

# Monetary Policy Economics

## AS Macroeconomics

May 2011

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## Basics of monetary policy

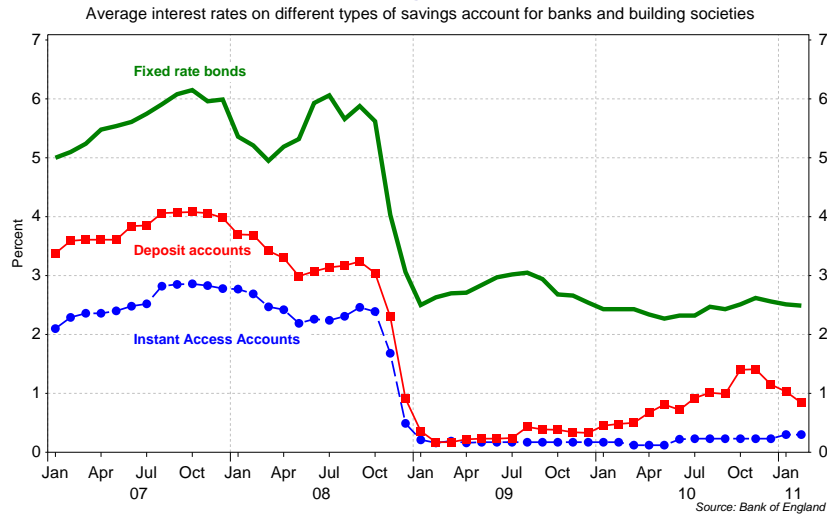


- Monetary policy involves changes in
  - Policy interest rates (and other interest rates in the economy)
  - The exchange rate
  - The size of the monetary base
  - The availability of credit
- To influence
  - The level and growth of aggregate demand and output
  - Control inflationary and deflationary pressures
  - Meet an inflation target and achieve price stability

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## Many different interest rates - savings

### Personal Savings Interest Rates

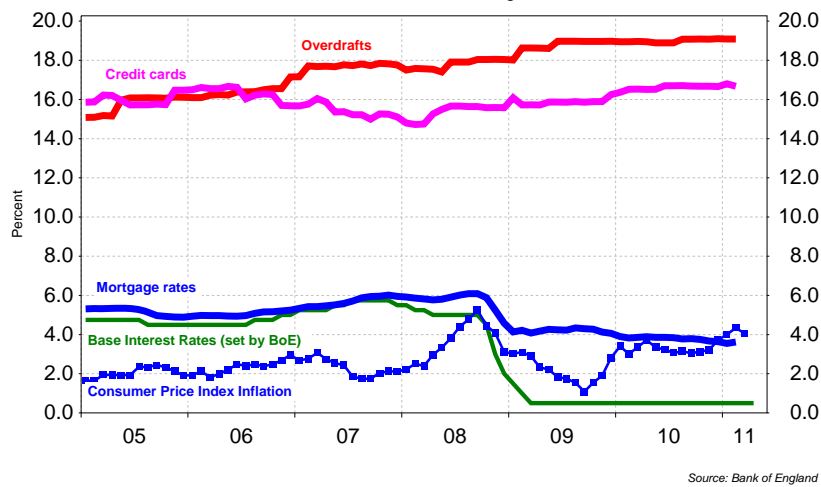


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## Interest rates on loans

### Cost of Borrowing and Inflation

Per cent, source: Bank of England



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## The real rate of interest

