Monetary Policy

What is monetary policy?

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Expansionary and Contractionary Monetary Policy

a) Expansionary Monetary Policy (also known as inflationary or looser monetary policy)

This involves cutting interest rates in order to boost aggregate demand.

b) Contractionary Monetary Policy (also known as deflationary or tighter monetary policy)

This involves raising interest rates in order to reduce aggregate demand.

Activity 1:

How might an increase in interest rates affect the following Economic agents?

Type of economic agent	Effect on the economic agent
Home owners (on a mortgage)	
Credit card users	
Firms	

Monetary Policy

Over the past 20 years Monetary policy has been the principle strand of macroeconomic policy and since 1997 has been principally managed by the Monetary Policy committee of the UK's central bank (the Bank of England).

The operational independence of the Bank of England was granted in 1997.

The MPC's job is to use interest rates to ***control aggregate demand*** and subsequently ***control inflation***.

Why do you think the Bank of England was granted operational independence?

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The rate of interest and monetary policy

There is no unique rate of interest. For example, we can distinguish between savings rates and borrowing rates. However, interest rates tend to move in the same direction. For example, if the Bank of England cuts the base rate of interest, we can expect to see lower mortgage rates and lower rates on savings accounts with banks and building societies.

Key definitions

- Interest rates – The cost of borrowing or the reward for savings.
- Real interest rates – The money (nominal) rate of interest minus the rate of inflation.
- Transmission mechanism – How changes in base interest rate influence the components of aggregate demand

Activity 2:

Use the space below to demonstrate (using an AD-AS diagram) how you would show the effects of an increase in interest rates to reduce inflation (**Use the Keynesian AD-AS diagram**)

Diagram	Explanation

Impacts of changes in interest rates on the aggregate demand

1. **Disposable incomes of mortgage payers**. If interest rates increase, the disposable income of homeowners who have variable-rate mortgages will fall, leading to a decline in their purchasing power.

   Possible evaluation point: However, a rise in interest rates boosts the disposable income of people who have paid off their mortgage and who have positive net savings in bank and building society accounts.

2. **Consumer demand for credit**. Higher interest rates increase the cost of serving debt on credit cards and should lead to a slow-down in the growth of retail sales and spending on consumer durables,

   Possible evaluation point: the extent of which depends on the impact of a rate change on consumer confidence.

3. **Consumer and business confidence**. The relationship between interest rates and business and consumer confidence is complicated, depending on economic conditions. For example, when businesses and consumers are worried about the risk of a recession, a fall in interest rates can boost confidence, and hence aggregate demand, acting as a reassurance to the public that the Bank of England is alert to the dangers of a down turn in economic activity.

   Possible evaluation points: It is possible, however, that a cut in rates could undermine confidence. For example if the Bank of England cut interest rates too quickly, sending a message to firms and consumers that the Bank is concerned about the prospect of a recession. Thus, the setting of interest rates requires a finely balanced judgment.

4. **Business investment.** Firms take the actual and expected level of interest rates into account when deciding whether or not to undertake new capital investment spending. A rise in interest rates will increase the cost of borrowing and might dampen business confidence.

   Possible evaluation point. However, many other factors influence investment decisions, including consumer trends, business confidence, the price of capital, etc.

Activity 3:

Evaluate one way in which an increase in interest rates might reduce inflation in the UK?

(Note: Explain one reason why an increase in interest rates might reduce inflation, followed by two evaluate points)

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Monetary Policy and Exchange rates

Activity 1: Complete the paragraph using the words below.

What is the effect of interest rates on hot money?

Higher UK interest rates might lead to a ……………………. of the pound because of an …………………. demand for the pound. Foreign holders of currency will swop their currencies for UK pounds to get a higher rate of interest - this ……………………. of money into the UK financial system is called …………………….

(Words to use: 'hot money'/'cold money', strengthening/weakening, inflow/outflow, increased/decreased)

SPICED

As the pound becomes stronger this will reduce the competitiveness of UK firms in overseas markets because our goods will seem more expensive.

- **S**
- **P**
- **I**
- **C**
- **E**
- **D**

The effect of an increase in hot money on the value of the pound

An increase in hot money will lead to an increase in the demand for the pound shifting the Demand curve the pound to the right.

Activity 2: Show this in the diagram below:

Activity 3:

The UK currently has inflation of 0.2% CPI, and is currently edging towards deflation. Explain why a decrease in interest rates may cause inflation to rise. Use an AD-AS diagram to support your answer

Hint: Think about SPICED, what's happening to import prices – could you relate this to the costs of raw materials, what's happening to exports? What are the two types of inflation? How can they be shown on an AD-AS diagram?

A decrease in interest rates will cause a decrease in the demand for the pound, as hot money flows out of the economy ....

