist economies go through regular fluctuations of growth, contraction, and eventual recovery. This repeating nature of the economy is known as the business cycle.

During the contractionary phase, gross domestic product (GDP) is decreasing, which can lead to a prolonged period of economic decline. To combat the slowdown, a nation's central bank will stimulate growth through an expansionary monetary policy.

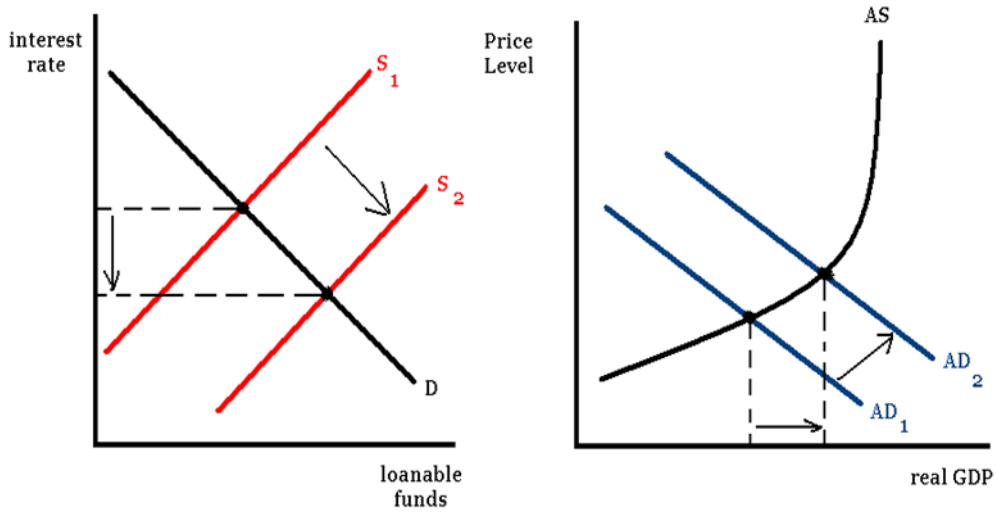
In conclusion, when GDP in a nation is declining and the economy is in a contractionary phase, a nation's central bank will implement an expansionary monetary policy.

The policy can be achieved in several different ways, including a lowering of interest rates, a lowering of the reserve requirement, and an increase in purchases of government securities.

All of these actions will increase the money supply in an economy, meaning that individuals and businesses can obtain loans at a lower cost, encouraging them to spend that additional money.

When consumers and companies buy more, it increases demand, which results in businesses needing to produce more to meet the increased demand, requiring them to spend more money and hire more workers, reducing unemployment.

Figure 1 expansionary monetary policy



Expansionary monetary policy is appropriate when the economy is in a recession and unemployment is a problem.

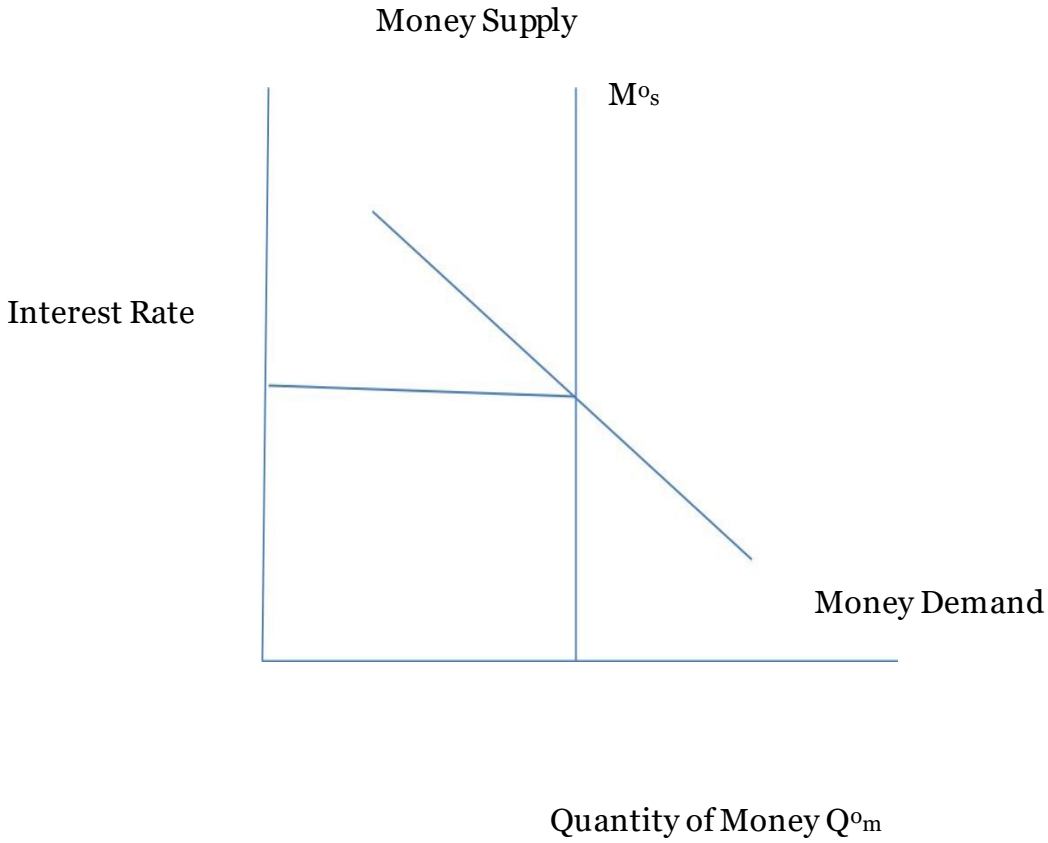
Figure 1 shows that changes in the money supply affect the economy through a 3 step process.

