Edexcel (B) Economics A-level

Theme 1: Markets, Consumers and Firms

1.4 Role of Credit in the Economy

1.4.1 Role of banks in the economy

Notes

Channelling savings towards investment

- Banks can manipulate the interest rate to discourage saving and encourage investment. When interest rates are low, the reward for saving is low. If the inflation rate is higher than the interest rate, the real value of savings falls. This discourages people from saving, since their money loses its purchasing power. Low interest rates also make it cheaper to take out loans, so it encourages spending and investment.

Role of banks in providing credit

The main source of income for commercial banks is interest, which banks earn through providing loans. Banks **create credit** by using deposited funds as loans.

Some loans are secured against an asset, such as a house. This is to protect the bank's funds if the loan is not repaid.

Loans could be in the form of cash credit, on demand or only for the short term. Cash credit loans are based on bonds and approved securities. Banks enter agreements with customers so money can be withdrawn several times a year. Banks deposit money periodically into the accounts of the customer. Loans on demand are when the entire loan is paid into the account of the borrower. Therefore, the loan is charged with interest immediately. Short-term loans tend to be personal or for working capital and are usually against a security.

Interest rates and collateral

- The central bank manages the currency, money supply and interest rates in an economy. For example, the European Central Bank (ECB), the Bank of England and the People's Bank of China are central banks.

- **Implementation of monetary policy**

The central bank takes action to influence the manipulation of interest rates, the supply of money and credit, and the exchange rate.

In the UK, the Monetary Policy Committee (MPC) alters interest rates to control the supply of money. They are independent from the government, and the nine members meet each month to discuss what the rate of interest should be. Interest rates are used to help meet the government target of price stability, since it alters the cost of borrowing and reward for saving.

The bank controls the **base rate,** which ultimately controls the interest rates across the economy.

- Collateral refers to a secured loan, such as a mortgage where property is pledged against a loan.
- A mortgage is a loan taken out to pay for a house. The loan is secured against the house, so if the loan cannot be repaid, the bank can repossess the house. The loan usually covers a long period, often around 25 years and the money is repaid on a monthly basis.