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Should We Expand

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Should We Expand

Abstract

Should we expand? is the age-old question asked by economists. To answer this question, we must first look at the state of the current economy. What effects would expansionary monetary policy have on our economy, if any? Would this expansion be beneficial or could it make an unstable economy even worse? The ultimate goal is to decide if expansionary monetary policy should be implemented.

About the author : Stacey Williamson, a math major, wrote this paper for her second economics class, Macroeconomics. Minor in Economics, Stacey's interest in the subject was sparked when she saw the vast opportunities to apply the techniques of her math courses to economic analysis. Stacey is interested in a career as an actuary, having interned in State Farm's Auto Insurance Department in January 1994.

SHOULD WE EXPAND?

Stacey L. Williamson

Should we expand?-- the age-old question asked by many economists. To answer this question, we must first look at the state of the current economy. What effects would expansionary monetary policy have on our economy, if any? Would this expansion be beneficial or could it make an unstable economy even worse? The ultimate goal is to decide if expansionary monetary policy should be implemented.

Where is our economy at right now? How are inflation and output? How competitive are interest rates? Various price indices and gross domestic product figures would give us insight on answering these questions. Inflation seems to be under control in 1993 (Harper, p.A2). Second quarter statistics show an increase in the fixed-weighted price index of 2.9% compared to a 4.3% increase in the first quarter (Harper, p.A2). Gross domestic product continues to increase at a meek but steady rate (Harper, p.A2). However, there is still room for more economic growth in terms of substantial gross domestic product growth. Interest rates are more of what the Federal Reserve Board has direct control over. Gross domestic product can be influenced by changes in the real interest rates.

What has been the current trend with interest rates? Interest rates have been the lowest they have been in more than twenty years (Harper, "Turning up", p.A1). Lower interest rates stimulate many areas within the economy; investment is one of these. Lower interest rates, along with other factors, have encouraged a capital-spending surge. "Investment in durable equipment soared at a nearly 20% annual rate in each of the first two quarters of this year, and there are no signs that the capital-spending fever is dying down" (Harper, "Turning up", p.A1). Lower interest rates have also helped to spark the housing market. "In August, housing starts hit their highest level in three years" (Harper, "Turning up", p.A1). Mortgage rates are the lowest they have been in decades, hitting 6.82%, the lowest rate since May 1969 (Yonan, p.A2).

Low interest rates "are by far the economy's largest source of strength," stated Alfred Broadus, president of the Richmond

Federal Reserve Bank (Harper, "Turning up", p.A2). Also, the effects of these low rates have not yet fully been reached. "Consumers have been using the low rates to reduce their debt loads instead of buying houses and cars" (Harper, "Turning up", p.A2). Even more positive effects on our economy are expected to be seen, assuming the interest rates stay low.

How would expansionary monetary policy affect the economy which we have observed? A short-run model of a large open economy would be best to model our economy.

Using the equations:

$$IS: Y = C(Y-T) + I(R) + G - CF(R)$$

$$and LM: M/P = L(R, y)$$

where $C(Y-T)$ represents consumption based on disposable income, $I(R)$ represents investment inversely related to interest rates, G represents government spending, and $CF(R)$ represents capital flow, we can develop an IS-LM model (Mankiw, p.372).

Figure 1 shows that a monetary expansion shifts the LM curve outward which causes interest rates to fall from R_1 to R_2 . Output rises from Y_1 to Y_2 , since investment is higher at lower interest rates and investment is included in output.

Figure 2 shows that at lower interest rates, capital inflow from abroad decreases from CF_1 to CF_2 . Foreign investors look for higher interest rates.

Figure 3 shows that as capital inflow decreases, net exports increase due to lower exchange rates.

There is one component we have left out of our analysis of expansionary monetary policy; that is inflation. What happens to price levels in both the short-run and long-run when the money supply is increased? We can look at a supply and demand model to answer this (Mankiw, p.227).

