

**H2 Economics Essay Practice – Essay Model**

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Topic: Monetary Policy

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*Discuss how a significant fall in the level of interest rates might affect the components of aggregate demand. [25]*

The Aggregate Demand (AD) in the economy is basically the summation of all the market demand across all markets in the economy and thus reflects and willingness and ability of the consumers to consume all the output of the economy. Interest Rates, on the other hand is the cost of borrowing and the reward of postponing consumption. Changes in the interest rates can thus have a huge impact on the AD of the economy, an impact transmitted through several different pathways influencing the different components of AD and eventually AD itself.

AD consists of the components, Consumption, Investments, Government Expenditure and Net Exports. The interest rates changes would have direct impact on consumption and investments while indirectly influencing net exports. A fall in interest rates is basically a result of a loose monetary policy that seeks expanding money supply through the printing of more currency or the relaxation of credit in the economy or both. In this case, the significant fall in level of interest rates would help to boost both consumption and investment in the economy. In the case of consumption, the fall in interest rates makes it less attractive to save additional income and thus could help to encourage an increase in Marginal Propensity of Consumption (MPC) of the economy. This implies that any rise in injections would be subjected to a higher multiplier, which gives rise to a gentler slope of the Withdrawal curve in the W&J analysis, and thus brings about a greater rise in eventual consumption and thus national income.

[Diagram of W&J, showing a steeper  $W_1$  changing to a gentler  $W_2$  and thus causing the equilibrium national income to rise]

On the other hand, compulsive shoppers may find it difficult to resist spending on credit since the significant fall of level of interest rates would mean that the cost of borrowing has fallen. In many sense, the fall in interest rates not only makes forgoing current consumption for future consumption (saving more) less attractive but increases the allure of forgoing future consumption for current consumption (raising debt). Both ways point to an increase in the component of Consumption in AD.

As mentioned, investments would also rise in the event of a significant fall in interest rates. This can be analysed and explained through the monetary transmission mechanism that is used to explain the workings of monetary policy. The expansion of money supply brings about the fall of interest rates, which in turn have a huge influence on the level of investment in the economy, if the MEI of the economy is interest-elastic enough. As observed in the diagram below, with an interest-elastic MEI, the significant fall in interest rates would help to raise the level of investment substantially.

Investments with returns that are originally lower than the interest rates would now become more attractive and these investments would be taken up when the interest rates falls. Theoretically, additional investments would be made until the return on the investments is equals to the new level of interest. In addition, businessmen with insufficient funds would now find it more attractive to borrow money from the banks to finance their investments since the cost of borrowing has fallen.

[Diagram of Monetarist Transmission Mechanism; including the Money Supply – Liquidity Preference diagram, the Marginal Efficiency of Investment (MEI) diagram and the AD-AS diagram to illustrate the effects of a fall in the level of interest rates]

As shown in the AD-AS diagram, this rise in investment would have the effect of pushing AD rightward because it causes the investment component of the AD to increase. Of course, the change in investment is very much dependent on the interest-elasticity of MEI. During times of recession and poor confidence in the economy, the MEI would become less sensitive to interest rates since businessmen and other investors becomes

particularly risk adverse and would be unwilling to take on too much risk. Even a significant fall in interest rates would not do much to raise the level of investments. On the other hand, during boom times, the confidence of investors could make the MEI particularly interest-elastic. A slight fall in interest rates would produce a large rise in the level of investments undertaken in the economy.

The eventual increase in national income would of course be higher given the multiplier effect in the economy but this will be analysed together when we consider all the combined effects of the significant fall in interest rates on the Aggregate Demand.

The fall in interest rates can have the effect of causing outflow of speculative capital, commonly known as 'hot money'. Such capital is short-term and stays in the economy when the interest rates yield the best returns. Since a significant fall in the interest rates implies that returns on the capital have fallen, it would flow out of the economy in search of better returns in economies with higher interest rates. This outflow of capital would result in the depreciation of the currency, making the exports cheaper from the perspective of foreign markets and imports more expensive from perspective of the local consumers. This would thus bring about an indirect impact on the Net Exports (X-M) component of AD.

The fall in the interest rates would thus affect the Net Exports differently depending on the price elasticity of demand for the imports and exports of the economy. If the Marshall-Lerner Condition ( $PE_{D_X} + PE_{D_M} > 1$ ) applies, the depreciation of currency caused by the fall in interest rates would help to raise the Net Exports given sufficient time. In short run, the economy suffers the J-curve effect as the affected markets (both imports and exports) takes some time to adjust to the change in exchange rates. Once the adjustment is complete, there will be an upward pressure on the level of Net Exports, thus increasing the (X-M) figure. If the Marshall-Lerner Condition is not satisfied, the depreciation of currency brought about by the significant fall in interest rates would reduce the Net Exports.

Since government expenditure component of the AD is dictated by the government and dependent on the discretionary fiscal policy stance of the government, it is not affected by the significant fall in interest rates. On the whole, the significant fall in interest rates would thus raise the consumption and investment while also possibly raising MPC at the same time and resulting in a higher multiplier than before. Net Exports would experience a rise after some time lag if the economy satisfies the Marshall-Lerner Condition and the overall effect of the fall in interest rates would thus be to increase AD. Even if the economy does not satisfy the Marshall-Lerner Condition, if the external sector of the economy does not take up significant proportion of AD, the boost in consumption and investment resulting from the fall in interest rates could more than compensate for the fall in Net Exports and raise AD.

In general, the significant fall in interest rates flushes the economy with liquidity and would thus have the effect of raising components of Aggregate Demand. There might be the unintended consequence of introducing a higher rate of inflation into the economy if it is already at or close to full employment. Unfortunately, the significant fall in interest rates may not increase the components of AD substantially if this happens during a depression or at the trough of a trade cycle because consumers would be too uncertain about the future and prefer to save even when they would only enjoy a low interest rates while businesses would be reluctant to invest believing that households are cutting back on expenditure. Therefore, despite the fall in interest rates, the sentiments of people in the economy would ultimately determine the degree by which the interest rates can influence the components of AD.