tutor2u™

Supporting Teachers: Inspiring Students

Economics Revision Focus: 2004

AS Economics

Monetary Policy

tutor2u™(www.tutor2u.net) is the leading free online resource for Economics, Business Studies, ICT and Politics.

Don't forget to visit our discussion boards too as part of your Economics revision.

Revision Focus on Monetary Policy

AS Syllabus requirements:

Candidates should know that monetary policy involves the use of interest rates, the money supply and exchange rates. They should understand how the Bank of England uses interest rates to influence the economy.
They should also be aware that a fall in the exchange rate will reduce the price of exports, raise import prices and stimulate domestic demand affecting output, employment and the balance of payments on current account.

A2 Syllabus requirements:

Candidates should understand the role of the Monetary Policy Committee of the Bank of England and how the Bank can influence the money supply and the rate of interest. In particular, they should be aware of the objectives of monetary policy and be able to identify and explain the instruments of policy which are currently employed by the Bank of England.

Note: a detailed knowledge of United Kingdom financial markets is not required.
Candidates should understand how the demand and supply of funds in different markets affects interest rates.

Exam Essentials

For AS level:

- i Understand the ways in which a change in interest rates can feed through to affect consumer and business behaviour and therefore impact on aggregate demand, national output and inflation
- ii Be aware of the possible effects of interest rate changes on the sterling exchange rate and the likely consequences for the demand for UK exports and imports of goods and services coming into the UK
- iii Be able to analyse the effects of this using relevant AD-AS diagrams
- iv Try to evaluate the issues – considering for example the time lags involved and also the possible effects of changes in interest rates on the supply-side as well as the demand-side of the economy

For A2 level:

- i Show a deeper understanding of the factors that the MPC consider when making rate changes
    - o For example the role of the output gap and the NAIRU when assessing monetary conditions
    - o The concept of a neutral rate of interest viz management of AD and short term growth
- ii Understand the importance of interest rate differentials in determining exchange rate changes
- iii Be aware of the inter-relationships between monetary and fiscal policy in meeting the Government's main macroeconomic targets
- iv Link interest rate setting to the use and role of inflation targets and different exchange rate regimes

Revision Notes

The Bank of England has been independent of the Government since 1997. In that time there has been a cycle of small changes in interest rates. They have varied from 3.75% (in the late autumn of 2003) to

7.5% in the autumn of 1997. Generally though, the UK economy has experienced a sustained period of low interest rates over recent years. And, this has had important effects on the wider economy.

Interest rates in the UK have been low by historical standards but they are also above the levels existing in the Euro Zone (where rates have been at 2% for some time) and also in the USA where the Federal Reserve under Alan Greenspan has been very proactive in cutting short term interest rates in order to keep the US economy from experiencing a sharp and severe recession.

As of the spring of 2004, the debate centres on whether UK interest rates will have to rise to control the growth of aggregate demand. And, if so, by how much will monetary policy in the UK have to be tightened to allow the Bank of England to meet their new inflation target of 2% for the consumer price index. The Bank of England prefers a gradualist approach to monetary policy – believing that a series of small movements in interest rates is a more effective strategy rather than sharp jumps in the cost of borrowing money.

The "policy dilemma on interest rates"

The Bank of England faces a "policy dilemma" when setting the right level of interest rates:

Holding interest rates at their current low level risks leading to an unsustainable increase in consumer borrowing and debt which could have damaging consequences for the economy in the medium term (e.g. possible demand-pull inflation and an ever growing trade deficit together with the risk of an unsustainable increase in consumer debt and the danger of a hard landing for the housing market)

But higher interest rates in the near-term might choke off what is still only a fragile recovery in the manufacturing sector and in export industries where demand and output has been weak in recent years because of weakness in the global economy. 2004 has seen a rebound in export demand – but set against the challenge of a strong sterling-dollar exchange rate

When deciding on an appropriate level of interest rates, the MPC must consider a wide range of macroeconomic data – much of which paints a mixed picture

