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Demand Side Policies - Monetary Policy

GCE A-LEVEL & IB ECONOMICS

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What are Interest Rates?

Interest rates determines the amount of interest we have to pay when borrowing. Thus it is the cost of borrowing money, but also the income received (or returns gained) from saving/depositing money with a bank.

https://www.bbc.com/teach/class-clips-video/the-banks-and-my-cash/zndmpg8

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Monetary Policy and Interest Rates

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Monetary policy is when the government changes an economy's interest rates or money supply to influence the level of economic activity in an economy. This is mainly done by affecting aggregate demand (AD), hence monetary policy is a type of "Demand-side policy".

Related Video:

https://www.bbc.co.uk/news/av/business-11238317/business-basics-why-do-interest-rates-matter

How to Implement Monetary Policy?

The government can directly raise or lower interest rates (cost of borrowing from banks for companies and individuals). This is done by changing the base rate of the economy i.e. the cost for banks to borrow from the government. Banks may borrow from the government when they are failing or when they have temporary liquidity issues to meet the amount of withdrawals demanded by depositors.

Related Video:

https://www.bbc.co.uk/news/business-31137261

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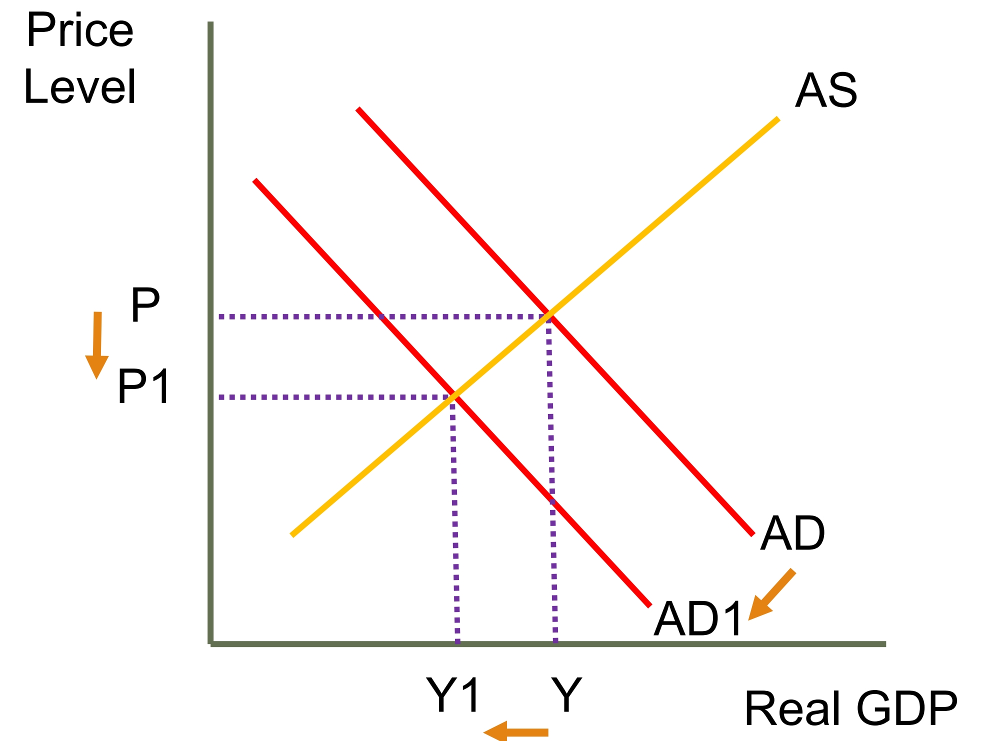
Taking Advantage of Interest Rates

- When interest rates are high (or increased), it would cost significantly more to borrow. As a result, there is less borrowing and hence consumption/investment taking place in the economy, thus reducing aggregate demand, causing a slowdown in economic growth and inflation.
- Similarly, when rates are high, more people tend to lend/save to gain higher returns/interest, causing them to spend less as well.
- Increasing the interest rate to achieve lower GDP and inflation is called "Contractionary Monetary Policy"