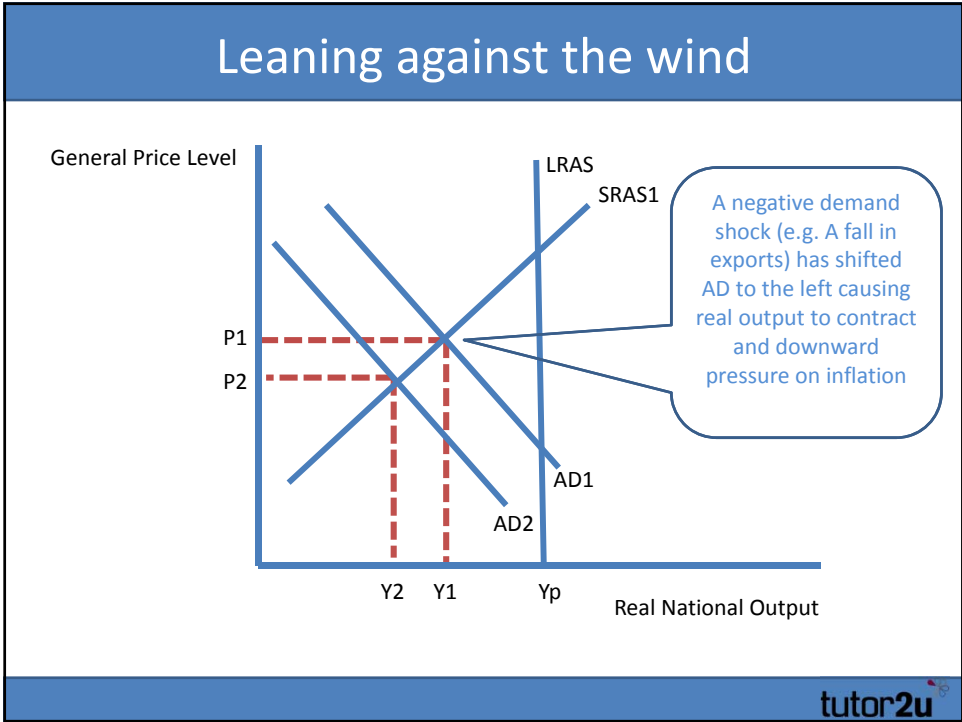
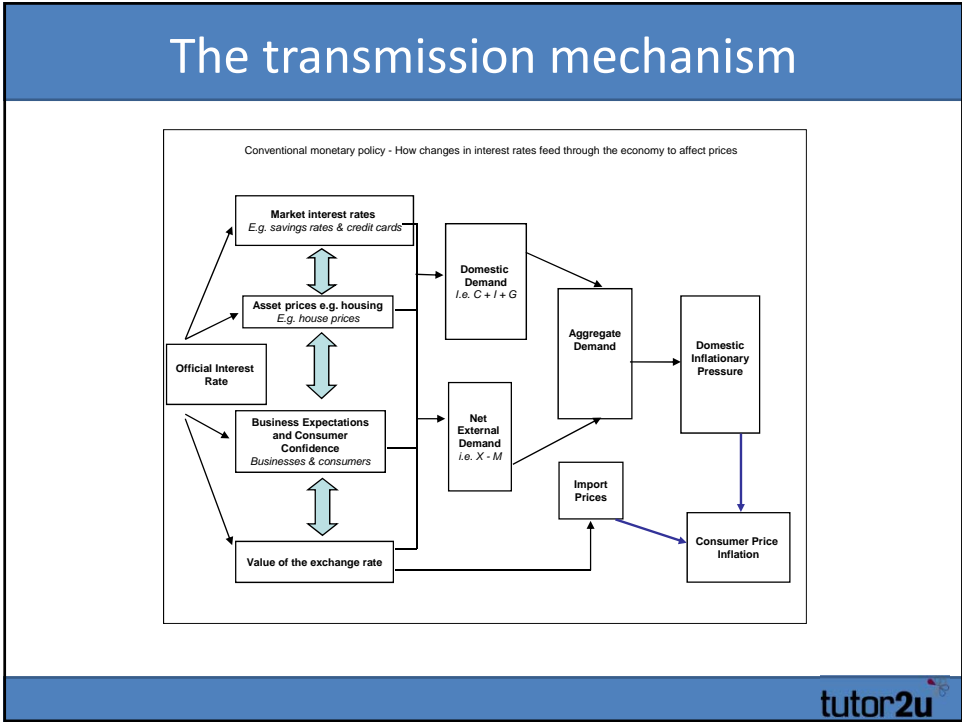
- Real rate of interest takes into account the effects of inflation
- Real interest rate = money rate of interest (%) – the inflation rate (%)
  - E.g. If money interest rates are 5% and inflation is 2%
  - There real interest rate =  $5\% - 3\% = +2\%$
- Real interest rates can become negative if the money rate of interest is less than inflation
- Real interest rates can be positive even if money interest rates are zero! Why?
- Because of the effects of price deflation
  - E.g. Money rate of interest = 0%, inflation = -2%
  - Real interest rate =  $0\% - (-2\%) = +2\%$

