

# AS Macro: Monetary Policy

Revision webcast aspects of monetary policy in the UK economy

# Interest Rates

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- There are many different interest rates in an economy
- 1/ Interest rates on savings in bank and other accounts
- 2/ Borrowing interest rates
  - Mortgage interest rates (housing loans)
  - Credit card interest rates and pay-day loans
  - Interest rates on government and corporate bonds
- The Bank of England uses **policy interest rates** to help regulate the economy and meet **macro objectives**

# What are the key objectives of macroeconomic policy?



Price Stability – i.e. Low Positive Inflation (CPI Inflation of 2%)



A Sustainable Growth of Real GDP (National Output)



Falling Unemployment / Rising Employment Rate



Higher Average Living Standards (national income per capita)



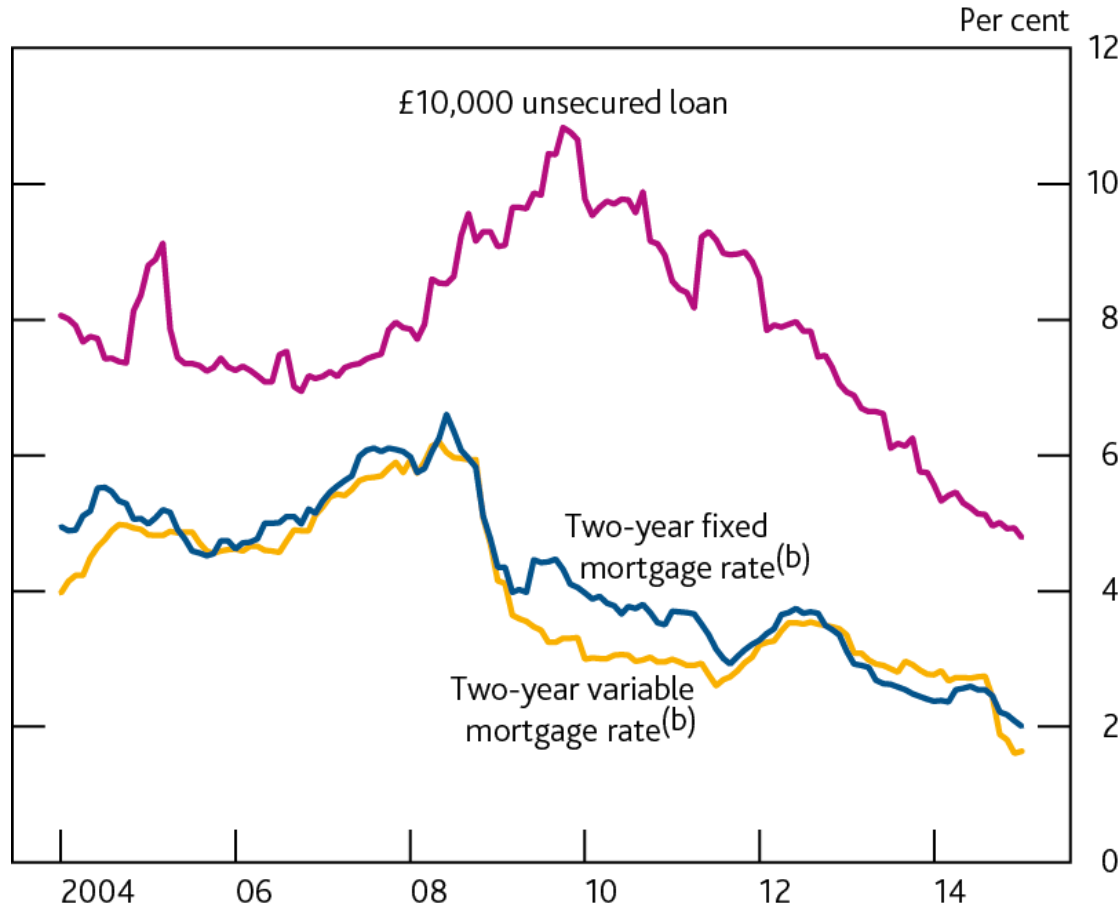
Improved Global Competitiveness / Trade Balance (BoP)



A More Equitable Distribution of Income and Wealth

# Interest Rates on Loans

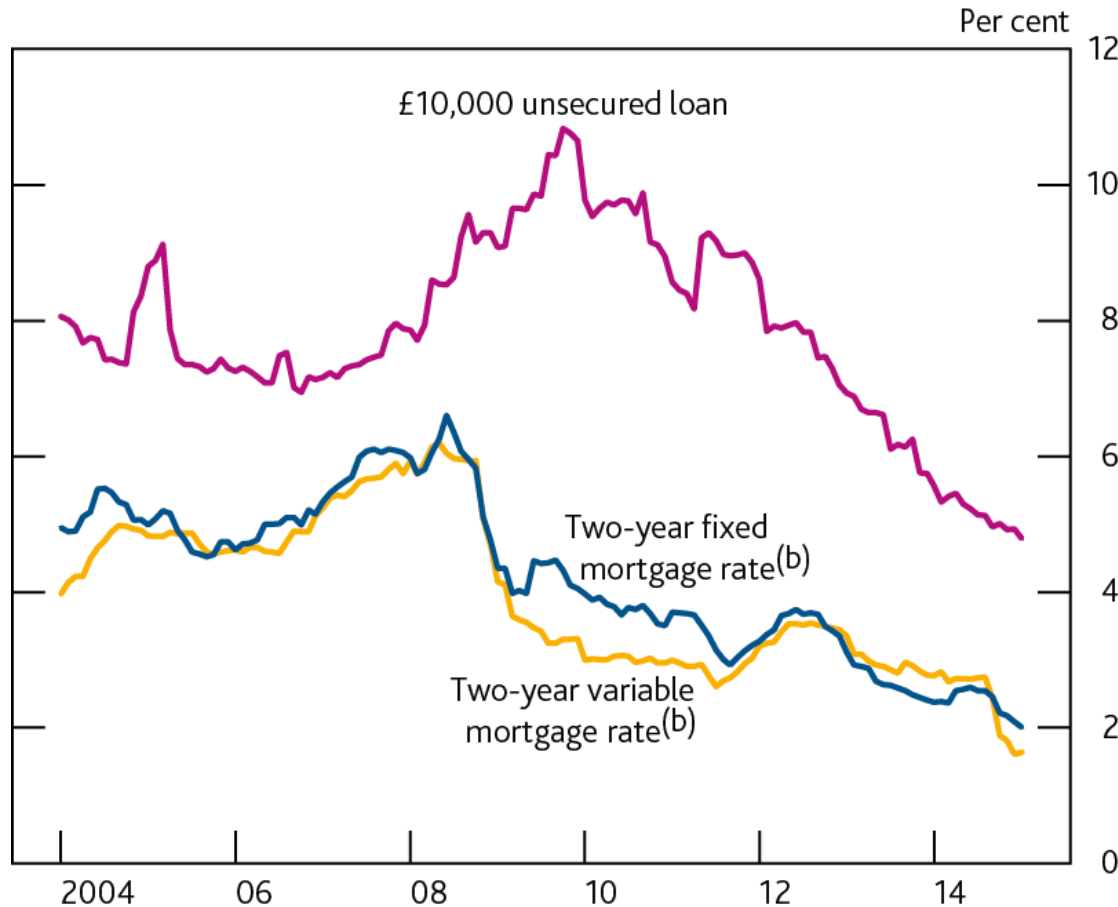
There are many different interest rates in a modern economy



