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
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

- **LRAS**: Long-Run Aggregate Supply
- **SRAS**: Short-Run Aggregate Supply
- **AD**: Aggregate Demand
- **Price level**: Vertical axis
- **Real National Output**: Horizontal axis

**Inflationary Gap**

- Above full-employment equilibrium
Interest rates since 1997

Base Rate of Interest for the UK
Percentage, since May 1997 base rates have been set by the Bank of England

Source: EcoWin
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”)

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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

Mapping out the transmission mechanism – the effects of changes in interest rates

- **Market interest rates**
  - *E.g. savings rates & credit cards*

- **Asset prices**
  - *E.g. house prices*

- **Official Interest Rate**
  - *Set by the MPC*

- **Expectations and Confidence**
  - *Businesses & consumers*

- **Exchange rate**

- **Domestic Demand**
  - *I.e. C + I + G*

- **Aggregate Demand**
  - **AD**
  - Drives short-term economic growth

- **Domestic Inflationary Pressure**
  - *I.e. changes in the output gap (actual GDP relative to potential GDP)*

- **Net External Demand**
  - *I.e. X - M*

- **Import Prices**

- **Consumer Price Inflation**
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 Land and House Prices
- Rise in Value of Financial Wealth
- Increase in Economic Activity
Interest rates and consumer borrowing

Interest Rates and Credit Card Borrowing by UK Consumers
Seasonally adjusted

Source: EcoWin
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
(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

Consumer Price Inflation for the UK and Base Interest Rates

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