Taking Advantage of Interest Rates

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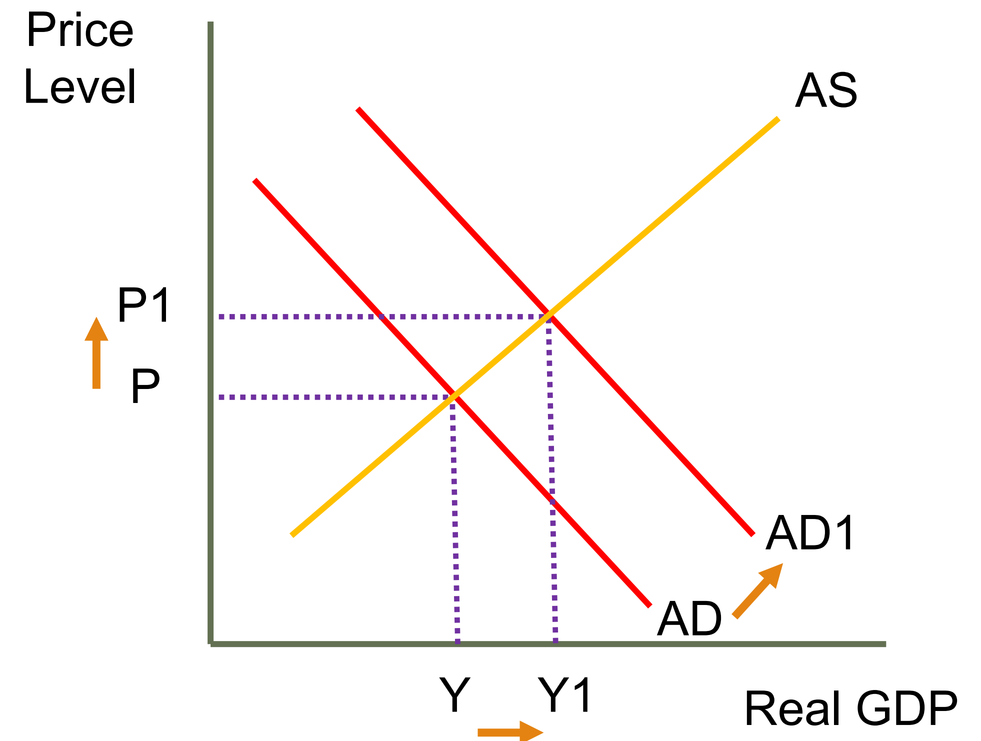
- On the flipside, when rates are low (or decreased), it would be much cheaper to borrow. This means companies and individuals are more inclined to borrow to fund their investments and consumption. As a result, this increases aggregate demand and accelerates economic growth and inflation.
- Similarly, when rates are low, less people tend to lend/save as returns from savings will be lower, causing them to spend more.
- Decreasing the interest rate to achieve higher GDP and inflation is called "Expansionary Monetary Policy"



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How Interest Rates Affect You

https://www.bankofengland.co.uk/monetary-policy/the-interest-rate-bank-rate

Assuming you are the person below, would you benefit or lose out from higher interest rates?

- Savers
  - Benefit from higher interest rates as they will gain higher interest/returns from their banks' saving accounts

- Pensioners
  - Similar to savers, pensioners tend to have more funds saved for retirement. They will hence benefit from higher interest rates as they tend to lend out those funds to receive interest.

- First-time home buyers
  - As first-time buyers tend to get a mortgage to afford their homes, they would need to borrow substantial amounts from a bank and will lose out if the cost of borrowing is high

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How Interest Rates Affect You

https://www.bankofengland.co.uk/monetary-policy/the-interest-rate-bank-rate

- Companies planning to invest
  - Lose out from higher interest rates as they will gain lower returns/gains/profits from their business investments if the cost to borrow money is higher

- Property owners
  - Property owners tend to lose out from higher interest rates. This is because higher rates reduces demand for mortgages (borrowing from banks to buy a house), as they are more costly. As a result, this decreases demand for housing and reduces housing prices and harm property owners.

Interest Rates and Macroeconomic Objectives

Base interest rates are set by the Monetary Policy Committee (MPC) from the Bank of England (BoE) each month. The MPC consists of 9 economic advisors who vote to determine the interest rate. They operate separately from the HM Treasury and hence are more independent from political influences.

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Interest Rates and Macroeconomic Objectives

As previously discussed, interest rates can be adjusted to affect inflation levels in the economy to help achieve a low and stable inflation rate, and also cause economic growth assuming the economy is not at its full capacity. Note that these two macroeconomic objectives are also tied with others as increasing economic activity in the economy may also reduce unemployment and help achieve a balanced budget.

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Evaluating Monetary Policy

How effective can monetary policy be? It depends on:

- The size of the rate change
  - The bigger the rate change, the more effective it should be
- The multiplier effect
  - The bigger the size of the multiplier in the economy, the bigger the contraction/expansion in AD and larger the impact on GDP/inflation
- Time period / Time lag
  - Depending on type of policy and other factors, it can take monetary policy 3 months to 2 years to affect consumers/businesses and the economy

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Evaluating Monetary Policy

How effective can monetary policy be? It depends on:

- Stage of the business cycle (for Economic Growth)
  - If an expansionary monetary policy is used on an economy nearing full capacity/employment, it is unlikely to have a significant effect on GDP as the economic activity is already at its highest given the productive potential of the economy; vice versa

- Cause of inflation
  - If contractionary monetary policy is used to reduce inflation, it may not be very effective if the inflation is caused by a decrease in AS (supply side factors i.e. cost-push inflation). This is because monetary policy affects AD as a demand-side policy but not AS directly.

