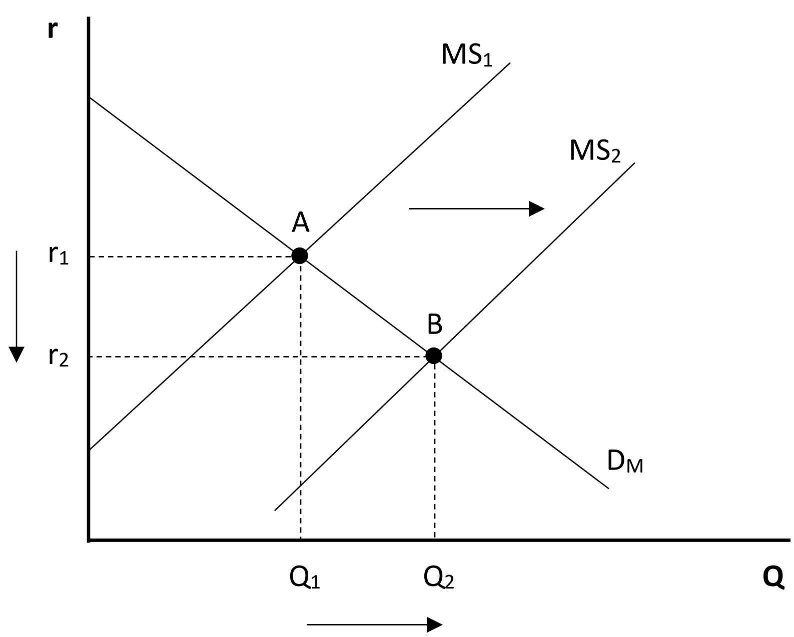
Monetary transmissions
Haworth/Econ 202

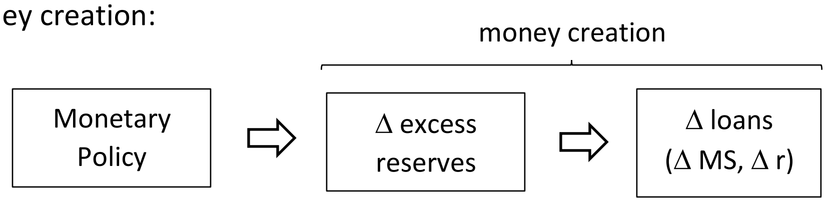
An important question for us to answer with monetary policy is how the process of money creation can lead to changes in Aggregate Demand and overall spending.

Money Creation
Let’s consider money creation within the context of how money creation increases the money supply. In this context, money creation is the process by which there is an increase in excess reserves, which leads to banks making more loans. As banks make loans, there is an expansion of demand deposits and the money supply increases.

Money Demand and Money Supply
We also know from the money market graph (the Demand for Money and Money Supply) that increases in the Money Supply curve lead to decreasing interest rates as shown below. As a general rule, we can say that monetary policy reveals an inverse relationship between the money supply and interest rates. I.e. increases in the money supply are associated with falling interest rates and decreases in the money supply are associated with rising interest rates.



This allows us to consider the following diagrammatic explanation for how monetary policy leads to money creation:



How does money creation lead to changes in spending?

There are 2 key changes that occur during this process of money creation – a change in borrowing and a change in expectations. Both of these paths lead us to changes in expenditure which ultimately involve shifts in the Aggregate Demand curve.

Changes in borrowing

Banks making more loans suggests that consumers and firms are borrowing more money, money we can assume they will spend. Here are some examples of how that borrowed money can be spent.

Consumers borrowing ⇨
- Expenditure on durable goods (e.g. cars, appliances) => ΔC
- Expenditure on more expensive services (e.g. college) => ΔC
- Expenditure on a home => ΔI

Firms borrowing ⇨ Expenditure on capital => ΔI

Changes in expectations

When the Fed announces their intent to follow a specific policy, these announcements can affect the expectations of consumers and firms. Of course, what consumers and firms expect about the future affects their spending today. E.g., assume that consumers and investors believe that the economy is headed into recession. As a result, consumers and investors with negative expectations would be more apprehensive about spending money on consumption and/or investment. Suppose, however, that the Fed announces a decrease in the discount rate, and that this announcement leads to consumers and investors having a change in their expecations. Knowing that the Fed will try to fix this recession, consumers and investors will feel more comfortable with spending money, and we could see a change in their spending patterns, thereby increasing Aggregate Demand.

Δ Consumer expectations ⇨
- Expenditure on consumption => ΔC
- Expenditure on durable goods (e.g. cars, appliances) => ΔC
- Expenditure on more expensive services (e.g. college) => ΔC
- Expenditure on a home => ΔI

Δ Investor expectations ⇨ Δ stock mkt values ⇨ Δ real wealth ⇨ Expenditure on consumption => ΔC

Δ Investor expectations ⇨ Expenditure on capital => ΔI

Once we have each of these different paths, we can put it all together (see below).

Below, is the finished product we get from combining what we know about money creation and ultimately monetary transmissions. Again, note that everything flows through either a change in borrowing or a change in expectations. And then, once we get to a shift in AD, if that shift is an increase, then we observe an increase in GDP and hopefully, the end to a recessionary gap. If that shift is a decrease, then we observe a decrease in the price level, and hopefully, the end to an inflationary gap.