- Bank loans
- Mortgages
- Credit card rates
- Payday loans
- Corporate bonds
- Government bonds

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## Exam Awareness

- Base interest rate **0.5%**
- Two year fixed rate mortgage **2%**
- £10k unsecured loan **5%**

## Negative and Real Interest Rates

- The **real rate of interest** is important to businesses and consumers when making spending and saving decisions
- The **real rate of return on savings** is the money rate of interest minus the rate of inflation.
- So if a saver is receiving a money rate of interest of **6%** but price inflation is running at **3%** per year, the real rate of return on these savings is only **+ 3%**.
- **Real interest rates become negative** when the nominal rate of interest is less than inflation
- For example if inflation is **5%** and nominal interest rates are **4%**, the real cost of borrowing money is negative at **-1%**.
- **Price deflation** can lead to an **increase in real interest rates**

# Key Challenges Facing the Bank of England



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Maintaining  
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i.e. a low,  
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**0% inflation now**



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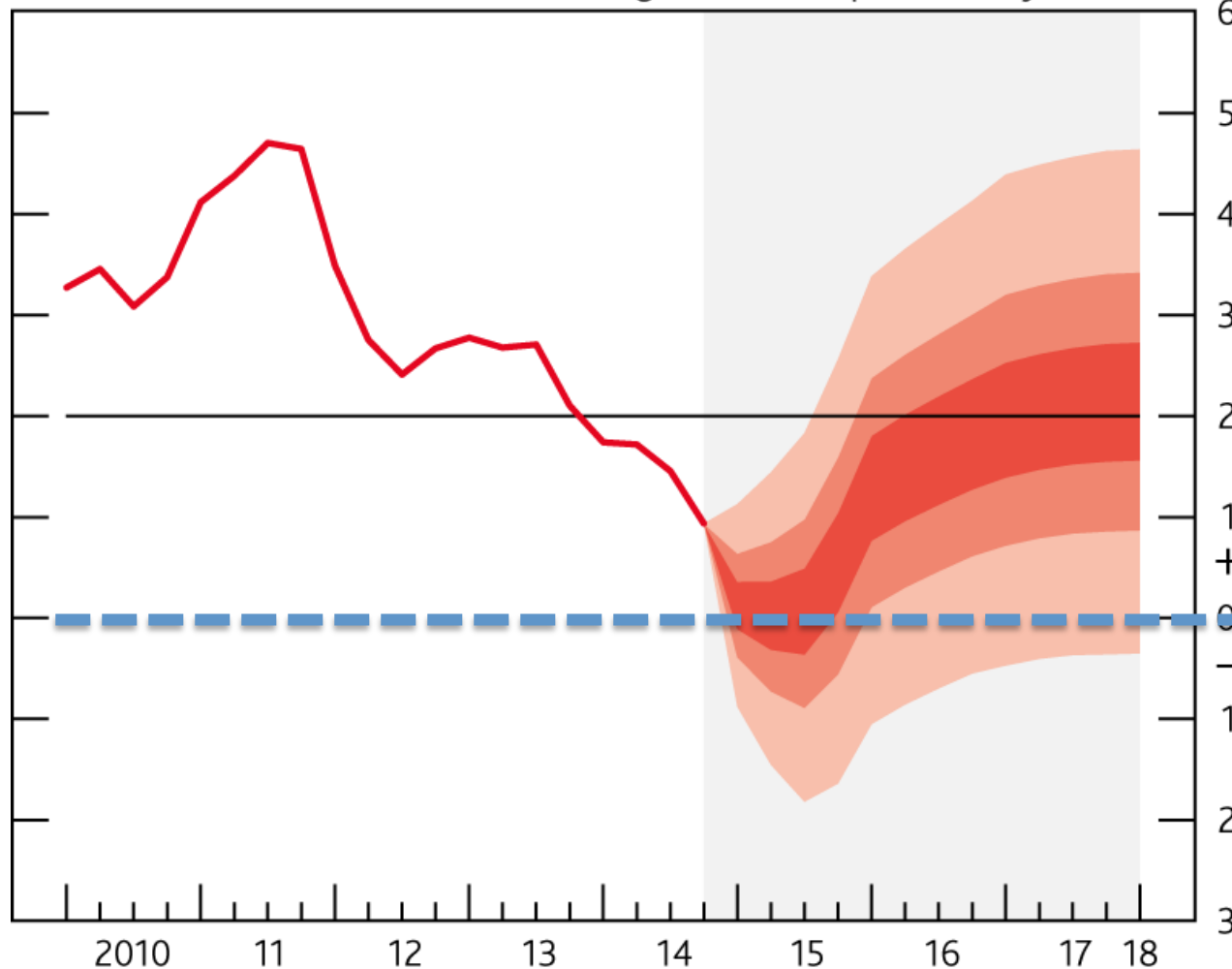
**Financial  
stability** –  
building a  
more secure,  
banking  
system for the  
future



# The Bank of England's Inflation Target

BoE sets **policy interest rates** consistent with the need to meet a **target** of consumer price inflation of 2%

