

Chapter 31 Monetary policy

Answers to Knowledge checks

- 31.1** If an individual chooses to hold money for transactions purposes, they forgo the possibility of earning a rate of return by investing that money in a financial asset. Hence, the interest rate (the rate of return on an asset) represents the opportunity cost of holding money.
- 31.2** Investment is sensitive to the rate of interest because the rate of interest represents the cost of borrowing. When the cost of borrowing is high, firms will find fewer projects to be profitable, so will undertake less investment expenditure.
- 31.3** A fall in interest rates would lead to an increase in spending by firms and consumers, so the *AD* curve would shift to the right.
- 31.4** An appreciation of the exchange rate means that import prices will be lower.
- 31.5** Quantitative easing is a measure taken by the central bank to increase the availability of credit by purchasing assets from banks using electronically created money. It is a way of expanding the money supply because by purchasing assets from the commercial banks, money is injected into the system.

Answers to Exercises and Case studies

Exercise 31.1

The rate of interest affects aggregate demand through a number of channels. An increase in the rate of interest affects investment by raising the cost to firms of borrowing — or the opportunity cost of using internal funds for investment. Similarly, it affects consumers in their decision to allocate income to either spending or expenditure. A higher rate of interest raises the cost of borrowing funds, which may affect expenditure on consumer durables or on housing. The increase may also raise the attractiveness of saving by raising the rate of return on saving. These channels lead to a fall in aggregate demand. In addition, there may be indirect effects via the exchange rate. If an increase in the rate of interest attracts funds from abroad, this will put upward pressure on the exchange rate. An increase in the exchange rate then reduces the international competitiveness of UK goods and services, so imports are likely to rise and exports will fall. Again, the effect is to reduce aggregate demand.

Exercise 31.2

I cannot know when you are tackling this question, so I cannot help very much. It may be that the Monetary Policy Committee (MPC) considered that the economy did not need intervention, so it may have left bank rate unchanged. If the MPC considered that the inflation rate was accelerating, it may have increased bank rate to reduce the pressure on aggregate demand and prices. Or it may have been concerned about impending recession, and therefore decided to reduce interest rates to encourage aggregate demand to increase.

Exercise 31.3

The fundamental aim of adopting a rules-based approach to fiscal and monetary policy is to influence the expectations of economic agents.

In the case of fiscal policy, the adoption of a rule is designed to be a pre-commitment by the government to exercise fiscal discipline. For example, this may assure voters that the incumbent government will not manipulate government expenditure to curry favour in advance of an election, perhaps by stimulating aggregate demand to bring about a reduction in unemployment at the expense of higher inflation in the longer term.

In the case of monetary policy, setting an inflation target, and then delegating responsibility for achieving the target to the central bank, again reduces uncertainty about the future so that economic agents can form their expectations in the secure knowledge that inflation will not get out of hand.

Case study 31.1

The Monetary Policy Committee

- a** The main channel of the monetary transmission mechanism is that a change in bank rate leads to a change in other interest rates in the economy, which in turn affects aggregate demand via both investment and consumption effects. These effects are reinforced indirectly through movements in the exchange rate.
- b** The MPC may allow inflation to move beyond its target range in the light of factors that are affecting the level of activity in the economy. For example, it might allow inflation to rise if there was imminent threat of a recession setting in, or if it regarded the rise in prices as being a temporary phenomenon that would drop away without intervention.
- c** The MPC influenced aggregate demand when bank rate was at a very low level by using quantitative easing — effectively by increasing the availability of credit in the economy.
- d** Hopefully the discussion on the Bank of England website will have helped you to tackle this question.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1** c. An increase in savings and a decrease in borrowing
- 2** c. Aggregate demand

B Knowledge and understanding questions

- 3** Quantitative easing is a process by which liquidity in the economy is increased when the central bank purchases assets from the commercial banks.

A full explanation of quantitative easing	2 marks
A vague or partial explanation of quantitative easing	1 mark

- 4**
 - An increase in the interest rate can lead to an increase in savings and a decrease in consumption, leading to a decrease in *AD* and inflation.
 - A decrease in the interest rate can lead to a decrease in savings and an increase in consumption, leading to an increase in *AD* and a reduction in inflation.

An explanation of how changes in the interest rate can be used to affect inflation in an economy	up to 2 marks
A diagram of how changes in the interest rate can be used to affect inflation in an economy	up to 2 marks

- 5** Interest rates are the reward for savings and the cost of borrowing.
Exchange rates are the price of one currency in relation to another currency.

If UK interest rates are high relative to elsewhere in the world they will attract overseas investors, increasing the demand for pounds. This will tend to lead to an appreciation in the exchange rate — which in turn will reduce the competitiveness of UK goods and services, reducing the foreign demand for UK exports and encouraging UK residents to reduce their demand for domestic goods and buy imports instead.

Explanation of the relationship between interest rates and exchange rates	4 marks
Identification of the relationship between interest rates and exchange rates	3 marks
Understanding of interest rates AND exchange rates	2 marks
Understanding of interest rates OR exchange rates	1 mark

C Stimulus response question

6 a Effects may include:

- Increased savings
- Decreased borrowings
- Appreciation of the currency
- Increased imports
- Decreased exports

An explanation of two effects	2 marks
An explanation of one effect	1 mark

b

AO1 Knowledge	1 mark
AO2 Application	1 mark
AO3 Analysis	5 marks
AO4 Evaluation	5 marks

Knowledge (1 mark) is likely to include:

- Interest rates

Application (1 mark) is likely to include:

- Application to the government's objective of low and stable inflation

Analysis (5 marks) is likely to include:

Analysis of possible consequences of an increase in interest rates in the UK economy, for example:

- Increased savings leading to a decrease in consumption, and a decrease in *AD* and a possible decrease in the price level
- Decreased borrowings leading to a decrease in consumption, and a decrease in *AD* and a possible decrease in the price level
- Appreciation of the currency leading to an increase in imports/decrease in exports, and a decrease in *AD* and a possible decrease in the price level

Evaluation (5 marks) is likely to include:

Evaluation that the consequences of an increase in interest rates in the UK economy may not occur, for example:

- Depends upon the level of increase of interest rates, only 0.25%
- Depends on the position of *AD* on the *LRAS* curve
- Depends upon the state of the rest of the economy
- Depends upon other factors influencing the economy

A judgement of the effectiveness of the Monetary Policy Committee's decision to increase interest rates to achieve the government's objective of low and stable inflation