WJEC (Wales) Economics A-level

Macroeconomics

Topic 3: Policy Instruments

3.2 The operation of monetary policy and monetary stability

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:

- **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.

- **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.

- **Funding for lending**

  Moreover, worsening conditions in the Euro area meant that UK banks faced 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.

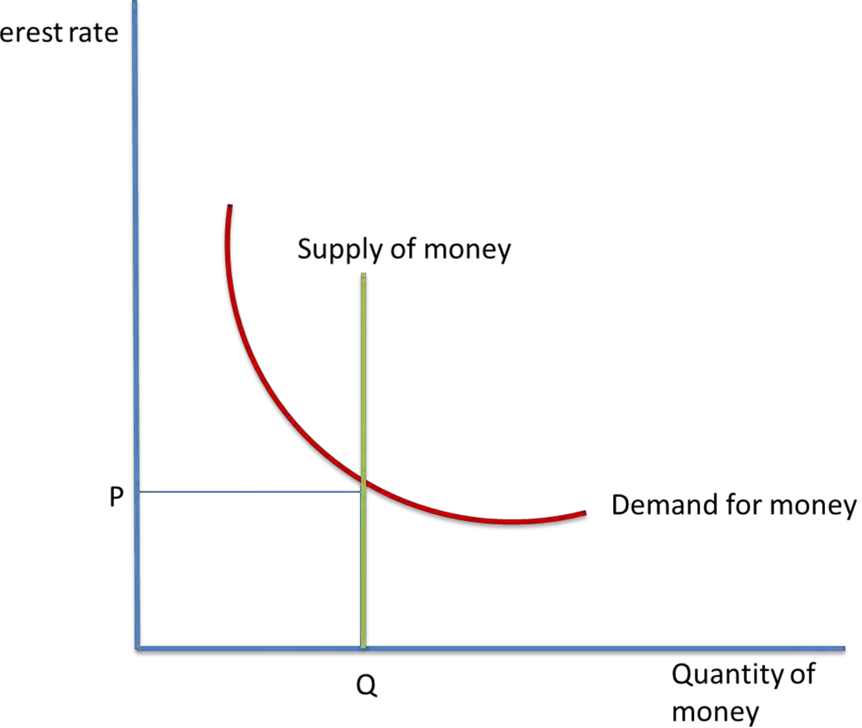
- **Forward guidance**

  This is used by central banks to detail what the future monetary policy will be. 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.

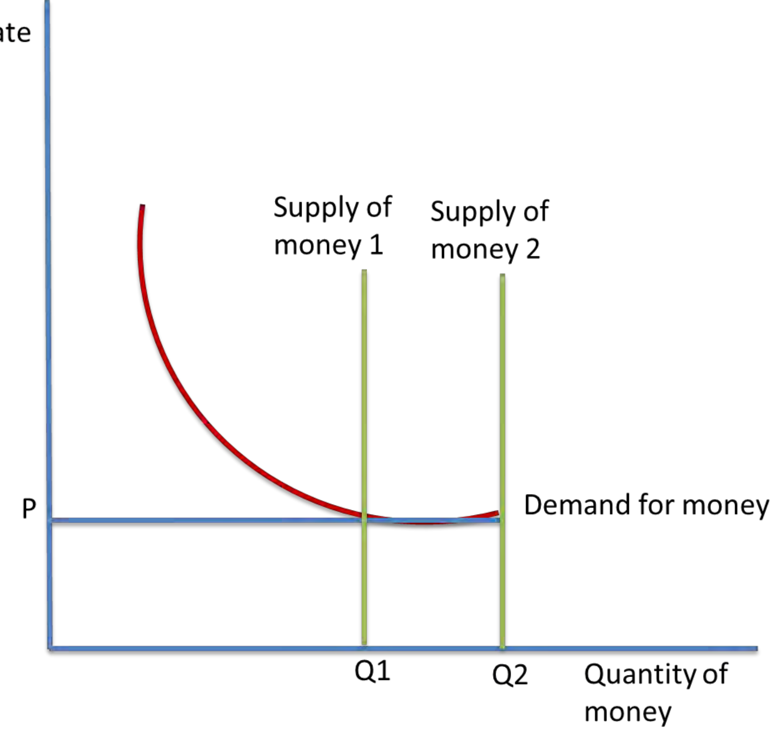
Limitations of monetary policy:

- 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 above diagram shows a liquidity trap. This is when a change in the supply of money does not change the interest rate. This means monetary policy cannot be used to influence consumption and investment.