WJEC (Wales) Economics
AS-level
Macroeconomics

Topic 3: Policy Instruments

3.2 Monetary policy

Notes

Monetary policy is used 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.

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

Monetary policy instruments:

- **Interest rates**

  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 objective of monetary policy, to ensure there is price stability is described here:

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

  The government inflation target is 2%, measured by CPI. It is symmetrical, so inflation should not fall 1% outside of this target.

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

  When interest rates are high, the reward for saving is high and the cost of borrowing is higher. This encourages consumers to save more and spend less, and is used during periods of high inflation.

  When interest rates are low, the reward for saving is low and the cost of borrowing is low. This means consumers and firms can access credit cheaply, which encourages spending and investment in the economy. This is usually used during periods of low inflation. However, during the financial crisis, the UK interest rate fell to a historic low of 0.5%, and has been at this rate since March 2009. Despite high inflation, the interest rate was set at a low rate to stimulate AD and boost economic growth.

  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 Bank of England will lend money to increase the supply.

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. Since imports become relatively more expensive, there would be an increase in net exports. The MPC might consider increasing the interest rate.

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.

How interest rate changes can impact the real economy and inflation:

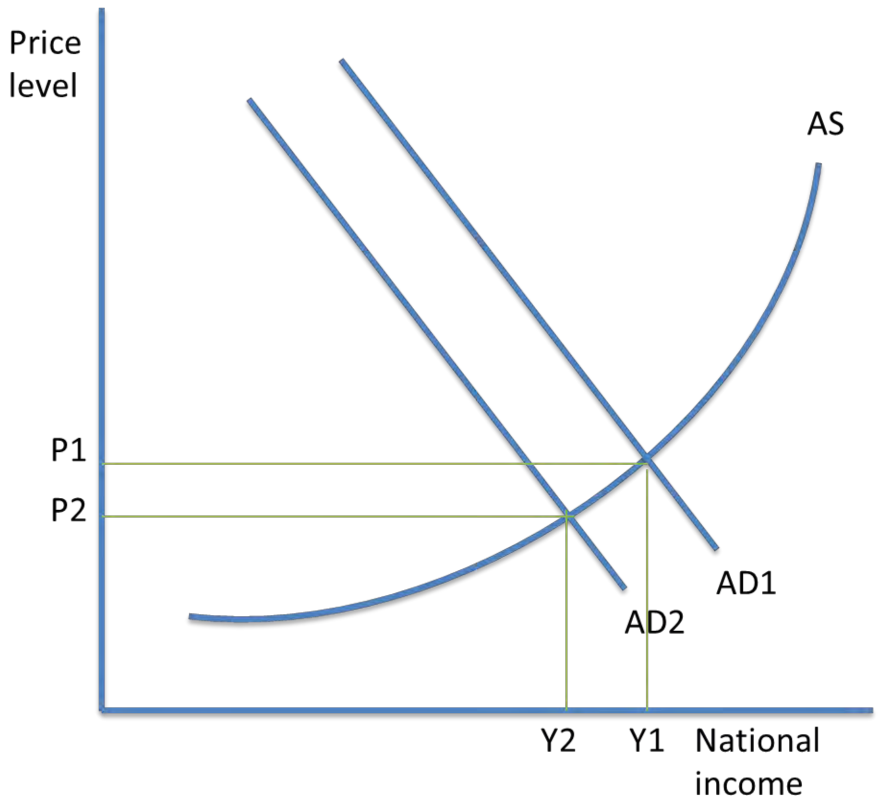
If interest rates are increased, the cost of borrowing increases. Loan repayments become more expensive, including mortgages, and it costs more to take out a loan in the first place. This leads to consumers having less disposable income, as well as being discouraged from borrowing. This decreases consumption and AD.

Higher interest rates give people a greater reward for saving. This encourages consumers to save more and spend less.

The currency appreciates with higher interest rates, due to increased hot money flows.

Governments are likely to face higher debt repayments with higher interest rates. If the government is trying to reduce their national debt, higher interest rates would mean it takes longer to pay off the debt.

Generally, AD with fall since spending and investment is discouraged, and saving is encouraged. The effects of higher interest rates are shown in the diagram below.



- **Evaluating the effect of interest rates:**

- Consumers and firms are affected differently by interest rates. Some consumers and firms will have higher level of debts, such as mortgages, which makes their repayments more expensive. Those who are saving will benefit, since the return on their savings is high.
- There might not be *ceteris paribus.* Other factors in the economy might encourage consumers to spend more, even if interest rates are high.
- There are significant time lags associated with interest rate changes.
- The base rate might not necessarily be passed onto consumers.

The extent to which changes in interest rates are likely to affect the exchange rate:

- An increase in interest rates, relative to other countries, makes it more attractive to invest funds in the country because the rate of return on investment is higher. This increases demand for the currency, causing an appreciation. This is known as **hot money.**
- However, the impact on exchange rates is not usually predictable. This is because other factors, such as the country's level of debt and the demand for the country's exports, also influence the exchange rate.
- A reduction in the exchange rate causes exports to become cheaper, which increases exports. This assumes that demand for exports is price elastic. It also causes imports to become relatively expensive. This means the UK current account deficit would improve.
- However, this is inflationary due to the increase in the price of imported raw materials. Production costs for firms increase, which causes cost-push inflation.