OCR Economics A-level

Macroeconomics

Topic 3: Implementing Policy

3.2 Monetary Policy

Notes

Monetary policy is used by the government to control the money flow of the economy. This is done with interest rates and quantitative easing. This is conducted by the Bank of England, which is independent from the government.

Monetary policy instruments

- **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.

- **Interest rates:**
  - A reduction in interest rates (i.e. expansionary monetary policy) affects each determinant of Aggregate Demand (C+I+G+X-M). However, not all of these are covered in the AS specification:

Consumer spending (C)

Low interest rates reduce the **opportunity cost** of saving, 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, 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.

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**.

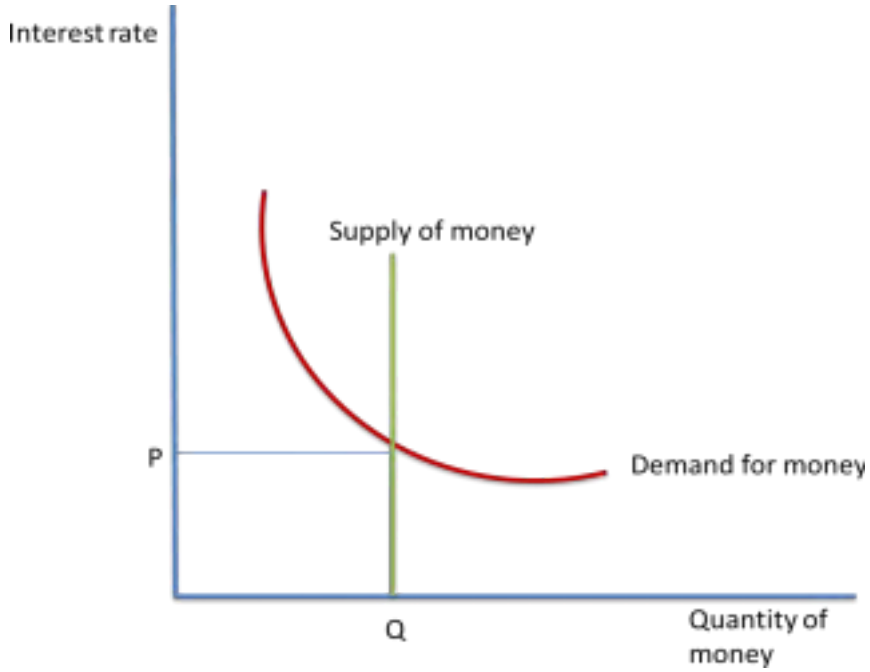
- As banks now have more money, they will naturally lend more to households and firms, thus increasing overall demand which will restimulate the economy. However, this assumes banks will simply not sit on the extra cash the BoE offers them, as they may be concerned about their clients' abilities to repay 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.

Limitations of monetary policy:

- Banks might not pass the base rate onto consumers, which means that even if the central bank changes the interest rate, it might not have the intended effect.
- Even if the cost of borrowing is low, consumers might be unable to borrow because banks are unwilling to lend. After the 2008 financial crisis, banks became more risk averse.
- Interest rates will be more effective at stimulating spending and investment when consumer and firm confidence is high. If consumers think the economy is still risky, they are less likely to spend, even if interest rates are low.

Liquidity trap:



Interest rates are determined as shown in the diagram above. The supply of money meets the demand for money at P, Q. A rate of interest above P means the supply of money exceeds demand. This causes the rate of interest to fall. The interest rate remains at equilibrium unless there the demand for or supply of money changes.

The second diagram below shows a liquidity trap. This is when a change in the supply of money does not change interest rates. This means conventional monetary policy cannot be used to influence consumption and investment, **so quantitative easing is introduced.**