Percentage increase in prices on a year earlier

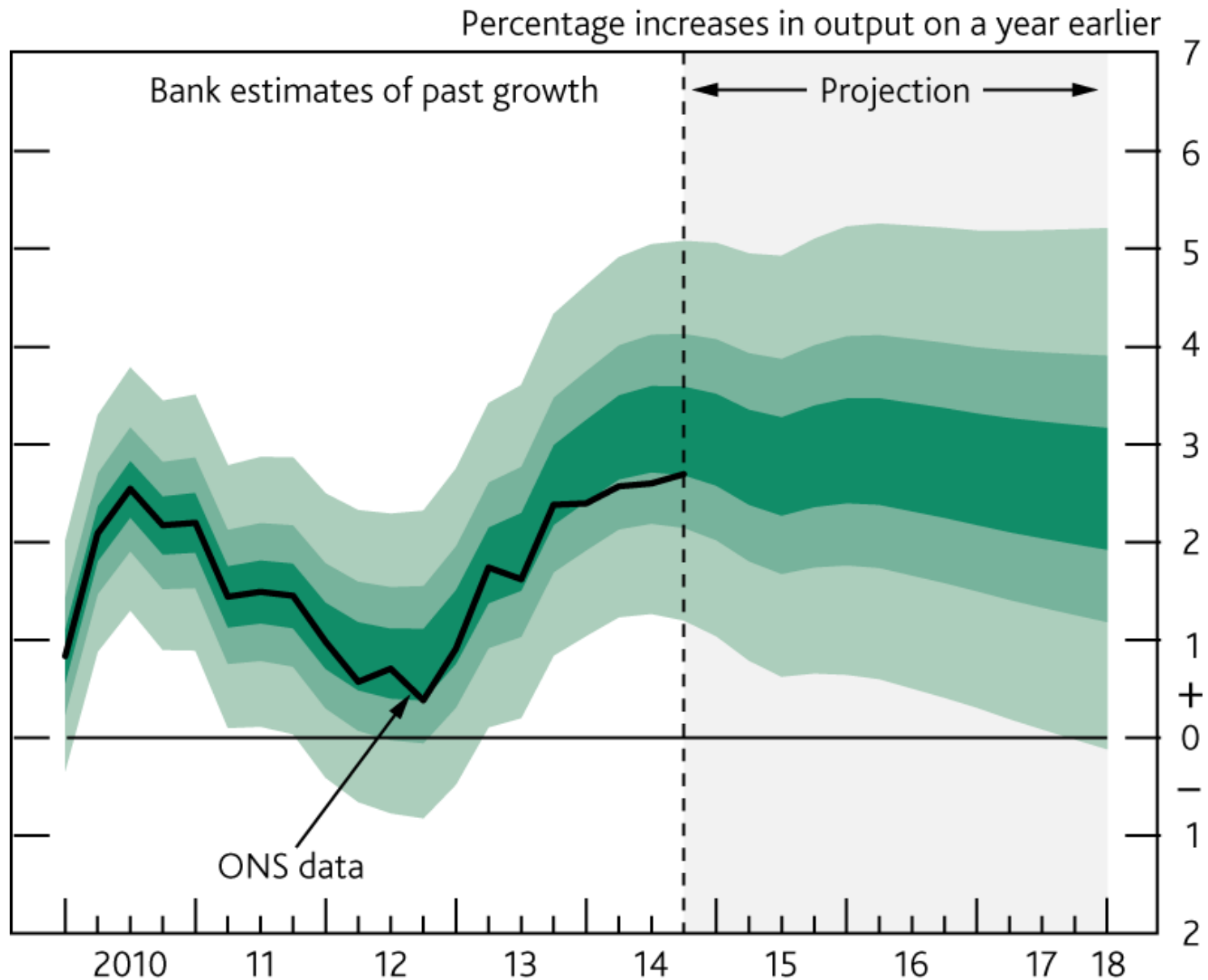


# Factors Considered When Setting Policy Interest Rates

The BoE sets **policy interest rates** consistent with the need to meet an **inflation target** of consumer price inflation of 2%

1. GDP growth and spare capacity / estimates of output gap
2. Bank lending, consumer credit figures, retail sales
3. Equity markets (e.g. share prices) and house prices
4. Consumer confidence and business confidence
5. Growth of wages, average earnings, labour productivity and unit labour costs, surveys on skilled labour shortages
6. Unemployment and employment data, unfilled vacancies
7. Trends in global foreign exchange markets (i.e. is £ appreciating or depreciation against other currencies)
8. International data – e.g. growth rates of major trading partners such as USA and Euro Area and emerging nations