Interest Rates and Exchange Rates

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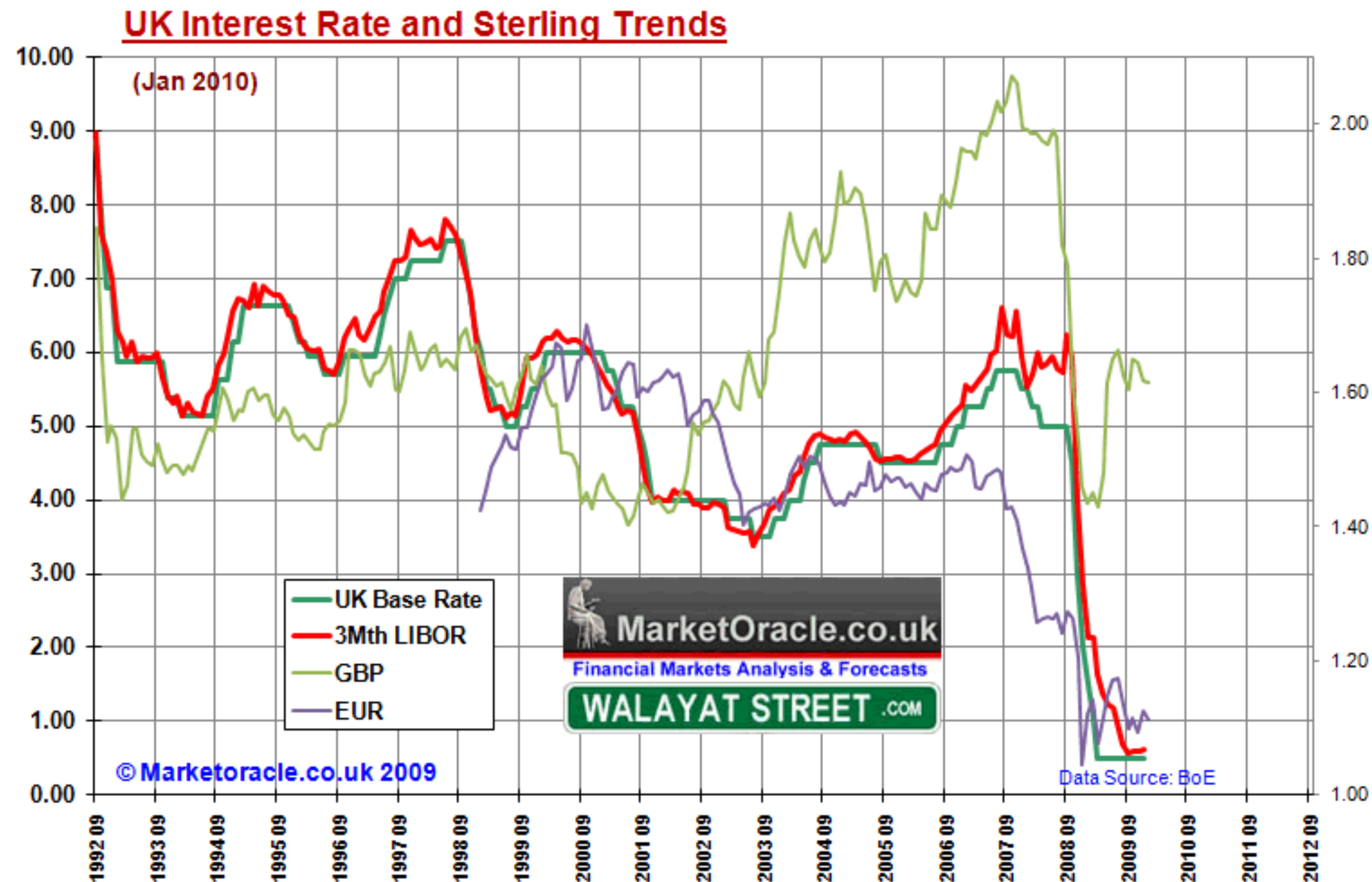

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Interest Rates and Exchange Rates

From the previous diagram, we can see that interest rates share a close relationship with exchange rates. Why?

- Speculators/investors from all over the world would take into account the interest rates of each country when saving/lending their funds to receive the best return. To deposit/save money into UK banks or to lend to UK businesses, the speculator would need to exchange their funds into British pounds.

- Hence, when interest rates are high in the UK and saving in British banks/lending to UK companies are more attractive, then there will be greater demand for the pound, increasing the exchange rate.

- The exchange rate may further impact the UK's import/exports and current account.

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Quantitative Easing

Quantitative easing aims to increase the money supply in the economy, which decreases interest rates. This involves the central bank printing electronic money so that the government can purchase financial assets from banks/pension funds to stimulate the economy and improve liquidity. We will go into more detail with regards to QE in Year 13 where financial markets and the role of central banks is discussed.

https://www.youtube.com/watch?v=J9wRq6C2fgo&index=23&t=0s&list=PLslyOrpjJ0z2Q_G5-2OtMfYcoAjzLRxfh

Quantitative Easing

What are some potential problems/limitations with this mechanism to stimulate growth?

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Bank of England creates new money electronically

The money is then paid to banks and financial institutions to purchase government bonds and other financial assets

Banks now use the surplus cash from selling those assets to lend to individuals and businesses, and to improve their financial condition

Individuals and businesses can access funds easier from banks and therefore pay a cheaper rate for borrowing (lower interest rates)

As a result, supply of money increases as businesses/individuals lend more to consume and invest.