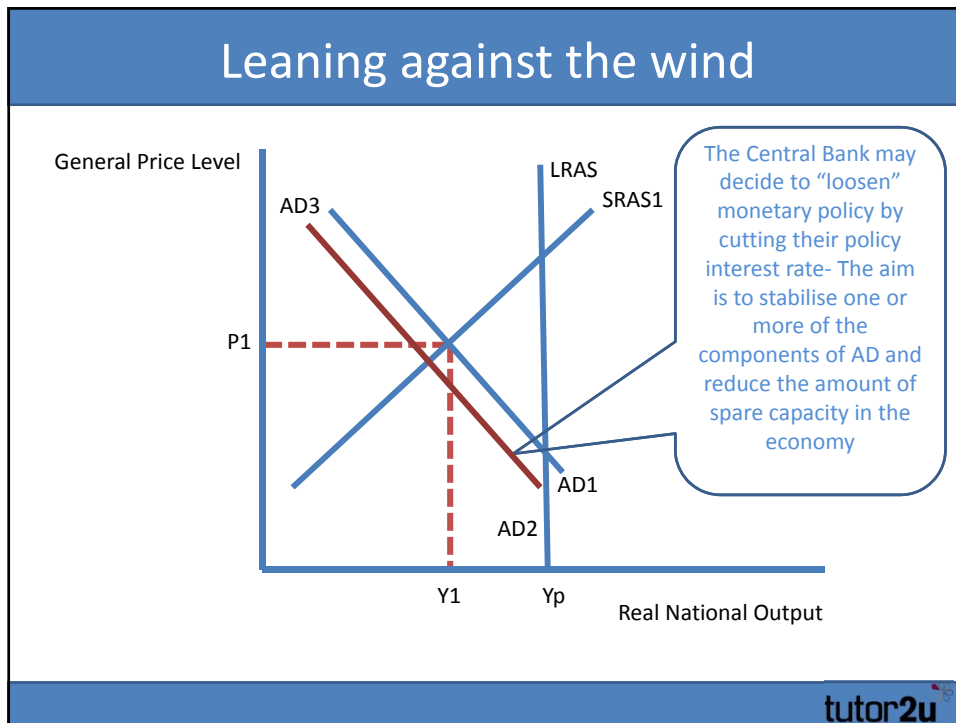
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## How do rate changes affect the economy?

- Interest rate changes affect:
  1. The cost of borrowing – affects demand for loans
  2. The incentive to save
  3. The effective disposable income of mortgage payers
  4. The real incomes of people with positive net savings
  5. Demand for housing and house prices
  6. Consumer confidence
  7. Business confidence and investment spending
  8. Demand for exports and imports through changes in the exchange rate (the external value of a currency)
- Interest rate changes and their effects are described by the **transmission mechanism of monetary policy**

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### The Bank of England

- Founded in 1694
- A central bank
  - Issues banknotes
  - A bank to the UK government and commercial banks
  - Manages the government’s debt by issuing bonds (gilts)
  - Operates monetary policy – setting the base (or policy) interest rate to influence the economy
  - Must try to balance price and output objectives

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## The Bank's strategy

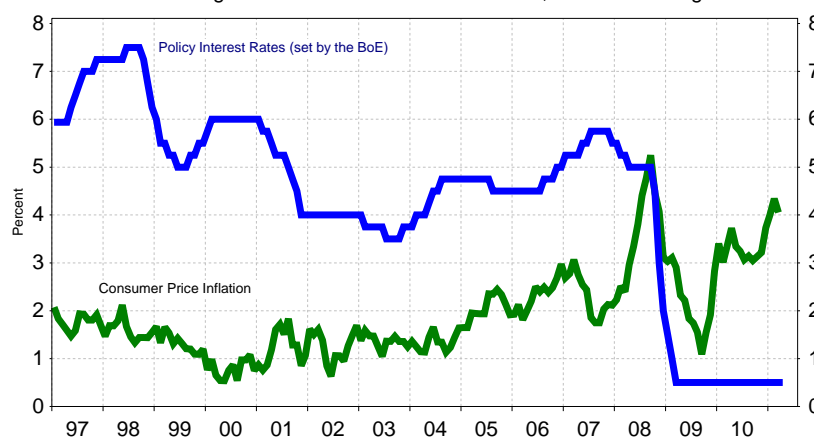
- For the first 11 years the monetary policy committee used changes in the price of borrowed money to manage demand and prices.
- Aim was for BoE to have an indirect influence on the costs of borrowing and rewards for saving by affecting interest rates on government debt, mortgages, credit cards and corporate debt.
- 2009 brought a change of approach
  - Series of sudden and dramatic policy rate cuts from 5% in October 2008 to 0.5% in March 2009
  - Start of quantitative easing – expanding the money supply by purchasing bonds