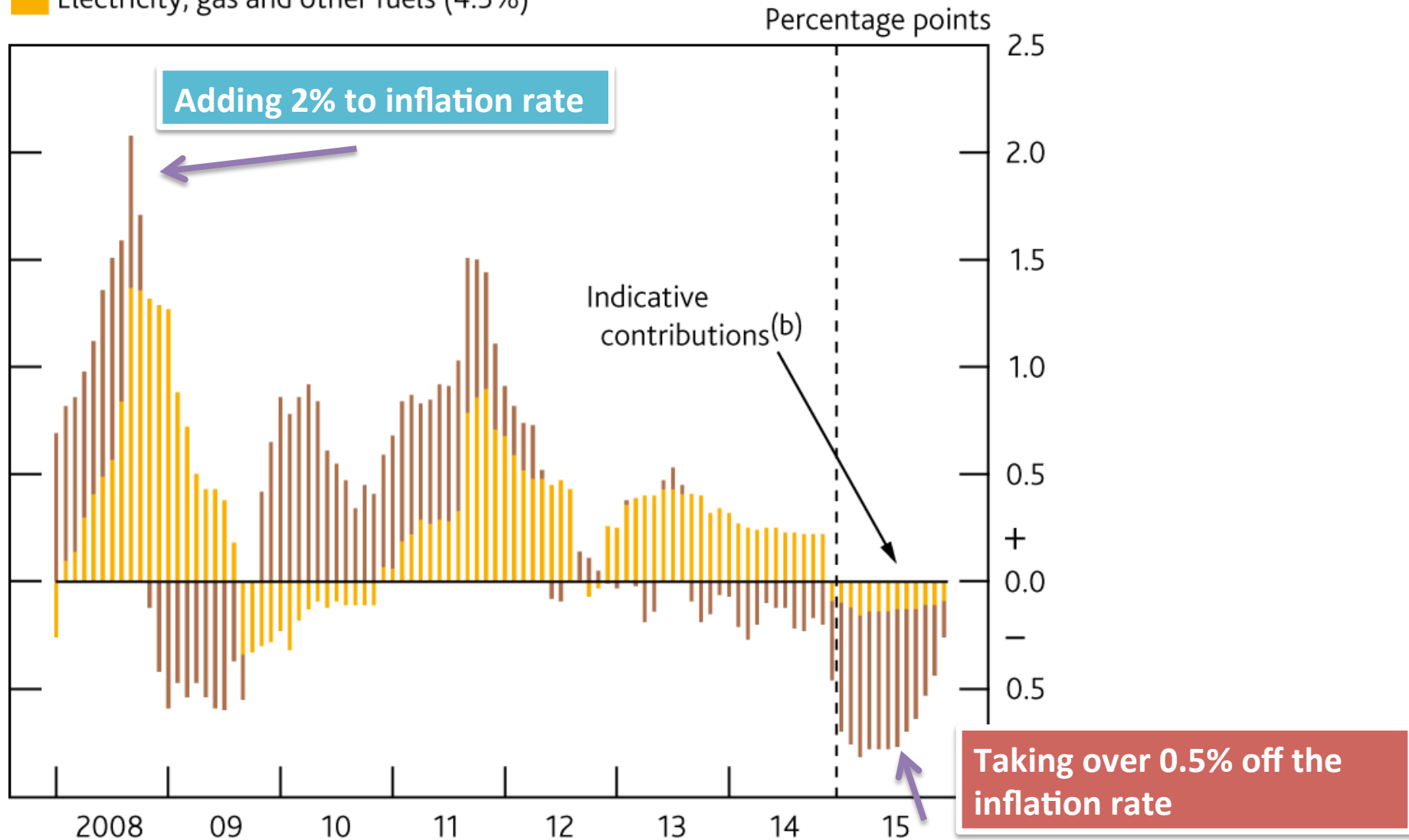
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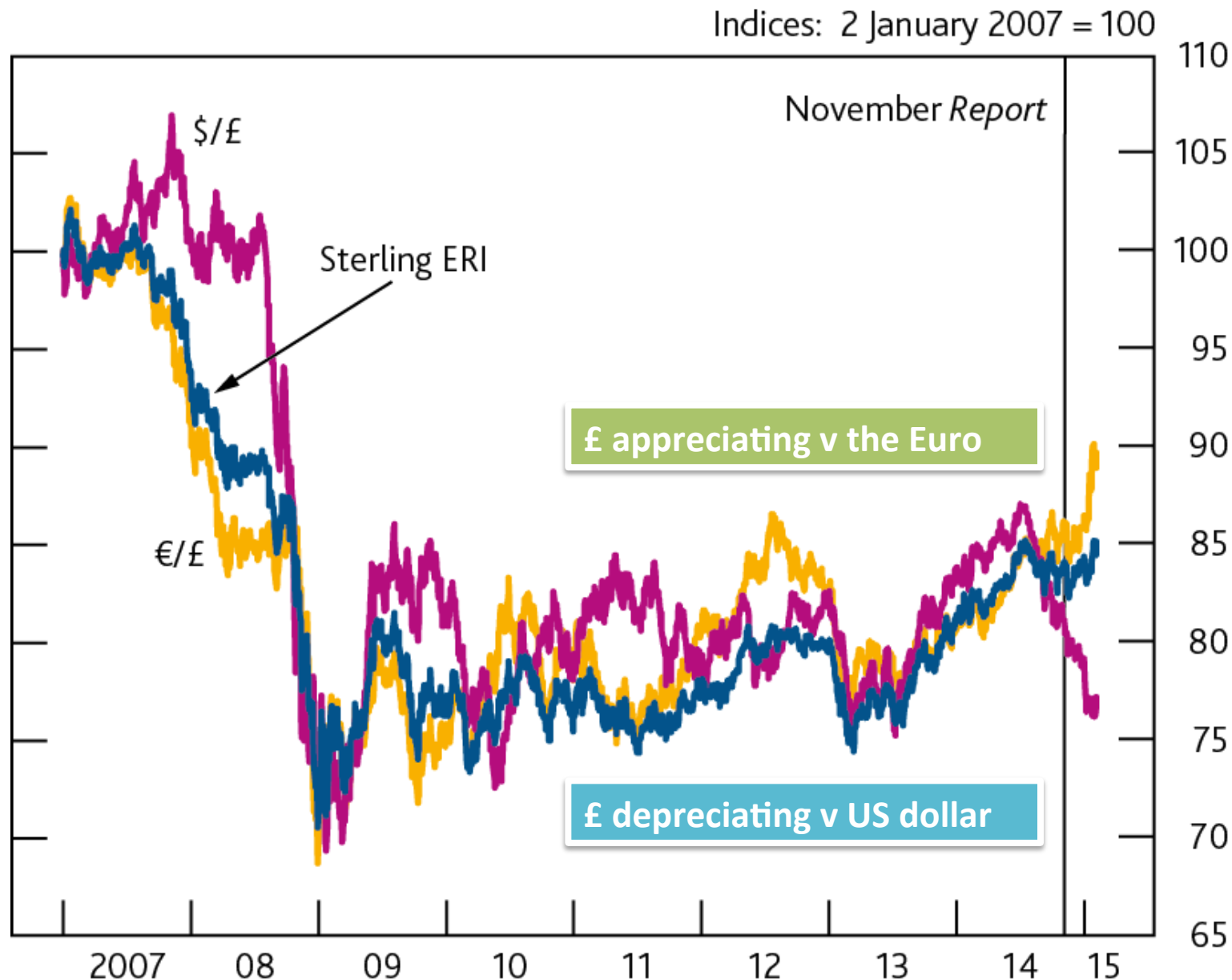
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Fuels and lubricants (3.5%)

Electricity, gas and other fuels (4.5%)