- An increase in the money supply causes interest rates to fall

- The decrease in interest rates causes consumption and investment spending to rise and so aggregate demand rises.
- The increase in aggregate demand causes real GDP to rise.

Money Market Equilibrium

***Figure 2*: Money Market Equilibrium**



The supply and demand of money in the money market are depicted in Figure 2. We display the money supply as a vertical line at a CBK-managed level. The intersection of the demand for money and the supply of money, referred to as the money supply, yields the equilibrium interest rate, or r0.

The demand for money curve is downward sloping. At higher interest rates less money will be demanded.

The money supply is vertical-The money supply is ultimately determined by the monetary base and the money multiplier. In most countries, that country's central bank determines the size of the monetary base. Remember that the monetary base includes reserves in vaults and currency in circulation outside of banks. For example, central banks might change the reserve requirements to change the monetary base.

The money supply doesn't depend on the interest rate, it only depends on the central bank. Because of this, the money supply curve is vertical at the quantity of the money supply, not upward sloping or downward sloping.

The nominal interest rate adjusts until the money market is in equilibrium-

In any market, an equilibrium occurs when the quantity supplied is equal to the quantity demanded. Prices adjust until the market is in equilibrium. The money market is no exception. In the money market, the nominal interest rate adjusts until the quantity of money that people want to hold is the same as the quantity of money that exists. If the nominal interest rate is above equilibrium high, people reduce their holdings of cash. If the nominal interest rate is below equilibrium, they increase their holdings of cash

Changes in the supply and demand for money

The central bank controls the money supply, so it can take actions to increase the money supply and decrease the money supply. Changes in the money supply lead to changes in the interest rate.

Why does the demand for money change?

The reasons include the following-

1. Changes in national income-when real GDP increases, there are more goods and services to be bought. More money will be needed to purchase them. On the other hand, a decrease in real GDP will cause the money demand curve to decrease.

2. Changes in the price level (inflation or deflation)if the price of everything increases by 20\%20%20, percent, you need 20\%20%20, percent more money in order to buy things. When there is an increase in the price level, the demand for money increases. Conversely, when there is a decrease in the price level, the demand for money decreases.

3. Changes in money technology- the demand for money is driven by the transactions motive (we want money so we can buy things). When new technologies make it easier to convert wealth into money, we keep less of it on hand.

3.1.1. Scope and Limitations

In the 1930s and 1940s, it was thought that monetary policy had far less success in promoting the recovery from a depression than in containing a boom and inflation. The Great Depression's experiences and the introduction of Keynes' General Theory led to the development of this viewpoint.