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## CPI inflation and UK policy rates

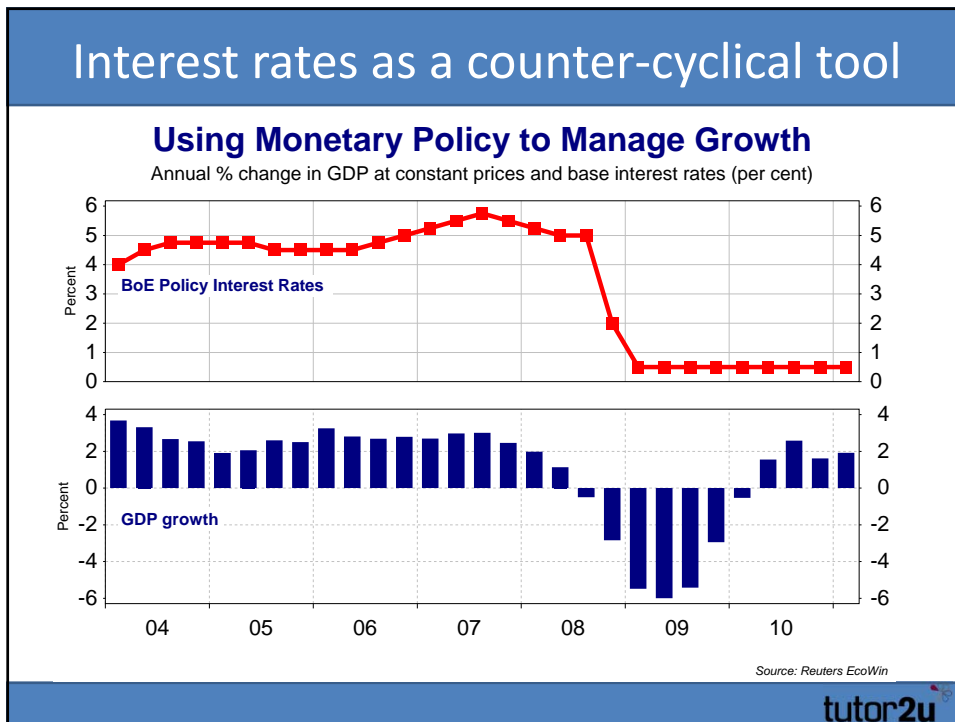
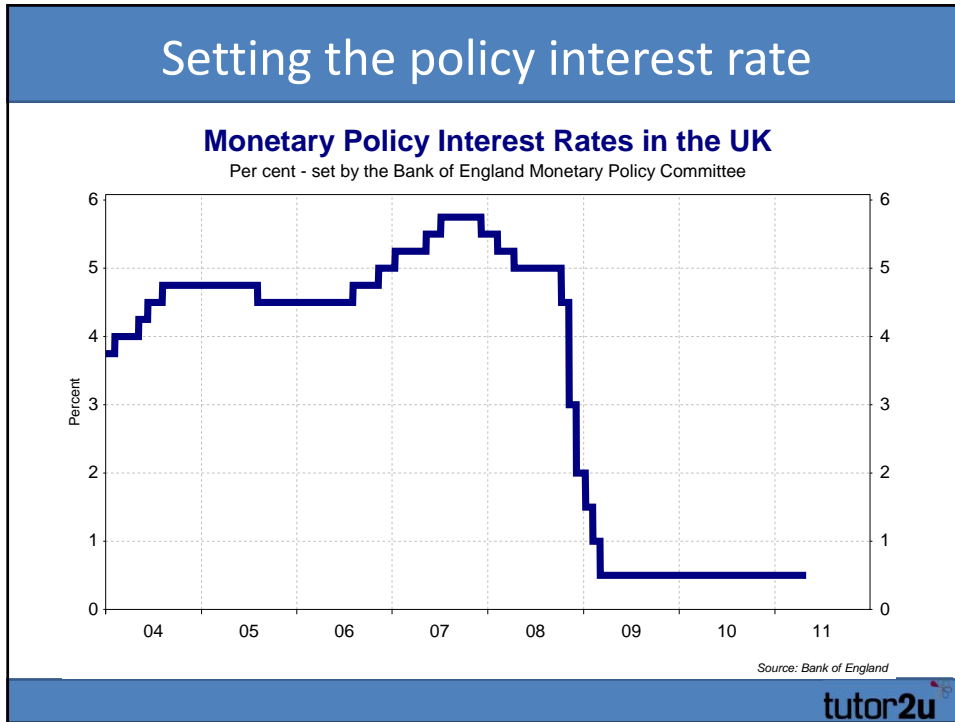
### CPI Inflation and Interest Rates for the UK