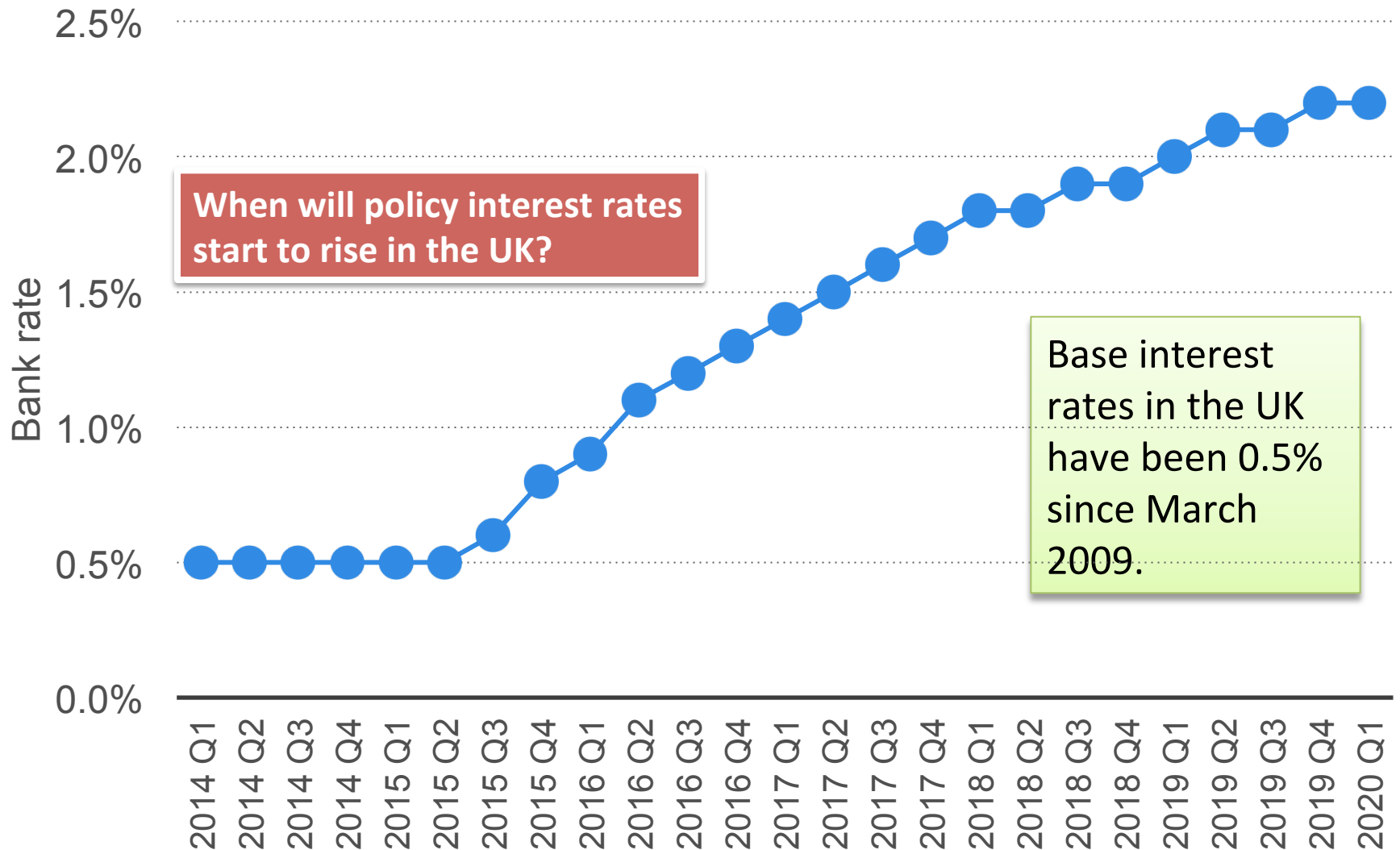


# Factors Considered When Setting Policy Interest Rates



# Policy Interest Rates in the UK Economy

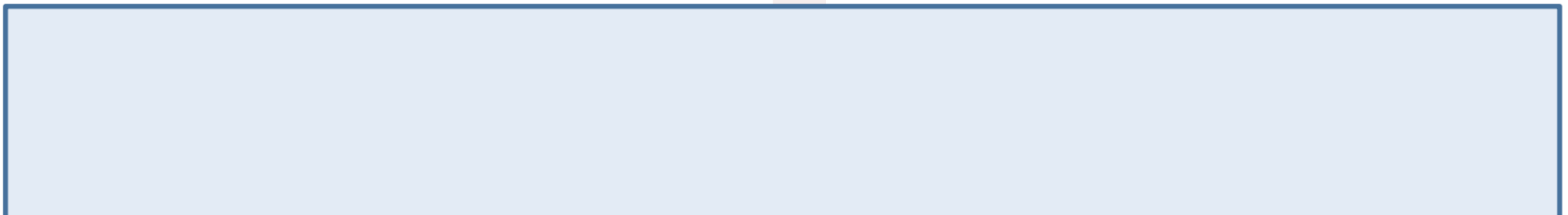
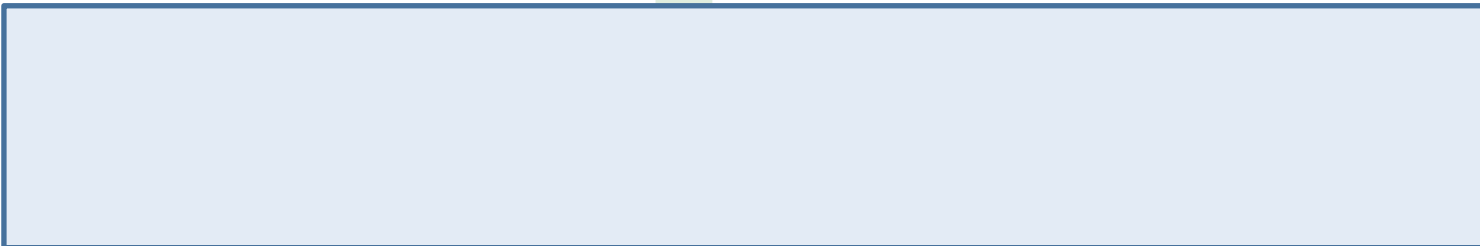
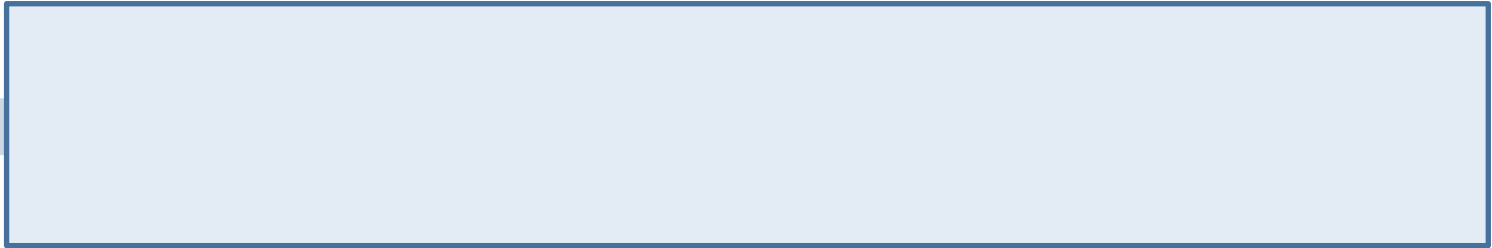
Forecasted Bank Rate in the UK from 1st quarter 2014 to 1st quarter 2020



# Transmission Mechanism of Monetary Policy

## 1 / Change in market interest rates

Normally a change in policy interest rates feeds through to borrowing/saving rates



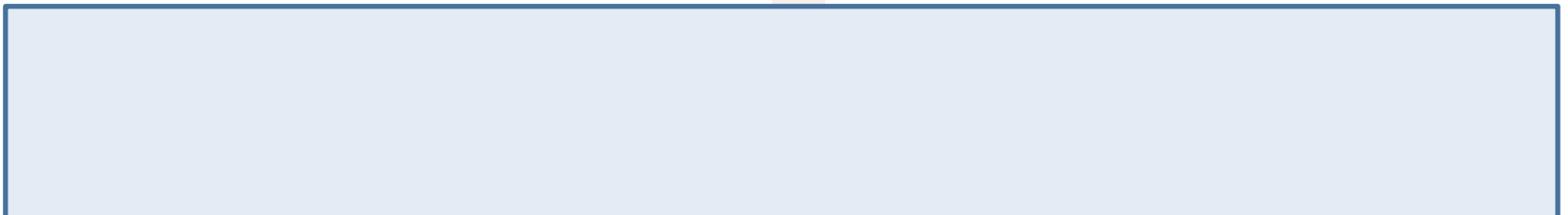
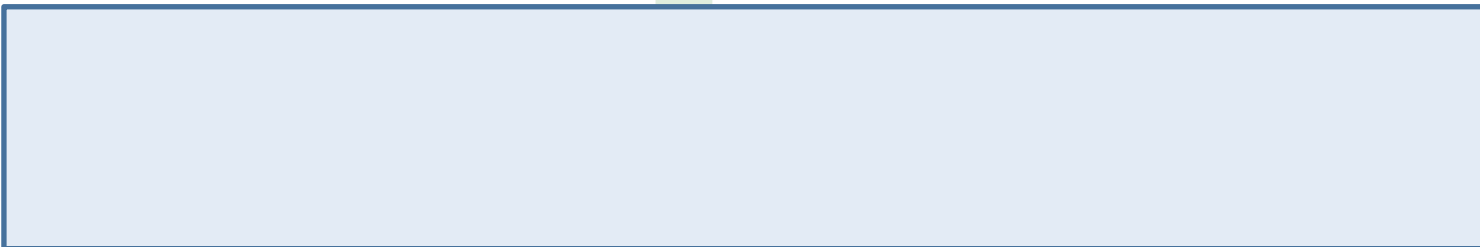
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Effect on spending, saving, investment and exports



