Central Banks and Monetary Policy

AQA A Level Economics
Revision Notes

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Monetary policy is used to control the money flow of the economy. This is done with interest rates and quantitative easing. This is conducted by the Bank of England, which is independent from the government.

The central bank takes action to influence the manipulation of interest rates, the supply of money and credit, and the exchange rate.

Functions of a central bank

The central bank manages the currency, money supply and interest rates in an economy. For example, the European Central Bank (ECB), the Bank of England and the People's Bank of China are central banks.
Central banks issue physical cash (notes and coins) securely and using methods to prevent forgery. This is so people trust the money.
The central bank can regulate bank lending to ensure there is stability in the financial system.

Implementation of monetary policy

The central bank takes action to influence the manipulation of interest rates, the supply of money and credit, and the exchange rate.

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In the UK, the Monetary Policy Committee (MPC) alters interest rates to control the supply of money. They are independent from the government, and the nine members meet each month to discuss what the rate of interest should be. Interest rates are used to help meet the government target of price stability, since it alters the cost of borrowing and reward for saving.

The bank controls the **base rate,** which ultimately controls the interest rates across the economy.

Banker to the government

The central bank provides services to the Central Government. It collects payments to the governments and makes payments on behalf of the government. It maintains and operates deposit accounts of the government. The central bank also manages public debt and issues loans.

The Bank can also advise the government on finance, including the timing and terms of new loans.

Banker to the banks – lender of last resort

The Bank of England is considered to be a lender of last resort. If there is no other method to increase the supply of liquidity when it is low, the Bank of England will lend money to increase the supply.

If an institution is risky or is close to collapsing, the Bank might lend to them. This is when they have no other way to borrow money.

It can protect individuals who deposit funds in a bank and might otherwise lose them. It also aims to prevent a 'run on the bank', which is when consumers withdraw their bank deposits in a panic, because they believe the bank will fail.

Usually, banks will avoid borrowing from the lender of last resort, because it is suggests the bank is experiencing a financial disaster.

Monetary policy instruments:

- **Interest rates**

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  The objective of monetary policy, to ensure there is price stability is described here:

  http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx

  The bank controls the **base rate,** which ultimately controls the interest rates across the economy.

  When interest rates are high, the reward for saving is high and the cost of borrowing is higher. This encourages consumers to save more and spend less, and is used during periods of high inflation.

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When interest rates are low, the reward for saving is low and the cost of borrowing is low. This means consumers and firms can access credit cheaply, which encourages spending and investment in the economy. This is usually used during periods of low inflation. However, during the financial crisis, the UK interest rate fell to a historic low of 0.5%, and has been at this rate since March 2009. Despite high inflation, the interest rate was set at a low rate to stimulate AD and boost economic growth.

- **Asset purchases to increase the money supply: Quantitative Easing (QE)**

This is used by banks to help to stimulate the economy when standard monetary policy is no longer effective. This has inflationary effects since it increases the money supply, and it can reduce the value of the currency.

QE is usually used where inflation is low and it is not possible to lower interest rates further.

QE is a method to pump money directly into the economy. It has been used by the European Central Bank to help stimulate the economy. Since the interest rates are already very low, it is not possible to lower them much more. The bank bought assets in the form of government bonds using the money they have created. This is then used to buy bonds from investors, which increases the amount of cash flowing in the financial system. This encourages more lending to firms and individuals, since it makes the cost of borrowing lower. The theory is that this encourages more investment, more spending, and hopefully higher growth. A possible effect of this is that there could be higher inflation.

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If inflation gets high, the Bank of England can reduce the supply of money in the economy by selling their assets. This reduces the amount of spending in the economy.

- **Funding for lending**

Moreover, worsening conditions in the Euro area meant that UK banks faced higher funding costs. In order to support them, the government introduced the Funding for Lending Scheme, which aimed to lower these costs and provide cheap funding to banks and building societies.

- **Forward guidance**

  This is used by central banks to detail what the future monetary policy will be. This is with the intention of reducing uncertainty in markets. For example, the MPC might state they will keep the interest rate at a certain level until a specified date.

Factors considered by the MPC when setting bank rate:

- **Unemployment rate**: if unemployment is high, consumer spending is likely to fall. This suggests the MPC will drop interest rates to encourage more spending.
- **Savings rate:** if there is a lot of saving, consumers are not spending as much. Interest rates might fall.
- **Consumer spending:** if there is a high level of spending in the economy, there could be inflationary pressures on the price level. This would cause the MPC to increase interest rates.
- **High commodity prices:** Since the UK is a net importer of oil, a high price could lead to cost-push inflation. This could push the MPC to increase interest rates to overcome this inflationary pressure.
- **Exchange rate:** A weak pound would cause the average price level to increase. This makes UK exports relatively cheap, so UK exports increase. Since imports become relatively more expensive, there would be an increase in net exports. The MPC might consider increasing the interest rate.

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How changes in the exchange rate affect AD and the macroeconomic policy objectives:

- A reduction in the exchange rate causes exports to become cheaper, which increases exports. This assumes that demand for exports is price elastic. It also causes imports to become relatively expensive. This means the UK current account deficit would improve.
- However, this is inflationary due to the increase in the price of imported raw materials. Production costs for firms increase, which causes cost-push inflation.

An increase in interest rates, relative to other countries, makes it more attractive to invest funds in the country because the rate of return on investment is higher. This increases demand for the currency, causing an appreciation. This is known as **hot money.**