AQA Economics A-level

Macroeconomics

Topic 4: Financial Markets and Monetary Policy

4.3 Central banks and monetary policy

Notes

Monetary policy is used to control the money flow of the economy. This is done using a wide range of policy tools (however for the AS specification, only interest rates and quantitative easing are covered). This is conducted by the **Bank of England**, which became independent from the government in the 1990's.

The central bank takes action to influence the manipulation of:

- ➔ Interest rates
- ➔ The supply of money/credit
- ➔ The exchange rate

Monetary Policy Committee (MPC):

- In the UK, the Monetary Policy Committee (MPC) alters interest rates to control the supply of money. They are independent from the government, and consist of 9 members who meet 8 times a year to discuss what the rate of interest should be.

- Interest rates are used to help meet the government target of price stability and a 2% inflation rate, since it alters the cost of borrowing and reward for saving. The objective of monetary policy, to achieve price stability, is described here:

  http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx

- The bank controls the **base rate**, defined as the interest rate set by central banks for lending to other banks. This is used as a benchmark for interest rates set by commercial banks.

Functions of a central bank:

- 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 (BoE) and the People's Bank of China are all central banks.

- Central banks issue physical cash (notes and coins) securely and use methods to prevent forgery. This is so people trust the money. The central bank can regulate bank lending to ensure there is stability in the financial system.

Banker to the government

- The central bank provides services to the Central Government. It collects payments to the governments and makes payments on behalf of the government. It maintains and operates deposit accounts of the government. The central bank also manages **public debt** and issues loans.

- The bank can also advise the government on **finance**, including the timing and terms of new loans.

Banker to the banks - lender of last resort

- The Bank of England is considered to be a lender of last resort. If there is no other method to increase the supply of **liquidity** when it is low, the BoE will lend money to increase this supply.

- If an institution is risky or close to collapsing, the bank might lend to them. This is when they have no other way to borrow money.

- It can protect individuals who deposit funds in a bank and might otherwise lose them. It also aims to prevent a '**run on the bank**', which is when consumers all withdraw their bank deposits at once in a panic, because they believe the bank will fail.

- Usually, banks will avoid borrowing from the lender of last resort, because it suggests to the government that the bank is experiencing financial difficulties and won't display confidence to their depositors.

Monetary policy instruments

Interest rates:

- A reduction in interest rates (i.e. expansionary monetary policy) affects each determinant of Aggregate Demand (C+I+G+X-M), and ***ALL*** of these are covered in the A-level specification.

Consumer spending (C)

Low interest rates reduce the **opportunity cost** of saving (see notes), because it is cheaper for consumers to borrow from commercial banks.
Households with variable rate mortgages benefit through lower repayments, which increases **disposable income** and, as a result, increases their **marginal propensity to consume**.
Lower base rates (and therefore interest rates) also increases the number of mortgages taken out by households, so the demand for houses rises. Due to the supply of houses in the UK being PES inelastic (see notes), this results in a proportionately larger increase in house prices. This triggers a **positive wealth effect**, whereby people spend more as they feel richer, which boosts consumption.

Investment (I)

Low interest rates mean it is cheaper for firms to borrow from commercial banks, and use these cheap loans to fund **R&D** or other forms of investment.
Investment will also increase if consumer spending does, according to Samuleson's **accelerator effect**, as *investment is a derived demand*.

Government spending (G)

Low interest rates mean government debt repayments will be lower, and so will encourage the government to issue more **bonds** to contribute to higher levels of government spending.

Exports minus imports (X-M)

Interest rates affect the amount of **hot money** flowing into an economy: this being money that flows from different countries in search of the highest interest rates to maximise short-term profits. So a low interest rate would reduce the flow of hot money into the economy, as the rate of return is lower than in other countries. This weakens the **exchange rate**, as it increases the supply of the £ on FOREX markets - or decreases the demand for the £ (see notes). This increases the **price competitiveness** of exports, as they become cheaper. However, imports become more expensive, and this could mean higher costs of production (and therefore prices), which would eliminate any increase in exports.

Quantitative Easing (QE):

- This is used by banks to help to stimulate the economy when standard monetary policy is no longer effective, i.e. interest rates cannot be lowered any further than their current rate.

➔ Bank of England electronically creates more money.

➔ It uses this to buy government and bank **bonds**.

- As banks now have more money, they will naturally lend more to households and firms, thus increasing overall demand which will restimulate the economy. However, this assumes banks will simply not sit on the extra cash the BoE offers them, as they may be concerned about their clients' abilities to repay loans, like we saw during the 2008 Great Financial Crisis (**GFC**).
- Now that the central bank has also bought up government bonds (often referred to as **gilts**), the government has the funds to spend more in the economy, for example on training and education (**T&E**) or other forms of **capital spending**, in the hopes of boosting the economy.
- Alternatively, if the BoE wants to initiate in **contractionary monetary policy**, they will stop the purchase of government and bank bonds. This means banks will hold back on lending to consumers and governments will delay spending on infrastructure, **R&D**, etc. This will overall reduce the rate of inflation to the BoE's target of 2% CPI.

Limitations of Quantitative Easing (QE):

X As the supply of the £ increases, the UK experiences a depreciation of its currency on FOREX markets. Although this makes exports cheaper, imports become more expensive, and because the UK imports a lot of raw materials from overseas, it could trigger **cost-push inflation**.

X QE lowers long-term interest rates (i.e. interest rates on bonds), because the supply of money has increased. This makes bonds less attractive to potential investors, as the rate of return is lower, so without anyone buying government bonds, there is less investment in the country which prevents the **productive capacity** of an economy from expanding.

Funding for lending:

- Moreover, worsening conditions in the Euro area meant that UK banks were faced with higher funding costs. In order to support them, the government introduced the Funding for Lending Scheme, which aimed to lower these costs and provide cheap funding to banks and building societies.

Forward guidance:

- This is used by central banks to detail what the future monetary policy will be to the general public. This is with the intention of reducing uncertainty in markets. For example, the MPC might state they will keep the interest rate at a certain level until a specified date.
- For example, Janet Yellon, the former chair of the Federal Reserve, was a strong advocate of forward guidance, and always put it to practice in her years at the central bank. She supported the idea as it reduced the levels of uncertainty amongst investors.

Factors considered by the MPC when setting bank rate

- Unemployment rate: if unemployment is high, consumer spending is likely to fall. This suggests the MPC will drop interest rates to encourage more spending.
- Savings rate: if there is a lot of saving, consumers are not spending as much. Interest rates might fall.
- Consumer spending: if there is a high level of spending in the economy, there could be inflationary pressures on the price level. This would cause the MPC to increase interest rates.
- High commodity prices: Since the UK is a net importer of oil, a high price could lead to cost-push inflation. This could push the MPC to increase interest rates to overcome this inflationary pressure.
- Exchange rate: A weak pound would cause the average price level to increase. This makes UK exports relatively cheap, so UK exports increase.