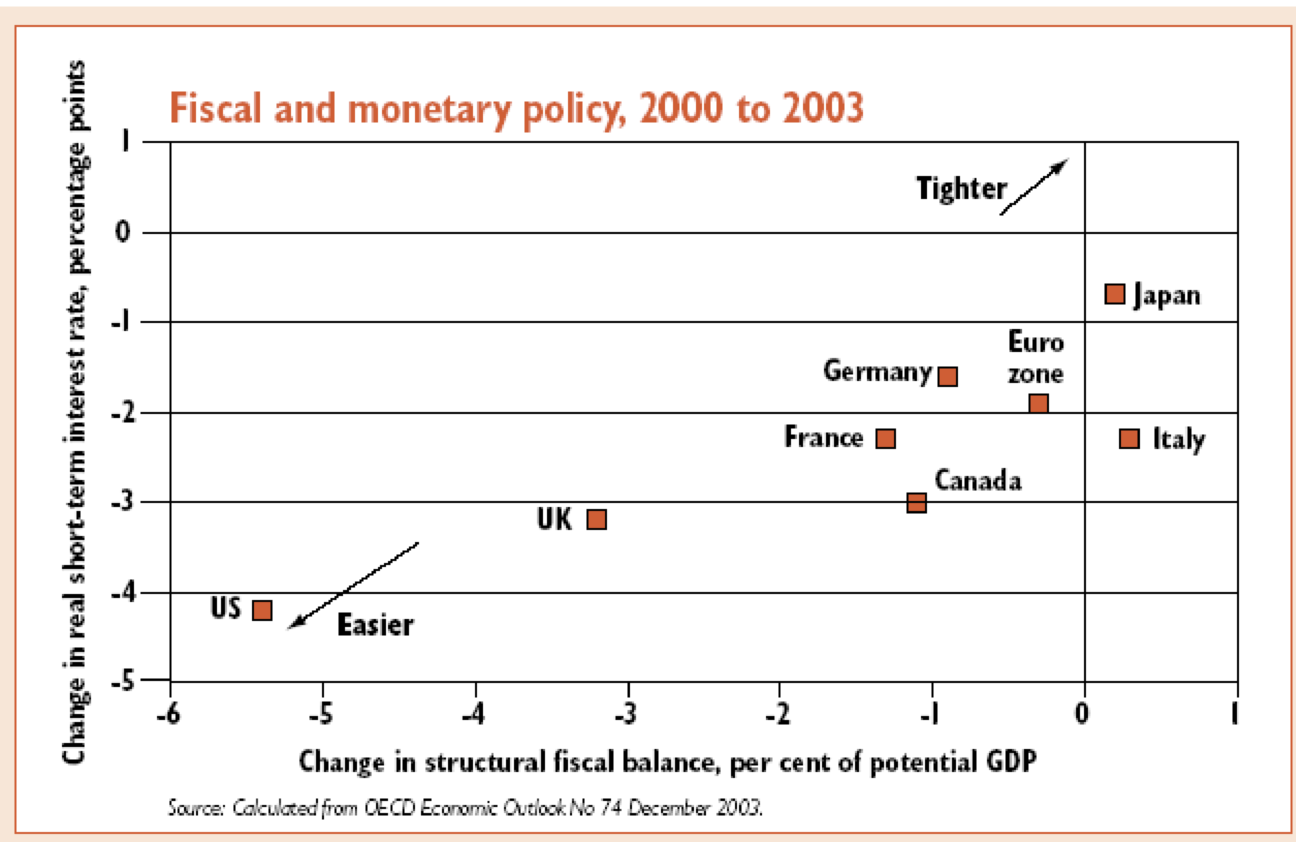
It must also recognise that there are **time lags** involved between a change in interest rates and these changes feeding through the circular flow, into aggregate demand and finally through to the general price level

The rate of interest is under the control of the Bank of England, but most other economic variables are not! The MPC's decisions can <u>influence</u> consumer and business behaviour but it cannot determine directly the rate of inflation

Raising interest rates **(i.e. a tightening of monetary policy)**	**Keeping them at their current low level**
Needed to curb the excessive growth of consumer borrowing and debt	Consumer and business confidence is fragile – too much of an early rise in interest rates might cause a sharp slowdown
The housing market is too strong, shows few signs of slowing down and threatens to cause rising price inflation in the medium term	Because of the high level of debt, a series of rate increases will lead expose people to this borrowing
UK fiscal policy is currently too expansionary (e.g.	The housing market should eventually slow down itself

rising government spending on health and education) – so monetary policy needs to compensate for the deliberate expansion of fiscal policy	without the need for higher interest rates
The global economy is picking up strongly – e.g. in the USA. This will help UK exporters and manufacturers – so the economy can cope with higher interest rates International commodity prices are rising quite quickly (in part because of the "China effect") – inflation may not be dead after all! Inflation might rise if strong economic growth is maintained during 2004. Better to raise interest rates a little now rather than wait and have to raise them by more later on in the year – this emphasises the role that a pro-active ("pre-emptive") monetary policy can make	Manufacturing industry is only just coming out of recession – higher interest rates might cause the sterling exchange rate to rise, making life difficult for exporters and causing further job losses The economy is still operating below capacity (AD < LRAS) so there is no major inflationary threat The Bank of England should allow the economy to grow and not be too worried by the slim threat of rising inflation

The Role of Monetary Policy in stabilising demand and output



Source: Adapted from the Treasury Red Book, March 2004

It is quite striking how, over the years 2000-2003, both monetary policy and fiscal policy in the UK and the United States has been used deliberately to provide a boost to short term economic growth. The chart above provides clear evidence of this. Short term interest rates have fallen in the UK by over 3%, in the United States by over 4%. With fiscal policy, there has been a significant relaxation of fiscal policy – shown by the increase in the structural budget balance. In the UK, the budget deficit has increased by over 3% of national income, even making allowance for the economic cycle. In the USA the scale of the fiscal expansion has been even greater.

Macro-policies that seek to raise the level of demand and output in the domestic economy are called "accommodatory policies". In other words, they boost demand beyond what would normally happen through the working of the automatic stabilisers.

Monetary and fiscal policy has been much less accommodatory in the Euro Zone. This may help to explain why real GDP growth in the Euro Zone has remained sluggish in the last three years.

The danger is that cutting interest rates to very low levels and allowing an aggressive relaxation of fiscal policy may be storing up problems for the UK and the USA economy in the medium term. Are interest rates in the UK now too low? Will the rising budget deficit become more of a problem and constraint for the government in the years ahead?

A number of economists, including those from the International Monetary Fund who have published recent research on the UK, claim that the British economy is unbalanced. Strong consumer demand fuelled by rising house prices and high demand for borrowing has kept recession at bay, but the effect has been to widen an already huge trade deficit. Meanwhile the export and investment goods industries remain weak and a strong pound and worried about a renewed global economic weakness may threaten the sustainability of the current cycle of growth in the UK. The Bank of England has some tough decisions to make on interest rates in the near future.