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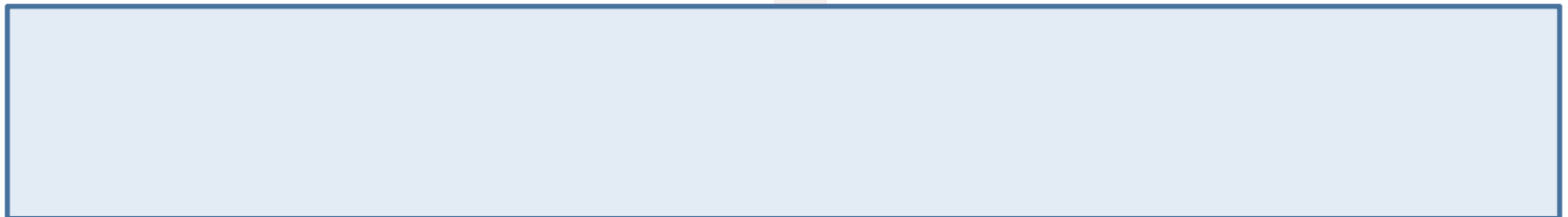
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Is there an expansion of production and employment?

## 3/ Effect on output, jobs & investment



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Rate changes then affect two of the key macro objectives

## 4/ Real GDP and Price Inflation

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## 4/ Real GDP and Price Inflation

It can take between 12-24 months for the **full final effects** on real GDP and the inflation rate after a change in policy interest rates

# When Interest Rates Fall

A reduction in interest rates or an increase in the supply of money and credit is an **expansionary** or **reflationary** monetary policy

1 Cost of servicing loans / debt is reduced – boosting spending power

2 Consumer confidence should increase leading to more spending

3 Effective disposable income rises – lower mortgage costs

4 Business investment should be boosted e.g. Prospect of rising demand

5 Housing market effects – more demand and higher property prices

6 Exchange rate and exports – cheaper currency will increase exports

An **expansionary monetary policy** is designed to boost consumer & business confidence and demand during a downturn / recession

