# AQA Economics AS-level

## Macroeconomics

## Topic 4: Macroeconomic Policy

### 4.1 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 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.

- **Asset purchases to increase the money supply: Quantitative Easing (QE)**

  This is used by banks to help to stimulate the economy when standard monetary policy is no longer effective. This has inflationary effects since it increases the money supply, and it can reduce the value of the currency.

  QE is usually used where inflation is low and it is not possible to lower interest rates further.

  QE is a method to pump money directly into the economy. It has been used by the European Central Bank to help stimulate the economy. Since the interest rates are already very low, it is not possible to lower them much more. The bank bought assets in the form of government bonds using the money they have created. This is then used to buy bonds from investors, which increases the amount of cash flowing in the financial system. This encourages more lending to firms and individuals, since it makes the cost of borrowing lower. The theory is that this encourages more investment, more spending, and hopefully higher growth. A possible effect of this is that there could be higher inflation.

  If inflation gets high, the Bank of England can reduce the supply of money in the economy by selling their assets. This reduces the amount of spending in the economy.

## 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.

## How changes in the exchange rate affect AD and the macroeconomic policy objectives:

- 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.