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Extension: What impact will this cut in interest rates have on the other 3 macroeconomic objectives?

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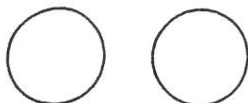


Evaluating Monetary Policy

1. Demand-side policies cannot achieve all objectives at once

By using AD policies alone the Bank of England cannot achieve all its macroeconomic objectives. For example, by raising interest rates to stop inflation rising, they will also reduce real GDP.

Keynesian Evaluation:

The impact of any AD shift will of course depend on the **elasticity of AS**:

e.g. When AD is near full employment (AS is inelastic) the impact of rising AD will be mainly a rising price level rather than increases in real output

The UK is currently operating well below full employment and therefore is more likely to be operating where AS is elastic. Therefore impacts of the MPC's decisions are more likely to be on growth rather than inflation.

2. There are time lags in Monetary Policy

There is generally a time lag in the use of **18-24 months** for the full impact of interest changes to totally filter through into the real economy. This is because investment, consumption and export decisions will not be altered instantly. For example, consumers & businesses will not instantly spend & invest in the economy and even if they did there will be time to organise loans if external finance is required. Furthermore, exporters and importers may be stuck in contracts short-term or take time to switch.

However, there can be a **smaller time lag with monetary policy than fiscal policy** as with fiscal policy will also suffer this time lag but can only be set annually; monetary policy can be set monthly.

3. Inadequacy of the model, data and knowledge

Like any policy decision, the MPC makes are often based on projections, forecasts and economic models (specifically its forecasts of GDP and inflation). This may lead to the wrong policy being pursued if:

- **The data used to make the decision is wrong**
- **The economic model is not accurate**
- **Policy makers do not have enough knowledge to successfully implement / interpret the suggestions from the economic model.**

For example, the inflation forecast may be indicating that in two years time inflation will be 0.5% and therefore there may be a need to cut interest rates. However, if the inflation forecast was wrong (due to the data or model being wrong) and instead the inflation forecast should have been 2% then the wrong policy decision will have been made and extra inflation added to the economy.

4. Longer-term Issues & Magnitude Issues

Furthermore, if the MPC decided to try and control inflation by **increasing interest rates** there will be some side-effects in the long-term too such as the impact on AS (via lower investment) and further falls in AD (via negative multiplier effects).

This will make it very difficult for the Bank of England to judge how much they need to change interest rate to meet their inflation target in the medium term.

5. Will interest rates be effective?

There are several reasons why interest rates may have had little effect during the credit crunch or during the current economic climate, such as:

a) Banks may not pass on the interest rate cuts as they are repairing their balance sheets: a lower base rate from the Bank of the England usually means lower interest rates on the high street. This is because high street banks lend from the Bank of England at the base rate. If the base rate is lower then the costs for high street banks is reduced and they can then pass on the rate cut. However, during the credit crunch banks did not pass on rate cuts to consumers and businesses as they wanted to keep interest rates higher (a higher price) to help repair their balance sheets. Therefore consumers and businesses would not benefit from lower interest rates.

b) Banks may not lend money even if the base rate is cut so firms and consumers may not be able to increase spending and investment. Again, banks may not be lending as much as they may not have the finance to lend out (due to low savings and low inter-bank lending) or want to increase their capital to reduce the risk of their banks failing (as some did during the credit crunch).

c) There is a limit to how far interest rates can be cut: as interest rates are already at 0.5% and cannot fall below zero. This is why central banks have decided in effect to print money (Quantitative Easing) as a way of expanding monetary policy further.

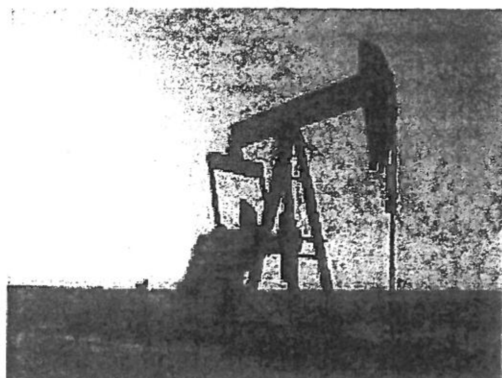
d) Will consumers spend and businesses invest if consumer and business confidence is low? If consumer and business confidence is low due to poor economic growth in the UK, worries over future profits for companies and possible job security issues for consumers they may not spend and invest even if interest rates are low.

e) Weaker world economic growth could stop net exports rising. If the interest rate caused the exchange rate to fall then the hope would be that net exports would rise. However, if major export markets for the UK go into recession / experience slow economic growth then consumers in those countries may not be able or willing to buy British goods even if the price is lower.