# Limits to the Effects of A Cut in Interest Rates

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```
graph TD; A[Banks have been reluctant / unable to lend to businesses] --- B[Low business and consumer confidence];
```

The diagram consists of two rounded rectangular boxes. The top box is red with white text and contains the text 'Banks have been reluctant / unable to lend to businesses'. A thin red line connects the bottom right corner of this box to the top left corner of the bottom box. The bottom box is green with white text and contains the text 'Low business and consumer confidence'. A thin green line extends from the bottom right corner of the green box downwards.

**Low business and consumer  
confidence**

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```
graph TD; A[Banks have been reluctant / unable to lend to businesses] --> B[Low business and consumer confidence]; B --> C[Low interest rates means falling real incomes for millions of savers];
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A flowchart with three rounded rectangular boxes connected by lines. The top box is red and contains the text 'Banks have been reluctant / unable to lend to businesses'. A red line connects it to a green box below and to the right, which contains 'Low business and consumer confidence'. A green line connects the green box to a purple box below and to the right, which contains 'Low interest rates means falling real incomes for millions of savers'. A purple line extends from the bottom of the purple box without connecting to anything else.

**Low business and consumer  
confidence**

**Low interest rates means  
falling real incomes for  
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# Limits to the Effects of A Cut in Interest Rates

**Banks have been reluctant / unable to lend to businesses**

**Low business and consumer confidence**

**High stock of personal debt means people more concerned with cutting debt**

**Low interest rates means falling real incomes for millions of savers**

Source: Bank of England

# Limits to the Effects of A Cut in Interest Rates

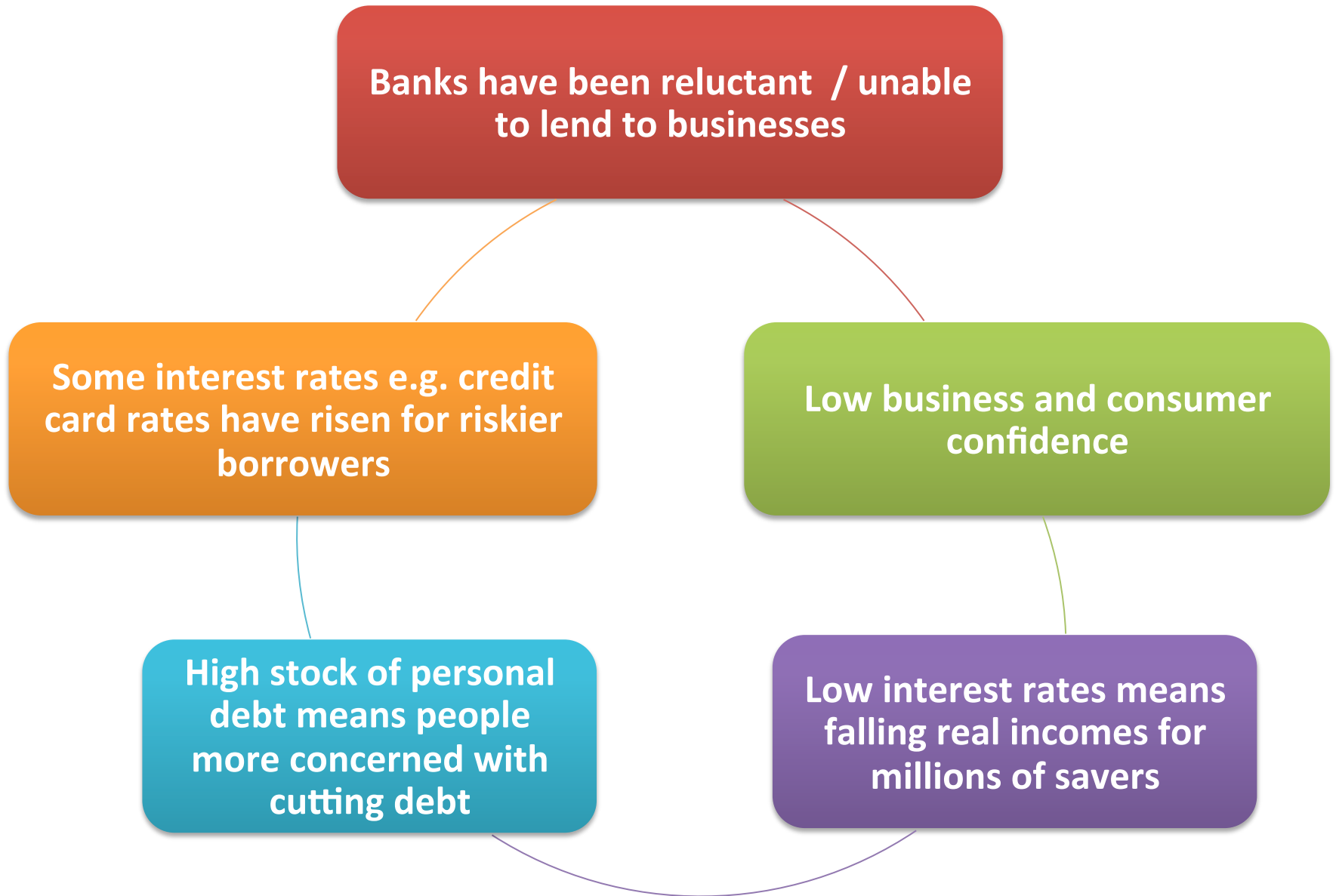
**Banks have been reluctant / unable to lend to businesses**

**Some interest rates e.g. credit card rates have risen for riskier borrowers**

**Low business and consumer confidence**

**High stock of personal debt means people more concerned with cutting debt**

**Low interest rates means falling real incomes for millions of savers**



A signpost with two green rectangular signs with white borders. The top sign says 'QUANTITATIVE' and the bottom sign says 'EASING'. The signpost is a silver pole. The background is a sky with orange, yellow, and blue clouds.

QUANTITATIVE

EASING

## Quantitative Easing (QE)

- In March 2009 the BoE started QE for first time.
- Bank of England uses QE to increase the **supply of money** in the banking system and **encourage banks to lend** at cheaper interest rates – especially lending to small/medium sized businesses
- The Bank of England **does not** print new £10, £20 and £50 notes!
- Instead, it uses money created electronically by the central bank to **buy government bonds**