Annual % change in the UK Consumer Price Index, the inflation target is 2%



Source: Reuters EcoWin

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## 2009-2010 – a policy of ultra low rates

### UK interest rate remains at 0.5%

The Bank of England has held UK interest rates at the record low of 0.5% in a widely-expected move.

It also announced no changes to its programme of pumping newly-created money into the economy - so-called quantitative easing (QE).

In November, the Bank of England said it would inject another £25bn, taking the total planned under QE to £200bn.

The Bank cut interest rates to 0.5% in March in an attempt to boost the recession-hit economy.



The Bank is pumping £200bn of newly created money into the economy

Cutting interest rates is an example of an expansionary monetary policy or a “loosening of policy”

- Rates below 1% designed to:
  1. Cut cost of borrowing for consumers & businesses
  2. Prevent sustained slump in house prices
  3. Help maintain a competitive exchange rate
  4. Stabilise consumer and business confidence
  5. Reduce the risks of deflation

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## Evaluation points on monetary policy


- **Time lags** should always be considered when analyzing effects of rate changes.
- Demand can be **interest inelastic** – making rate changes less effective in managing aggregate demand.
- **Monetary policy does not work in isolation!**
  - Always consider how the government’s fiscal policy is affecting demand and inflationary pressures
  - Monetary policy decisions in other countries will affect demand for UK produced goods and services
- Conventional monetary policy seemed to have become less effective during the 2008-10 downturn
  - This has led to use of unconventional policies e.g. **Quantitative easing**

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## Quantitative easing (QE)

Quantitative easing explained

### Supplying more money how it happens




The bank creates money and uses it to buy assets such as government bonds and high-quality debt from private companies.


Stimulating business and money flow in the wider economy.

QUANTITATIVE EASING

Bank of England




£200bn



First, with the permission of the Treasury, the Bank of England creates lots of money. It does this by just crediting its own bank account. It plans to have created £200bn in this way by early 2010.

1 of 4

[← BACK](#)
[NEXT →](#)



## Understanding QE

- A high-brow term for increasing the money supply – i.e. Expanding the monetary base / injecting cash
- The Monetary Policy Committee has a programme of asset purchases (a form of open market operations)
- Aims of quantitative easing:
  1. Increase cash deposits that banks hold at BoE
  2. In theory banks will then be more ready to lend to households and businesses – i.e. it aims to get money flowing round the economy again
  3. This should help to relieve the credit freeze and stimulate increased business loans

## Potential problems / weaknesses of QE

- If too much money is pumped into the market for too long, inflation could start accelerating in a few years
- There could still be a problem in persuading the banks to engage in more spending – this is the so-called liquidity trap
  - Evidence that banks are hoarding the new deposits
- The Bank of England is already uneasy about the amount of money it will need to print to keep bond interest rates low.
  - £200bn so far (Dec 2009)
  - Bank of has become buyer of first resort for the huge level of government debt – may call the independence of BoE into question
  - Has the BoE an exit strategy for QE if and when the domestic / global economy starts to recover?

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## 10 key terms to understand

- Interest elasticity of demand
- Loosening of monetary policy
- Tightening of monetary policy
- Real interest rate
- Effective disposable income
- Policy rate
- Transmission mechanism
- Time lags
- Quantitative easing
- Exchange rate

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