According to the monetarists, a central bank can boost commercial banks' reserves during a slump by pursuing a policy of easy credit. By purchasing assets and lowering the interest rate, they can achieve this. As a result, they are better able to offer borrowers credit facilities. However, the Great Downturn's lessons teach us that when businessmen are pessimistic, a significant depression will almost certainly not succeed with such a policy. In such a scenario, banks are powerless to spark a comeback. Even

when the interest rate is extremely low, firms do not have the desire to borrow in order to increase inventories because business activity is practically at a standstill. Instead, they seek to minimize their inventory by paying back bank loans that they have previously accessed.

Additionally, during a depression when economic activity is already at a very low level, the issue of borrowing for long-term capital requirements does not come up. Similar circumstances apply to consumers who prefer not to obtain any durable goods through bank loans due to unemployment and lower revenues. Therefore, all that the banks can do is make credit available; they are powerless to compel consumers or businesspeople to take it. Very low interest rates and the buildup of idle bank reserves during the Great Depression had little to no effect on the struggling economies around the world.

This is not to imply that a loose monetary policy will have no positive effects during periods of severe contraction; rather, its effects will primarily serve to keep things from getting worse. The classic illustration of this was the monetary policy in 1931, which contributed to the worsening of the Great Depression. However, a restrictive monetary policy coupled with an economic slowdown would unquestionably aggravate the depression. However, it is obvious that credit has a stabilizing effect provided it is easily accessible and on advantageous conditions. It can lessen the severity of the slump by ensuring that businesses have the liquidity they need.

But why did monetary policy deteriorate in the 1930s and 1940s? In addition to the depressing and demoralizing experiences of the Great Depression and its aftermath, Keynes' General Theory was responsible for the fall of monetary policy as a tool for

economic stabilization. Keynes noted that a liquidity trap—a highly elastic liquidity preference schedule—makes monetary policy ineffective during periods of severe depression.

3.2. Restrictive Monetary Policy

A monetary policy designed to curtail aggregate demand is called restrictive (or dear) monetary policy. It is used to overcome an inflationary gap. The economy experiences inflationary pressures due to rising consumers' demand for goods and services and there is also boom in business investment. The central bank starts a restrictive monetary policy in order to lower aggregate consumption and investment by increasing the cost and availability of bank credit. It might do so by selling government securities in the open market, by raising reserve requirements of member banks, by raising the discount rate, and controlling consumer and business credit through selective measures. By such measures, the central bank increases the cost and availability of credit in the money market and thereby controls inflationary pressures.

Contractionary Monetary Policy

To decrease the money supply, the Federal Reserve can-

- sell government bonds (an open market sale)
- raise the discount rate
- raise the reserve ratio

A contractionary monetary policy is appropriate when inflation is a problem.

1. A decrease in the money supply causes interest rates to rise.
2. The increase in interest rates causes consumption and investment spending to fall and so aggregate demand falls.
3. The decrease in aggregate demand causes real GDP to fall.

3.2.1. Scope and Limitations

But the effectiveness of monetary policy in containing inflation is severely constrained. It has the following restrictions.

Increase in the Velocity of Money

One of the key factors impeding monetary policy's capacity to contain inflation is the increase in the velocity of money held by the general public. people. The central bank can control the amount of money that is accessible and the cost of money by implementing a rigorous monetary policy, but it has little control over how quickly money travels. A constrained monetary strategy is ineffective because the public can use their money supply in a variety of efficient ways.

(a) Commercial Bank Portfolio Adjustments

Commercial banks sell government securities to the central bank in order to meet the demand for loans from borrowers in the face of a restrictive monetary policy. With such a program, inactive deposits held by banks as securities are simply converted into active deposits. Loans are replaced with government securities held in the bank's portfolio. However, neither the overall amount of deposits nor the amount of money available at the banks have changed. However, when banks lend money to borrowers, this results in an increase in overall spending. As a result, the central bank's restrictive monetary policy is made obsolete.

Additionally, when banks sell government assets to the central bank, their costs decrease and market interest rates increase. The market's general interest rate structure will increase as a result. However, the decline in the value of securities results in capital losses for the banks, who could be unwilling to take them on. Whether they anticipate the decline in asset prices (or increase in interest rates) to last either briefly or persist over time will determine how they respond. The banks will choose to hold onto securities rather than sell them at a loss if the decline in security prices is anticipated to be temporary. However, if they anticipate it will last for long time, they will sell securities in order to offer loans to clients at higher interest rates, making up for the capital loss on the sale of the securities through higher lending interest rates. The banks can purchase back government securities now at prices lower than those at which they sold them, and again in the deal, after the demand for loans declines. Thus, even in the face of a strict monetary policy, the commercial banks' policy of portfolio adjustment increases the velocity of the overall money supply, rendering the latter ineffective.