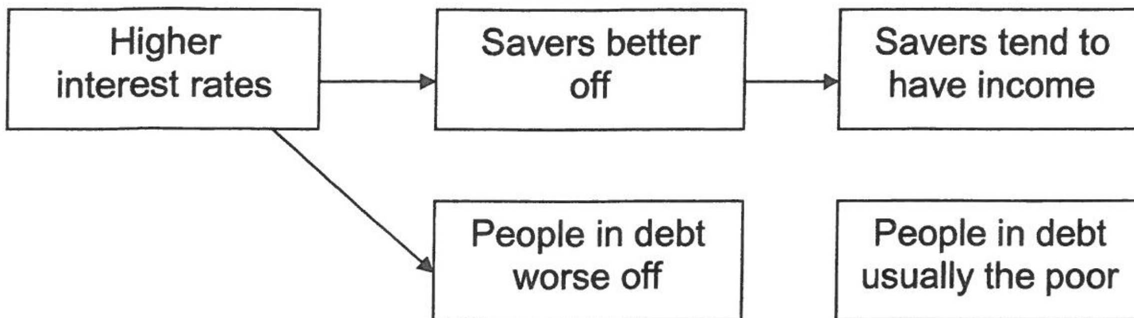
6. Side-effects of Monetary Policy

If the MPC decided to try and control inflation by **increasing interest rates** there will be some side-effects:

a) Imported inflation: if the exchange rate appreciates this will help reduce AD further as (X – M) will fall but there will be **imported inflation** as the price of imports increases. This will have impacts on UK businesses who import raw materials from abroad via higher costs of production.



b) Inequality impacts: if the interest rate rises then this will benefit savers and hurt borrowers. If we assume that those on higher income will have more money in savings and those on lower income have a greater need to borrow then inequality will increase. This is because high earners get more interest on their savings (boosting their income further) and those on low income pay more for their loans / credit (reducing their income further).



However...

- **High income groups are not necessarily high savers** they may spend their income to improve their standard of living

- **High income groups may have to pay mortgage payments** which could represent a higher % of their income

- **Impact of inflation on low income groups:** in the longer term low income groups may benefit from lower inflation and a lower cost of living as interest rates rising will curb inflationary pressure by reducing AD.

- **Time lags:** there may be a time lag associated with interest rates. For example, time lag of interest rates being passed onto consumers, businesses and mortgage owners.

- **Would fiscal policy be better?** If fiscal policy was used to reduce AD then this could be done in a more progressive way (e.g. taxing high earners whilst preserving spending on state education & benefits). Although these have negative long-term implications.

Monetary Policy MCQs

(1)

Inflation in an economy is currently at 10%. Which of the following changes in monetary and fiscal policy, A, B, C or D, is most likely to reduce the rate of inflation in the economy?

	Interest rates	Government expenditure	Taxation revenue
A	Increase	Increase	Decrease
B	Decrease	Decrease	Increase
C	Increase	Decrease	Increase
D	Decrease	Increase	Increase

(2)

An expansionary monetary policy designed to increase aggregate demand is less likely to achieve this objective if, at the same time, the government

A increases spending on defence.

B cuts the basic rate of income tax.

C increases unemployment benefits.

D reduces the budget deficit.

(3)

Which one of the following statements relating to monetary policy is correct?

A A cut in interest rates always increases inflation.

B While reducing excess demand, an interest rate rise may increase cost-push inflation.

C Interest rate changes have no effect on aggregate supply.

D An increase in interest rates will raise the level of investment.

(4)

Which one of the following is a correct statement about monetary policy in the UK?

A Monetary policy is used mainly to affect the supply side of the economy.

B Whenever the government uses contractionary fiscal policy, the Bank of England will use expansionary monetary policy to offset the effects.

C Higher interest rates may reduce inflationary pressure but they may also reduce employment.

D Monetary policy may involve the expansion of the money supply to reduce aggregate demand.

Do **not** answer Context 2 if you have answered Context 1.