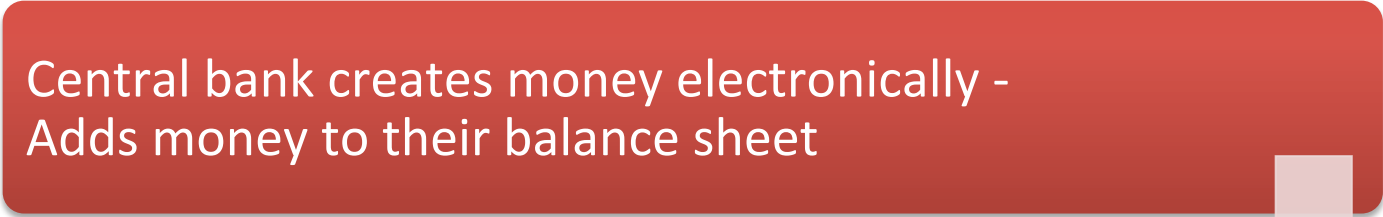
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Central bank creates money electronically -  
Adds money to their balance sheet




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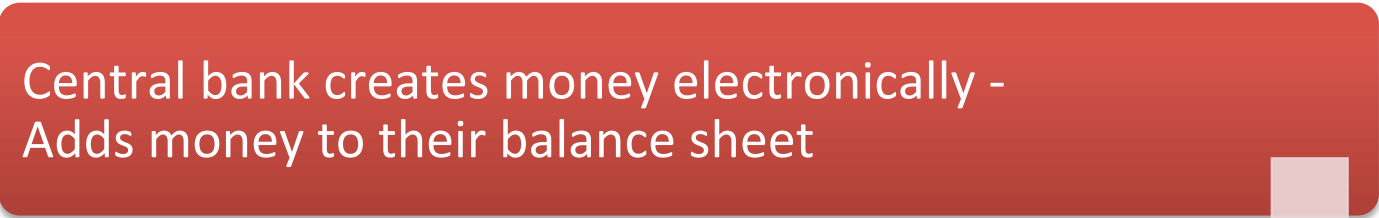
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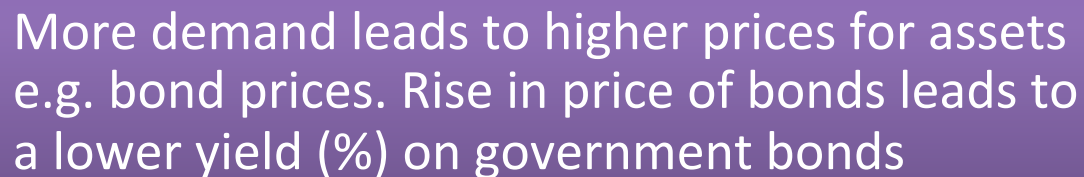
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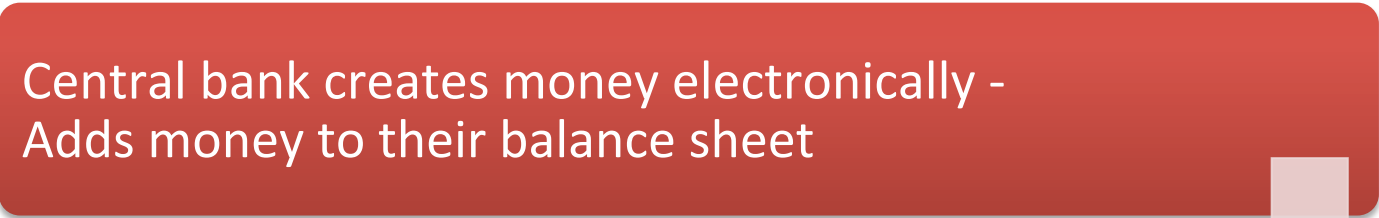


More demand leads to higher prices for assets  
e.g. bond prices. Rise in price of bonds leads to  
a lower yield (%) on government bonds





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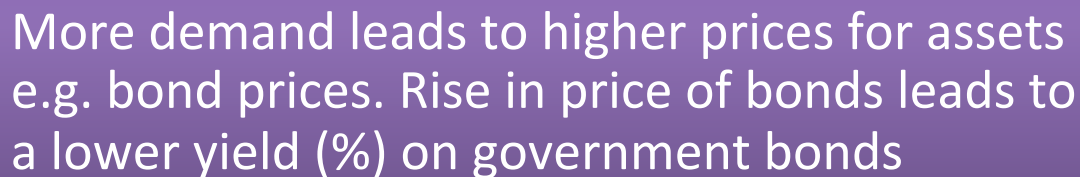
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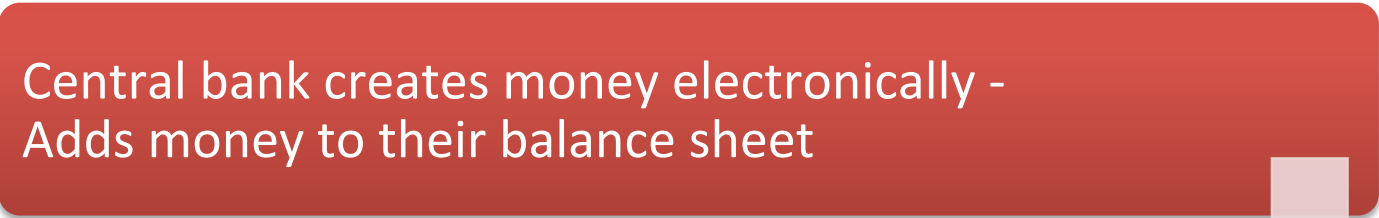


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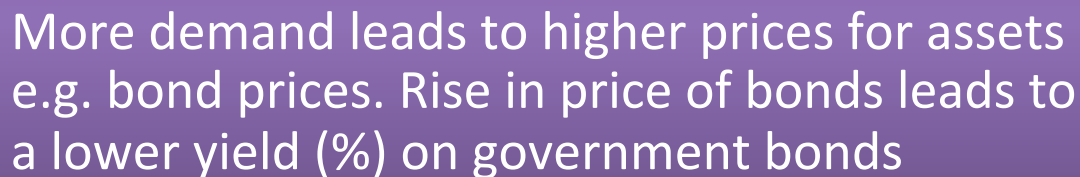
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Lower interest rates and increased cash in the  
banking system should stimulate the economy



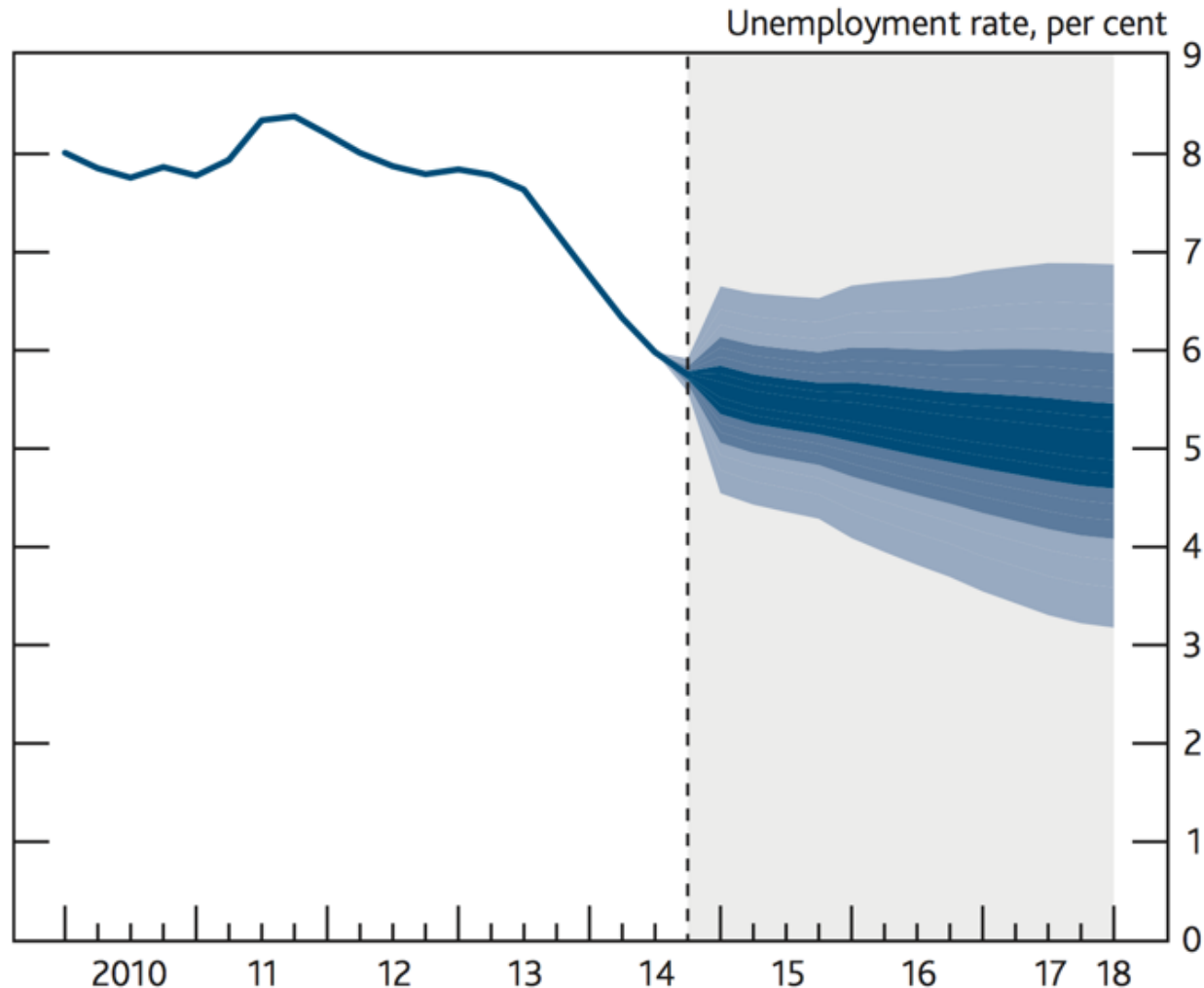
# Forward Guidance when Setting Interest Rates

- Forward Guidance was introduced by Mark Carney in August 2013
- It has been signalled that the Bank of England will leave **their policy interest rates unchanged** as long as the unemployment rate is above 7.0% and inflation is under control
- The main aim is to **build confidence** by signalling that interest rates would stay at low levels for some time
- In 2014, Mark Carney signalled that forward guidance would evolve – LFS unemployment is not the sole data measure to be used



# Forward Guidance when Setting Interest Rates

**Chart 5.10** Unemployment projection based on market interest rate expectations and £375 billion purchased assets



# Has the Bank of England's Monetary Policy helped?

## Case for Bank

Avoided a damaging depression

Avoided sustained deflation + faster growth than many EU nations

More competitive currency has helped export sector to recover

Haven't raised interest rates too early – responding to Euro Crisis



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## Criticisms

Inflation allowed to rise well above target in 2008 and 2012

Signs of another unsustainable housing boom

Low interest rates have become less effective e.g. in stimulating investment

Britain has record current account deficit – symptom of wider structural problems

# Final Evaluation Points on UK Monetary Policy



Hard to set interest rates with an economy vulnerable to external shocks

- Unpredictable nature of economic & financial cycles
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- Coalition fiscal austerity policies since 2010
- Changes in economic policy in major trading partners

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Low interest rates and inequality

- Substantial falls in real incomes for savers
- Rising house prices – has worsened affordability for young people – but chronic housing shortage is bigger problem



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# **AS Macro: Monetary Policy**