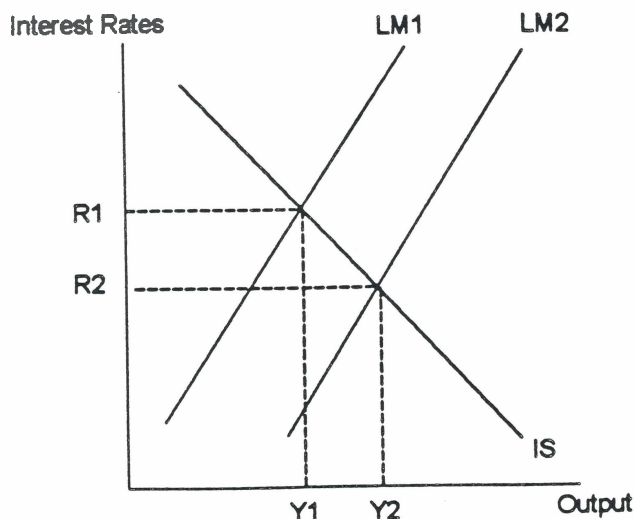


Figure 1. The IS-LM Model

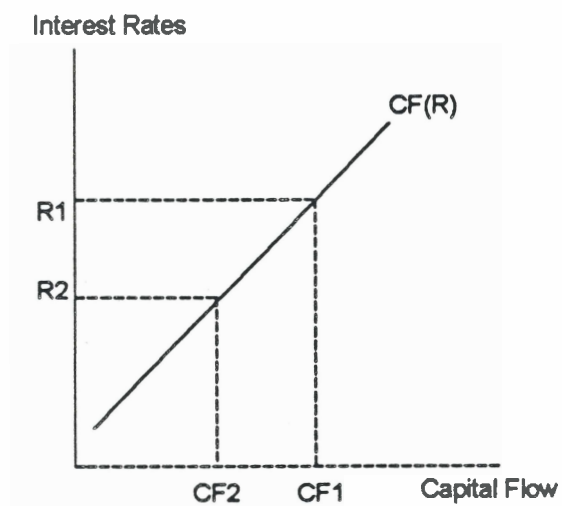


Figure 2. The Capital Flow From Abroad

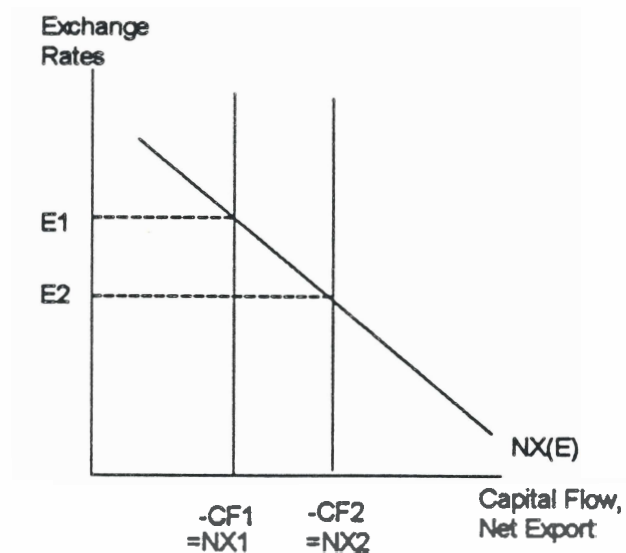


Figure 3. The Market for Foreign Exchange

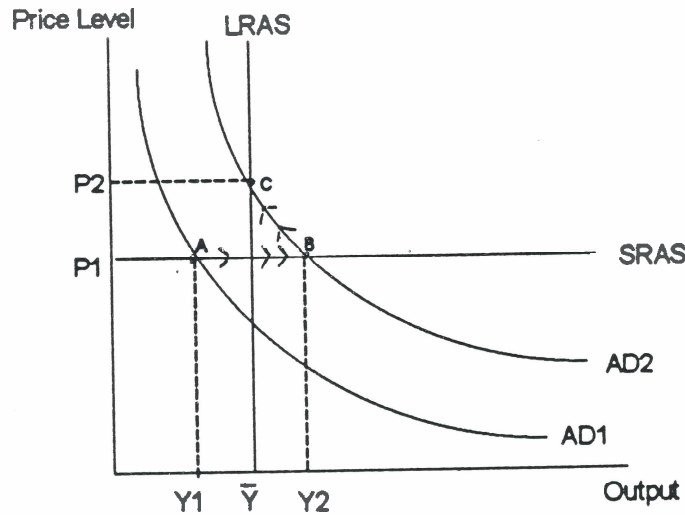


Figure 4. An Increase in Aggregate Demand

Expansionary monetary policy shifts the AD curve outward. Under the assumption that our economy is below the natural level of output, in the short-run, we move from point A to point B, increasing output above its original level and above the natural level. Output cannot stay above the natural level, therefore we move from point B to point C, taking a modest price increase on the way.

So far we have noted that expansionary monetary policy should lower interest rates which stimulates capital investment, decrease foreign capital inflow which lowers exchange rates and increases net exports, and increase output in the short-run. The cost of doing this seems to be slight inflation. Is this actually what has happened recently with the expansionary policy the Federal Reserve Board has been pursuing?

We have already noted that interest rates have been incredibly low. This can only be due to increases in the money supply:

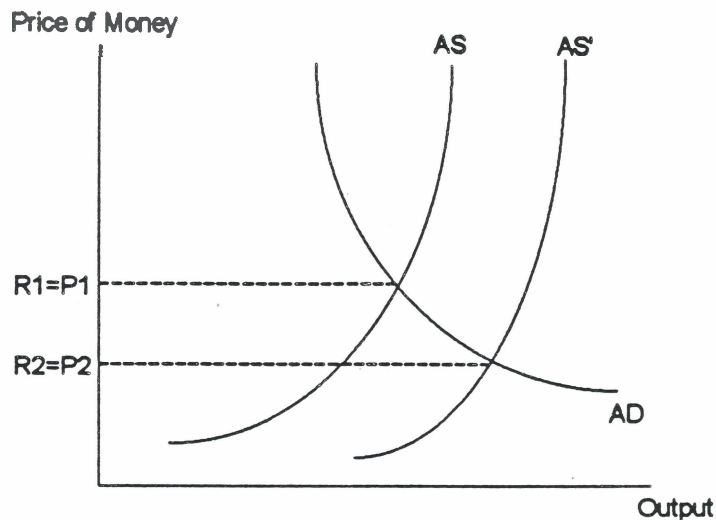


Figure 5. Real Aggregate Demand and
Real Aggregate Supply

An increase in the supply of money shifts the supply curve outward which lowers the price of money, i.e., interest rates!

These low interest rates have been extremely beneficial to several different areas of the economy. What about the inflation which is supposed to be the cost of lower interest rates? We noted earlier that inflation seems to be under wraps (Yonan, "Tracking the economy", p.A2). Perhaps, this is due to the fact that the "Federal Reserve Board acted in several small steps to help get the economy moving again, instead of making one big cut in interest rates" (Harper, p.A2). But looking into the future, "Fed policy makers have concluded that monetary policy probably would have to move in the direction of restraint at some point to resist any incipient tendency for inflationary pressures to intensify" (Wessel, p.A2). Somewhere down the line, the trade-off between low interest rates and inflation will have to be more closely examined.

Domestic capital spending is up and capital inflows are down. However, net exports are also down. The identity which states that capital inflow must balance the current account does not seem to be holding true! How can this happen? Other countries, namely our major trading partners are in recessionary periods. They simply do not have the money to invest in capital or take advantage of lower exchange rates. Our economy seems to be doing just fine, especially compared to other countries'.

In conclusion, monetary policy should remain stable. Low interest rates are in the slow yet ongoing process of stimulating

our economy. Giving them time to filter through the economy and perhaps giving other economies time to build up theirs to capitalize on low exchange rates would be the best idea.

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