Total for this Context: 50 marks

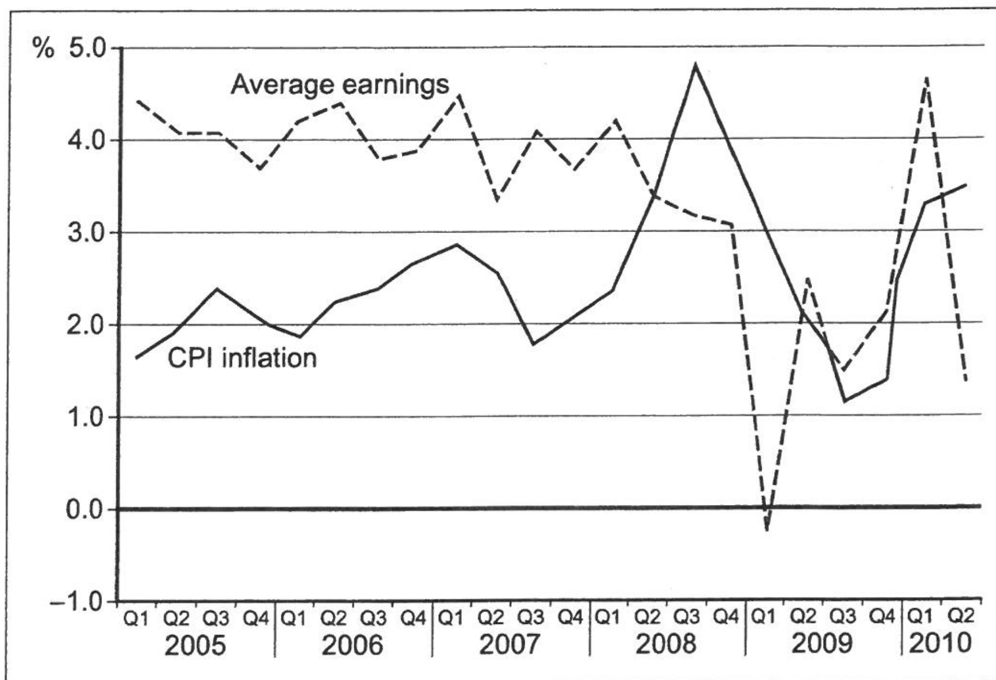
OR

Context 2

INFLATION IN THE UK

Study **Extracts D, E and F**, and then answer **all** parts of Context 2 which follow.

Extract D: CPI inflation and the rate of growth in average earnings in the UK, 2005 to 2010, quarterly



Source: official statistics, January 2011

Extract E: Inflation has been above target throughout 2010

The Bank of England's forecasts for inflation have been over-optimistic for some time now. Inflation has increased partly as a result of the fall in the value of the pound, rapidly rising commodity prices and increases in Value Added Tax (VAT). The pound has fallen by more than 20% against other currencies since the beginning of 2008, pushing up the price of imports. On top of this, the restoration of VAT to 17.5% in January 2010 increased CPI inflation by about 1%.

The further increase in VAT to 20% in January 2011 put more upward pressure on inflation. Without the effect of increases in indirect taxes, such as VAT and excise duties on petrol, inflation would have been around 1.5% over the previous 6 months. Instead, inflation has exceeded the Government's 2% target and has been over 3% for most of 2010. Inflation will continue to rise over the next few months but the Bank still believes that it will return to target in 2012.

Source: news reports, January 2011

Extract F: Will rising commodity prices fuel inflationary expectations?

Food prices, fuel bills, clothing and other costs are rocketing. Figures released yesterday by the United Nations (UN) *Food and Agriculture Organisation* show that global food prices rose to a record high last month. Many other raw materials and agricultural commodities are close to, or above, their previous peaks. The price of oil, although still well below the $140 a barrel level it reached in the summer of 2008, is once more approaching $100 a barrel. This rise in world commodity prices will ensure that inflation in the UK remains high throughout 2011. Many economists believe that this type of cost-push inflation is difficult to control through the use of interest rates.

The real danger is that inflationary expectations will increase and change people's behaviour. With rising inflation, people will be expecting higher pay. However, pay increases will be hard to obtain in the face of rising unemployment and public sector pay freezes. If wages do start to rise, firms will want to pass on the increase in costs. However, this will not be easy when household disposable income is being constrained by tax rises and benefit cuts.

Contractionary fiscal measures should help to reduce inflation, as might supply-side policies. However, if growth in the economy reduces the amount of spare capacity and unemployment falls, earnings may start to rise rapidly. In these circumstances, the Monetary Policy Committee of the Bank of England will raise Bank Rate to try to reduce inflation. Some think that this will be too late.

Source: news reports, January 2011

0 5 Define the term 'cost-push inflation' (**Extract F**, line 8). *(5 marks)* 3

0 6 Using **Extract D**, identify **two** significant points of comparison between CPI inflation and the rate of growth in average earnings over the period shown. *(8 marks)* 4

0 7 Extract E (line 2) states: 'Inflation has increased partly as a result of the fall in the value of the pound...'.

Using an appropriate diagram, explain why a fall in the exchange rate is likely to increase inflation. *(12 marks)*

0 8 **Extract F** (lines 17–19) states: 'In these circumstances, the Monetary Policy Committee of the Bank of England will raise Bank Rate to try to reduce inflation.'

Using the data and your economic knowledge, assess the view that the use of interest rates is the best way to control inflation in the UK. *(25 marks)*

END OF QUESTIONS

Monetary Policy Notes: