# Monetary Policy

**AS Economics Presentation**

**2005**

# Key Issues

- What is monetary policy?
- How is monetary policy used to control inflation?
- What are the main effects of changes in interest rates?
- Recent trends in UK interest rates
- Independence for the Bank of England

# What is Monetary Policy?

- Monetary policy involves the use of interest rates and other instruments of policy to control
  - The growth of aggregate demand (C+I+G+X-M) relative to the economy's productive potential
  - The demand for and supply of money and credit
  - To occasionally influence the value of the exchange rate

# What is Monetary Policy?

- Since 1997 monetary policy has been in the hands of the Bank of England
- Currently monetary policy concerns changes in short term base interest rates
  - The main objective of monetary policy is price stability
  - Monetary policy seeks to influences aggregate demand – it has little direct impact on LRAS
  - The Government sets the inflation target

# Monetary Policy Committee

- Main objective for the Bank of England:
  - Meet the inflation target: Inflation of 2.0%
  - Monetary policy is designed to be pre-emptive (forward-looking) I.e. raise interest rates before inflation accelerates, or cut interest rates to avoid an inflation under-shoot / economic recession
- The Bank of England Act (1998): “monetary policy should be consistent with government objectives for sustained growth and high employment”
- Changes in official interest rates filter their way through the rest of the UK financial system (e.g. savings rates and mortgage rates)

# Setting Rates – The Economic Assessment

**Demand-side factors**

- Real GDP growth
- Estimate of the output gap
- Consumer spending
- Net Exports (Trade)
- Government spending
- House Prices
- Unemployment
- Consumer borrowing
- Business & Consumer Confidence

**Supply-side factors**

- Wages and earnings
- Labour Shortages
- Import prices
- Commodity prices (e.g. oil)

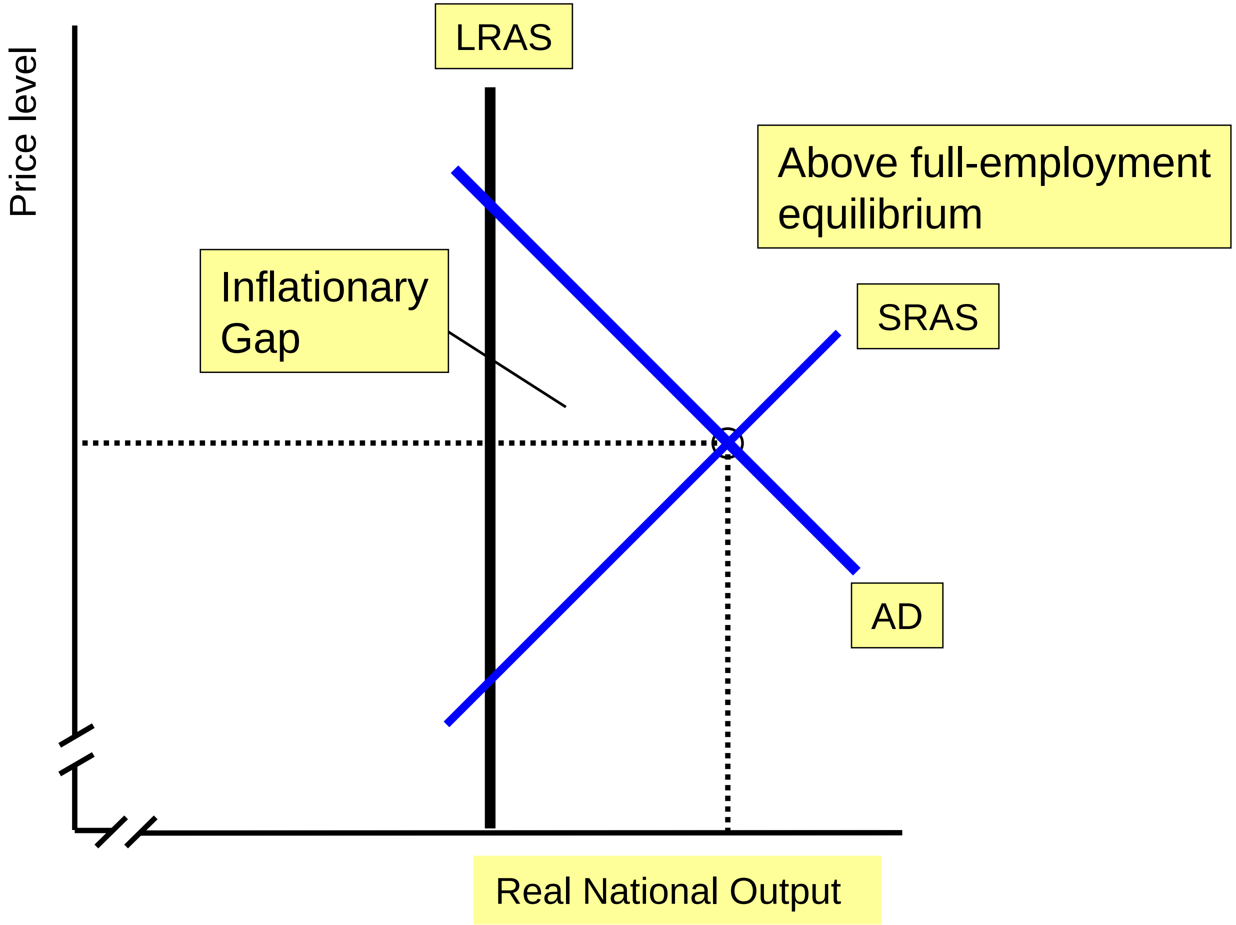
- **International Factors**
- Sterling Exchange Rate
- Global Inflation Trends

# The Monetary Policy Committee

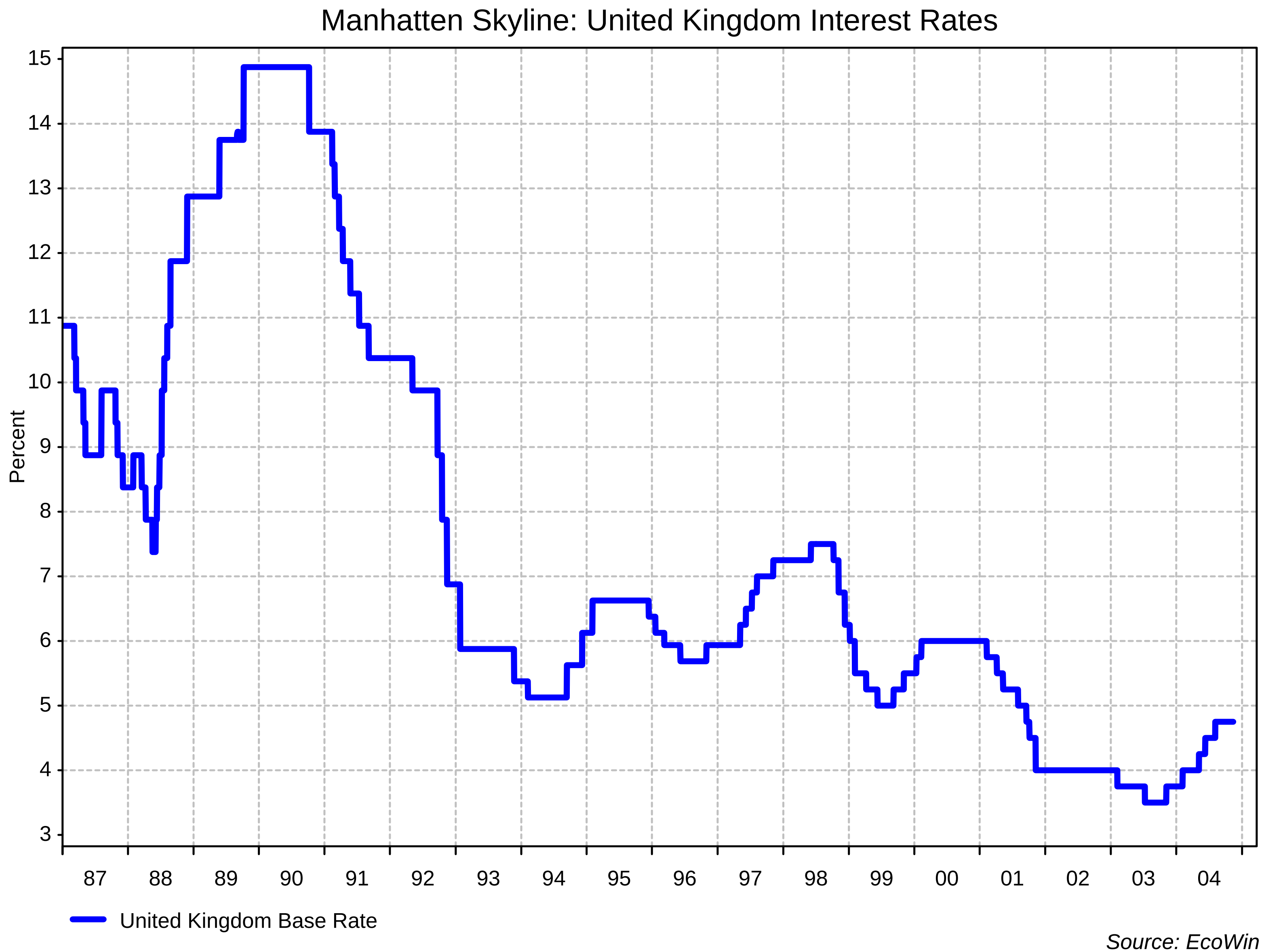
# MPC Meetings

- The MPC considers the macro-economic background
- They assess a broad range of economic indicators
  - Is aggregate demand too strong?
  - Are there inflation signals from the labour market?
  - Is there a risk of inflation from import prices?
  - How will exchange rate changes affect costs and prices

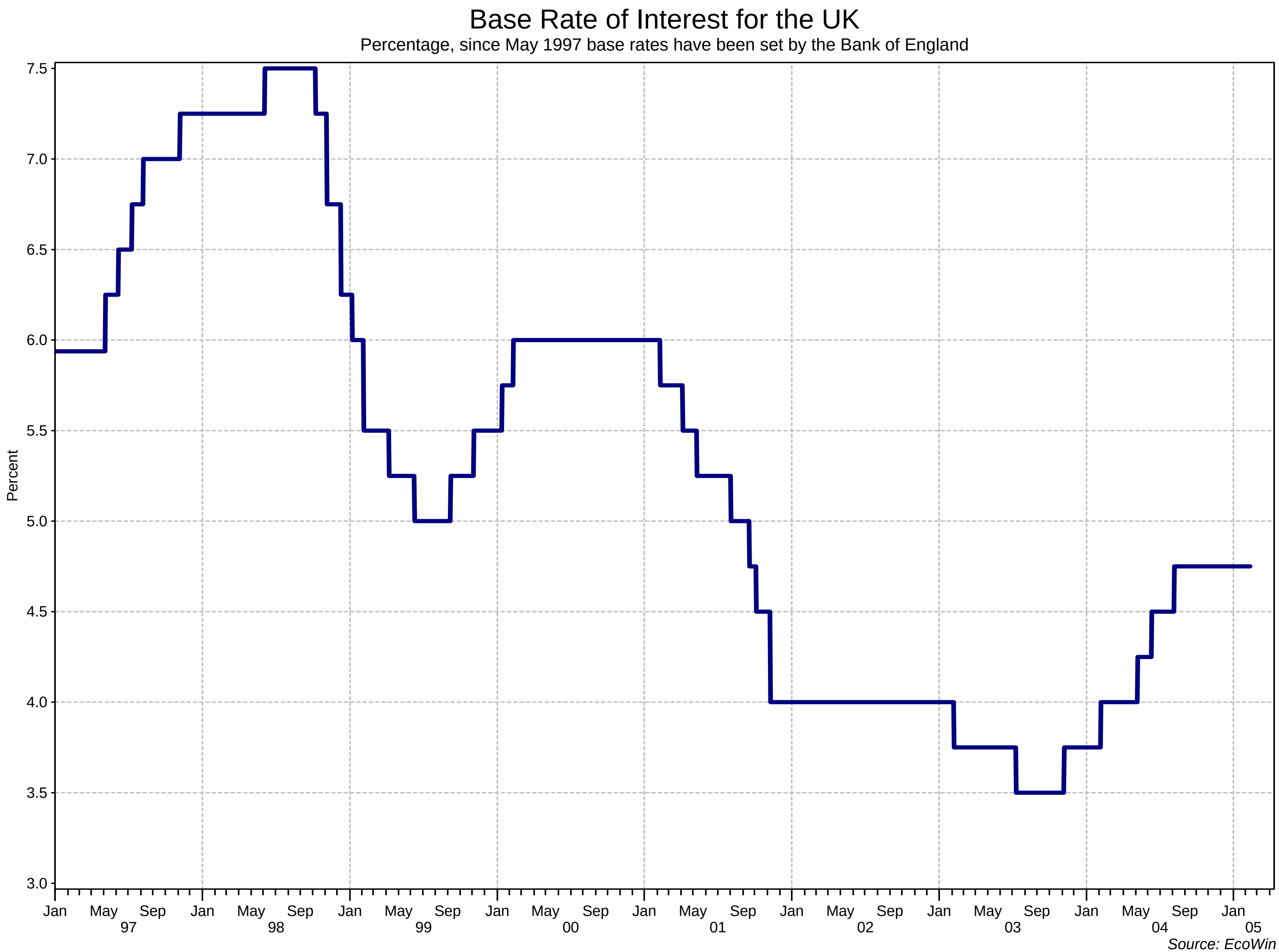
# An Inflationary Gap



# Base Interest Rates – The Long Run Picture



# Interest rates since 1997



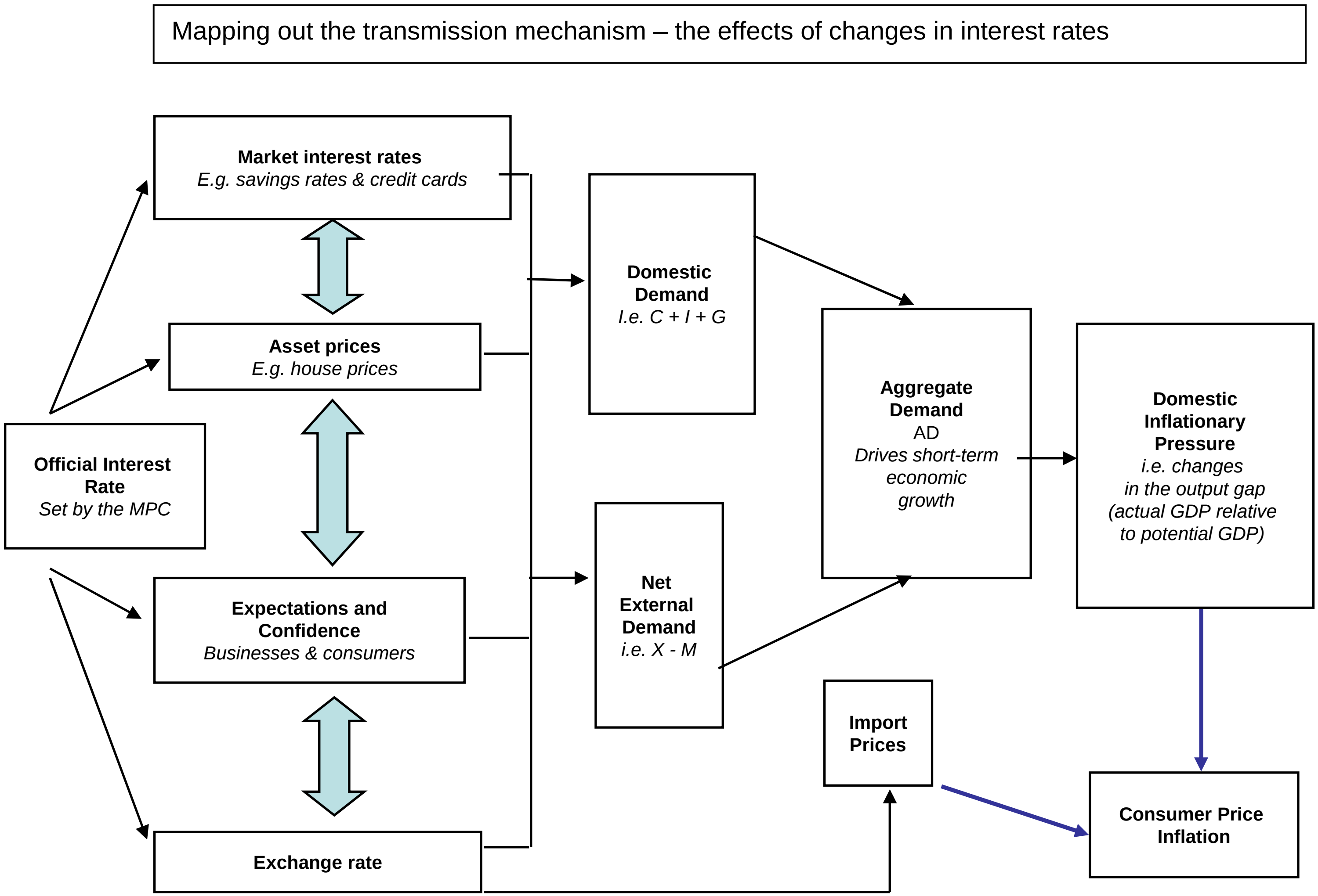
# The Interest Rate Debate during 2004

- The case for higher interest rates in 2004
  - Needed to curb growth of consumer borrowing and debt
  - Strong housing market
  - Fiscal policy is expansionary (e.g. rising government spending on health and education)
  - The global economy is picking up strongly – e.g. in the USA. This will help UK exporters and manufacturers
  - International commodity prices are rising quite quickly (in part because of the “China effect”)

# The Interest Rate Debate during 2004

- The case for keeping rates at a low level
  - Consumer and business confidence fragile
  - Because of the high level of debt, a series of rate increases will lead expose people to this borrowing
  - The housing market should eventually slow down itself without the need for higher interest rates
  - Manufacturing is only just coming out of recession
  - The economy is still operating below capacity (AD < LRAS) so there is no major inflationary threat
  - The Bank should allow the economy to grow and not be too worried by the slim threat of rising inflation

# How Monetary Policy affects AD



# Channels of Monetary Policy

**INTEREST RATE CHANNEL**

Expansionary Monetary Policy → Lower Interest Rates → Stimulate Investment Spending → Increase in Economic Activity

**BANK LENDING CHANNEL**

Expansionary Monetary Policy → Increase in Bank Loans → Stimulate Consumer Spending → Increase in Economic Activity

**EXCHANGE RATE CHANNEL**

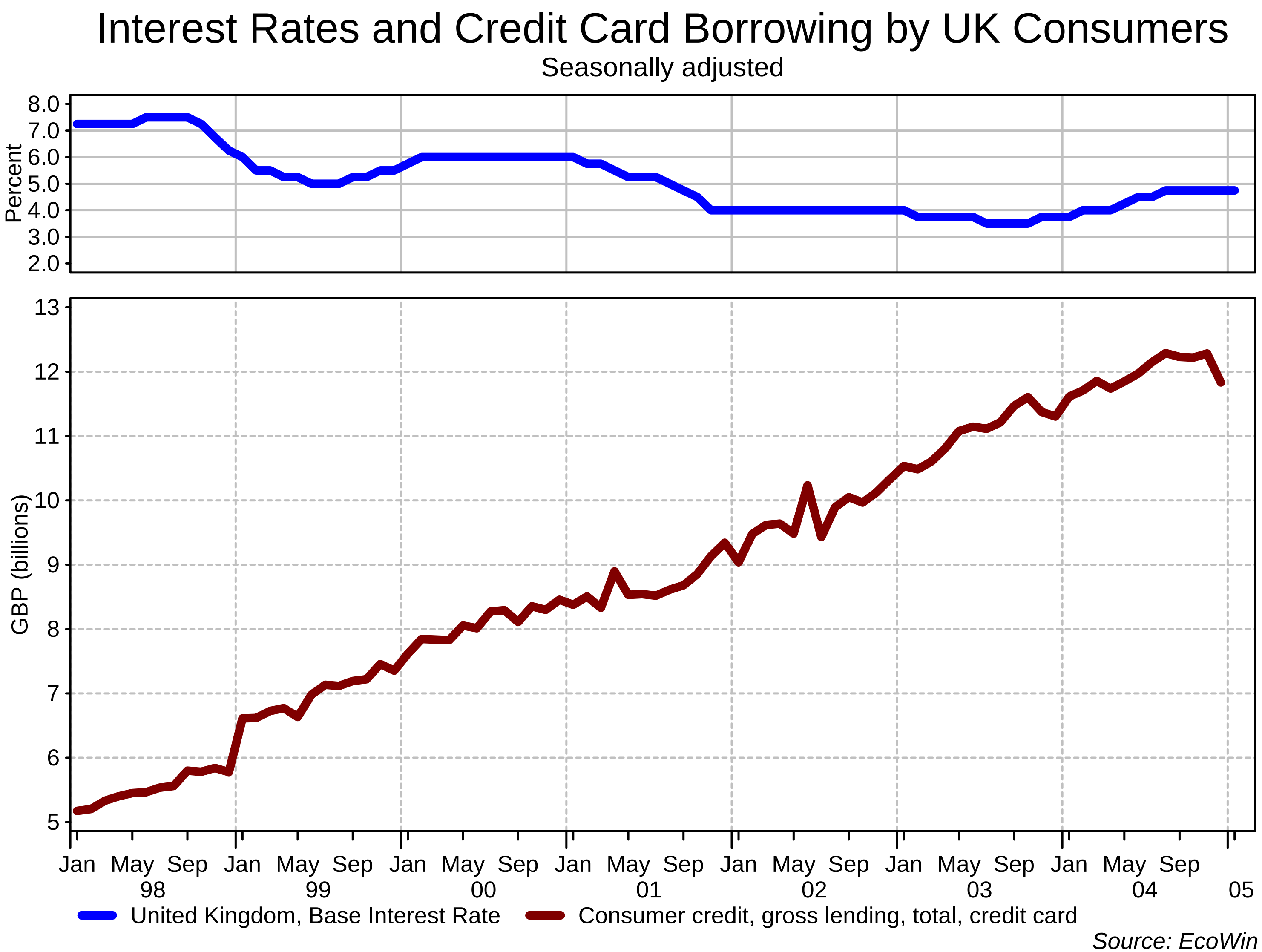
Expansionary Monetary Policy → Exchange Rate Depreciation → Stimulate Net Exports → Increase in Economic Activity

**WEALTH EFFECT CHANNEL**

Expansionary Monetary Policy → Rise in Equity Prices → Rise in Value of Financial Wealth → Increase in Economic Activity

Expansionary Monetary Policy → Rise in Land and House Prices → Rise in Value of Financial Wealth → Increase in Economic Activity

# Interest rates and consumer borrowing



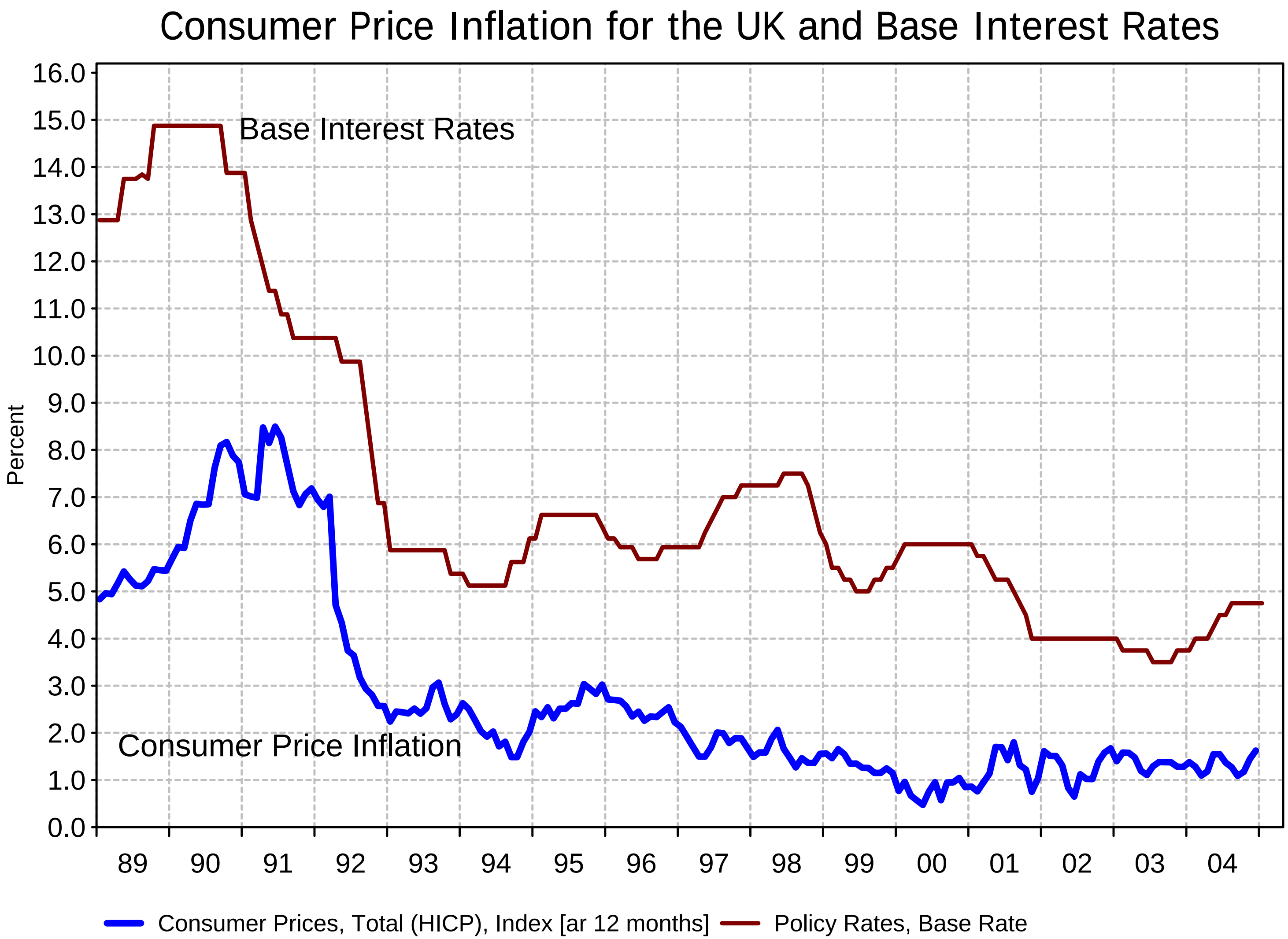
# Limits to the Impact of Rate Changes

- Some factors may dampen the impact of rate changes:
  - (1) Mortgage interest rates do not always follow base rate changes
  - (2) Many home-owners are on fixed rate mortgages
  - (3) People in rented property see no direct effects from changes
  - (4) Credit-card lenders may not change rates immediately

# Limits to the Impact of Rate Changes

- (5) If businesses are operating with spare capacity, a fall in rates will not necessarily lead to higher planned capital investment
- (6) Many sources of funding for capital spending (e.g. loans and debentures) are at fixed rates of interest
- (7) Lower interest rates causes a fall in the effective disposable income of millions of people with net savings

# Interest Rates and Inflation




*Source: EcoWin*

# Revision: Monetary and Fiscal Policy

**Monetary Policy**

- The main instruments of monetary policy are
- (i) Interest rates
- (ii) Changes in the exchange rate
- (iii) Changes in the supply of credit

**Fiscal Policy**

- The main instruments of fiscal policy are
- (i) Government spending
- (ii) Direct taxation
- (iii) Indirect taxation
- (iv) Government borrowing