Monetary Policy Basics

- Monetary policy involves changes in
  - Policy interest rates (and other interest rates in the economy)
  - The exchange rate
  - The size of the monetary base
  - The availability of credit
- To influence
  - The level and growth of aggregate demand and output
  - Control inflationary and deflationary pressures
  - Meet an inflation target and achieve price stability

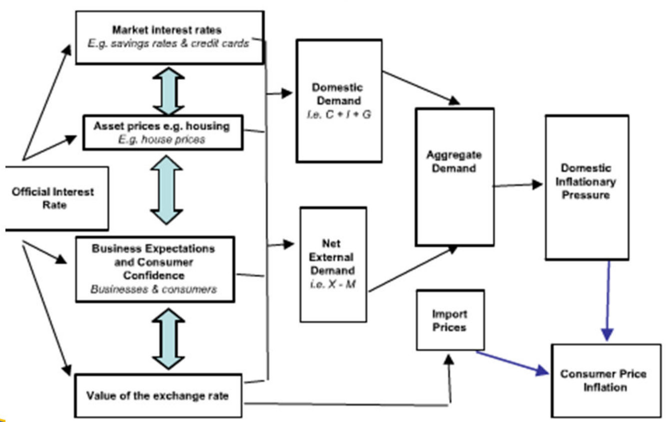
Effects on economies

- Interest rate changes affect:

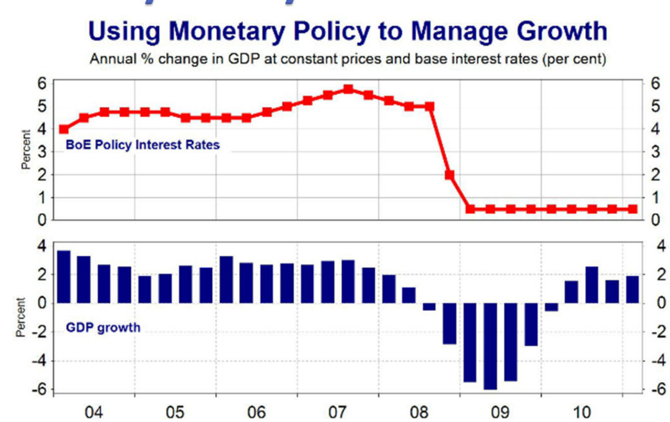
1. The cost of borrowing – affects demand for loans
2. The incentive to save
3. The effective disposable income of mortgage payers
4. The real incomes of people with positive net savings
5. Demand for housing and house prices
6. Consumer confidence
7. Business confidence and investment spending
8. Demand for exports and imports through changes in the exchange rate (the external value of a currency)

- Interest rate changes and their effects are described by the **transmission mechanism of monetary policy**

Broad effects on prices



Monetary Policy and Growth



Low Interest Rates

UK interest rate remains at 0.5%

The Bank of England has held UK interest rates at the record low of 0.5% in a widely-expected move.

It also announced no changes to its programme of pumping newly-created money into the economy - so-called quantitative easing (QE).

The Bank is pumping £200bn of newly created money into the economy

In November, the Bank of England said it would inject another £25bn, taking the total planned under QE to £200bn.

The Bank cut interest rates to 0.5% in March in an attempt to boost the recession-hit economy.

Cutting interest rates is an example of an expansionary monetary policy or a "loosening of policy"

- Rates below 1% designed to:

1. Cut cost of borrowing for consumers & businesses
2. Prevent sustained slump in house prices
3. Help maintain a competitive exchange rate
4. Stabilise consumer and business confidence
5. Reduce the risks of deflation

Summary

Stable Economic Growth

High Inflation? → Interest rates raised to reduce demand and lower prices

Low Growth/Recession? → Interest rates lowered to increase demand

and reduce loan costs for business expansion.

Effects on Business Activity

High Interest	Low Interest
Increased costs reduces profits due to high debts; reduced consumer borrowing/increases saving; leads to exch. Appreciation	reduces costs and increase profits; businesses borrow more for expansion (employment?); increases demand and revenue; Exch. depreciation

Basically...

Interest rate increases → Exchange rate appreciates → SPICED

Why?

- International investors will leave their capital in UK banks to gain interest
- They have to convert their foreign currency first, therefore increasing demand for the domestic currency
- This leads to appreciation in the domestic currency

Exchange Rate Policy

Governments have three choices…

1. Allow their exchange rate to ‘float’ – rate varies with demand for the currency
2. ‘Fix’ their exchange rate – rate stays fixed at a specific value
3. Join a common currency, like the Euro