

Chapter 39 The central bank and financial regulation

Answers to Knowledge checks

- 39.1** The principal impact of a rise in interest rates in the economy is on aggregate demand. A rise in interest rates represents an increase in the cost of borrowing, so firms are deterred from borrowing to undertake investment and consumers are reluctant to borrow for spending on consumer goods.
- 39.2** The target is set by the government, and specified in terms of the Consumer Price Index. The Bank of England is required to keep inflation within 1 percentage point either way of the 2% per annum.
- 39.3** By buying securities in the open market, the demand for bonds increases. The price of bonds therefore increases, and the rate of return on bonds (i.e. interest rates) falls.
- 39.4** Yes, inflation fell rapidly at this time.
- 39.5** People withdraw their funds from some of the large banks that were coming under pressure in the time of crisis, such as the Royal Bank of Scotland and Lloyds, which in turn meant that firms were unable to borrow, and there were negative multiplier effects that plunged the economy into recession. In practice, recession did come, but arguably it would have been much deeper if the financial system had collapsed because of the loss of confidence in the banking system.
- 39.6** The UK's performance was very similar to that of the EU19 until about the end of 2011. There followed a period in which the UK outperformed the EU19 (until the end of 2015), but the UK seems to have hit problems in 2017.
- 39.7** The Financial Conduct Authority is responsible for investigating allegations of market rigging by bankers.

Answers to Exercises and Case studies

Exercise 39.1

In the UK, the Bank of England was given responsibility to meet the government's inflation target in 1997. A key advantage was seen to be an improvement in the credibility of monetary policy. An independent central bank will maintain focus on achieving the target, and will not be subject to political pressure — or political temptation to sacrifice low inflation in order to achieve growth or to curry favour with the public before an election. For the next decade, this policy was perceived to be effective, with inflation remaining within its target range for all but a small number of months. It is not entirely clear that this success can be entirely attributed to the inflation targeting regime. After all, most developed countries were experiencing similar stability in this period, and not all of them were using inflation targeting. The financial crisis underlined the importance of tempering concern with maintaining low inflation with an awareness of other economic indicators. When commodity prices accelerated in the late 2000s, the inflation rate in the UK moved above its target range, but the Bank decided not to counter this by raising interest rates, otherwise the recession would have been much deeper and probably more prolonged. These are some of the issues you will need to discuss in response to this question.

Exercise 39.2

With surplus liquidity in the economy, there will tend to be downward pressure in interest rates, as financial institutions are keen to lend the surplus funds. The central bank can counter this tendency by selling securities in the open market, therefore soaking up the excess liquidity.

Exercise 39.3

I don't know when you will be accessing these websites, so I cannot comment on what you will have found.

Case study 39.1

The bailout of Greece in 2010

The problem of sovereign default can be viewed from different angles. In particular, the international financial community may take a very different approach than the government of a country that is in difficulties.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 d. Managers of fiscal policy
- 2 c. The World Bank

B Knowledge and understanding questions

- 3 Functions may include:
 - As banker to the government
 - To manage the government's programme of borrowing
 - To manage the government's foreign exchange reserves
 - As the issuer of notes and coin
 - As managers of monetary policy
 - As a regulator of the financial system

Two functions explained	4 marks
One function explained AND one function identified	3 marks
One function explained OR two functions identified	2 marks
One function identified	1 mark

- 4 Purposes may include:
 - To protect consumers
 - To ensure financial stability
 - To maintain confidence in the financial sector

Two purposes explained	4 marks
One purpose explained AND one purpose identified	3 marks
One purpose explained OR two purposes identified	2 marks
One purpose identified	1 mark

- 5 The International Monetary Fund (IMF) was set up with a specific brief to offer short-term assistance to countries experiencing balance of payments problems. The IMF continues to play an important role in maintaining the stability of the interconnected global financial system. In particular, it has provided loans to prevent sovereign default.

A full explanation of the role of the IMF	2 marks
A vague or partial explanation of the role of the IMF	1 mark

C Stimulus response question

- 6 a** Financial regulation might have been used to protect consumers from the mis-selling of PPI by introducing regulations to restrict the sale of PPI or to enable better provision of information to consumers over the details of PPI. Financial regulation may also have been used to restrict which financial institutions were allowed to sell PPI.

A full explanation of how financial regulation might have been used to restrict the sale of PPI	2 marks
A vague or partial explanation of how financial regulation might have been used to restrict the sale of PPI	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:

- Financial regulation

Application (1 mark) is likely to include:

- Application to the market for PPI

Analysis (5 marks) is likely to include:

Analysis of possible benefits to the UK economy of increased PPI financial regulation, for example:

- Increased consumer protection
- Avoid mis-selling
- To ensure confidence in the financial sector
- To ensure financial stability

Evaluation (5 marks) is likely to include:

- Evaluation that financial regulation in the market for PPI may be ineffective
- Evaluation that financial regulation in the market for PPI may have more costs than benefits:
 - Depends upon the level of regulation
 - Depends upon other factors influencing the economy

A judgement of the benefits to the UK economy of increased PPI financial regulation