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**
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

- Maintaining price stability, i.e., a low, positive rate of inflation
- Supporting a sustainable recovery – i.e., a return to "normal conditions"
- Helping to re-balance the economy towards exports (X) and capital investment (I)
- Financial stability – building a more secure, banking system for the future
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ROUGH ROAD
Key Challenges Facing the Bank of England

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Financial stability – building a more secure, banking system for the future
BoE sets **policy interest rates** consistent with the need to meet a **target** of consumer price inflation of 2%
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
Factors Considered When Setting Policy Interest Rates

Bank estimates of past growth

Percentage increases in output on a year earlier

Projection

ONS data
Factors Considered When Setting Policy Interest Rates

- Adding 2% to inflation rate
- Taking over 0.5% off the inflation rate
Factors Considered When Setting Policy Interest Rates

Indices: 2 January 2007 = 100

- £ appreciating v the Euro
- £ depreciating v US dollar
- Sterling ERI

November Report
Base interest rates in the UK have been 0.5% since March 2009.

When will policy interest rates start to rise in the UK?
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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2 / Impact on demand

- Effect on spending, saving, investment and exports

Is there an expansion of production and employment?

Rate changes then affect two of the key macro objectives.

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.
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<table>
<thead>
<tr>
<th>When Interest Rates Fall</th>
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<tbody>
<tr>
<td>A reduction in interest rates or an increase in the supply of money and credit is an <strong>expansionary</strong> or <strong>reflationary</strong> monetary policy</td>
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| 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

Banks have been reluctant / unable to lend to businesses.
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Some interest rates e.g. credit card rates have risen for riskier borrowers

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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
How Quantitative Easing (QE) is meant to work

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

This money is used to buy financial assets -
Mainly the purchase of government bonds

More demand leads to higher prices for assets -
E.g. bond prices.
Rise in price of bonds leads to
a lower yield (%)
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Can feed through to fall in long term interest rates -
E.g. mortgages and corporate bonds

Lower interest rates and increased cash in the banking system should stimulate the economy
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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.
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
- Volatile world commodity prices (e.g. oil, food etc.)
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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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