(b) The Role of Non-Bank Financial Intermediaries

NBFIs limit the effectiveness of monetary policy by limiting the money supply in two different ways. First, they advance loans by selling securities, increasing velocity in the same way that commercial banks do as previously mentioned. Second, financial intermediaries raise interest rates on deposits with them in order to entice more money from savers as interest rates on securities rise in a tight monetary policy. This encourages savers to transfer more idle funds to the intermediaries, increasing their ability to extend credit. They are able to increase the velocity of money in this way, rendering stringent, restricted monetary policy useless.

(c). Methods to Make Better Use of Available Money Supply

A restrictive monetary policy is ineffective due to the numerous ways the private sector has developed to utilise the money supply more effectively. By obtaining funds from sources other than commercial banks, such institutions are able to increase the velocity of the available supply of money even under restrictive monetary policy. Some of the methods include the evolution of improved methods of collecting funds by sales finance companies, borrowing funds by companies from the public at higher rates than offered by commercial banks, etc.

Discriminatory

The impact of a restrictive monetary policy on different economic sectors are discriminatory. Firms that rely on internal sources of finance are said to be unaffected by a tight monetary policy. However, only businesses that rely on the banking system for funding are impacted. A strict monetary policy "is assumed to work against small firms because they are worse credit risks and against residential development and various types of state and local government spending because they are particularly susceptible to changes in credit cost," according to one study. It can cause them to spend less or possibly stop.

Threat to Credit Market

Loanable funds to the credit market may stop flowing if the central bank aggressively regulates the credit market and investors anticipate ongoing interest rate increases. Securities might not be sold as a result, and the credit market might stop functioning.

Threatens Solvency of NBFIS

The viability of NBFIs like savings banks and savings and loan organizations may be threatened by a vigorously restrictive monetary policy that quickly raises interest rates. This is due to the fact that, in contrast to commercial banks, they are unable to adapt to quickly rising interest rates.

Alter Expectations of Borrowers and Lenders

The expectations of lenders and borrowers may change in response to a highly tight monetary policy. As a result, they bring about permanent changes to the lending market. Lenders could be hesitant to provide long-term loans because of the belief that interest rates will rise quickly again, even after this strategy is abandoned and an expansionary one is implemented. However, in anticipation of future increases in interest rates, borrowers may borrow long-term funds even if they do not immediately need them.

Time Lags

The occurrence of time lags that are connected to the need for action, its perception, and the decision and execution of actions in time constitutes another significant limitation of a restrictive monetary policy. Due to these time lags, the monetary authority is unable to quickly employ restrictive monetary measures, which makes monetary policy work very slowly and ineffectively to control inflation.

4.0 CONCLUSION

We can draw the conclusion that monetary policy, by affecting the cost and availability of credit, by containing inflation, and by keeping the balance of payments' equilibrium, contributes significantly to raising the rate of economic growth. Bond prices rise and interest rates decrease because of expansionary monetary policy. Additionally, it brings down financing rates, which boosts capital investment.

The CBK responds to instances of either high inflation or an expected rise in future inflation by employing a restrictive monetary policy. The CBK will either stop or delay the increase of aggregate demand by hiking interest rates. A recession is likely to result if the CBK boosts interest rates to reduce aggregate demand in order to combat actual high inflation rates. In this scenario, the GDP growth turns negative and the unemployment rate increases. The right CBK policy is to raise interest rates only enough to restrict the growth rate of aggregate demand if, however, the CBK is dealing with expected future inflation. If done properly, the development of aggregate supply (productive capacity) will be compatible with the growth of aggregate demand, which is also referred to as the legendary soft landing.

5.0 SELF ASSESSMENT EXERCISE

1.Define expansionary policy and the role in economic growth

2.Briefly explain 3 tools used in expansionary monetary policy

3. With the aid of a diagram show how contractionary monetary policy is used to stabilize the economy.

4.Differentiate between deflation and inflation in relation to expansionary and contractionary monetary policy.

6.0 REFERENCES/FURTHER READINGS

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