

# Monetary policy

In this second centrespread about macroeconomic policy, Peter Smith highlights the key aspects of monetary policy

## The instruments of monetary policy

- The key tools of monetary policy available to the authorities are interest rates and money supply.
- The main focus must be on one of these approaches, as it is not possible to control both together without causing disequilibrium in the money market.
- A further complication is the way that the exchange rate influences the equilibrium.
- In a modern economy, there is a multitude of ways in which money can be created, so controlling money supply is difficult.
- Interest rates have therefore been the prime way in which the Bank of England has sought to influence the economy.

## Inflation targeting

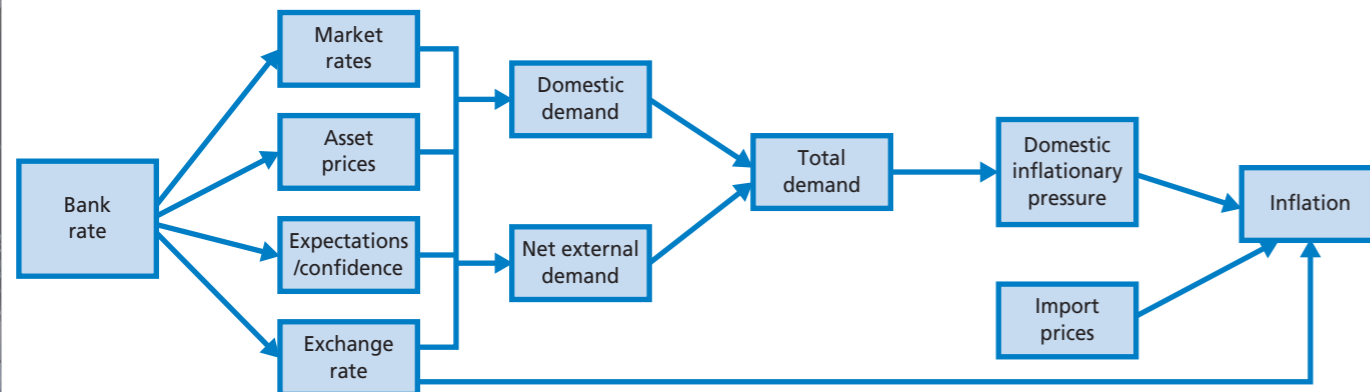
- When the Bank of England was given independent responsibility for monetary policy in 1997, it was also given a target for inflation by the government.
- Initially, this was set in terms of the retail price index (RPI) at 2.5% p.a.
- The RPI was replaced by the consumer price index (CPI) in 2004, with the target set at 2% p.a.
- The Bank's Monetary Policy Committee monitors the rate of change of the CPI to ensure that the target is being met.
- If the rate of CPI inflation is more than 1% above or below the target rate, the bank's governor must write a justification letter to explain why this has occurred.

## What is monetary policy?

- Monetary policy is the use of monetary variables such as interest rates or money supply to influence the macroeconomy.
- Monetary policy has been the main approach used to influence the economy since the mid-1970s.
- Since 1997, the conduct of monetary policy has been delegated to the Bank of England.
- This was intended to improve the credibility of macroeconomic policy, as it demonstrates the commitment of the government to controlling inflation.

## Bank rate and aggregate demand

- Figure 1 shows how changes in the official interest rate (the 'bank rate') are transmitted through the economy to influence the rate of inflation.
- An increase in interest rates is expected to reduce aggregate demand, because firms and consumers face higher costs of borrowing.
- In setting the bank rate, the bank takes into account other indicators of the economy's performance.
- A challenge has been to balance the need to achieve monetary stability by influencing inflation against the need to ensure financial stability, which became an important issue at the time of the financial crisis in 2008–09.

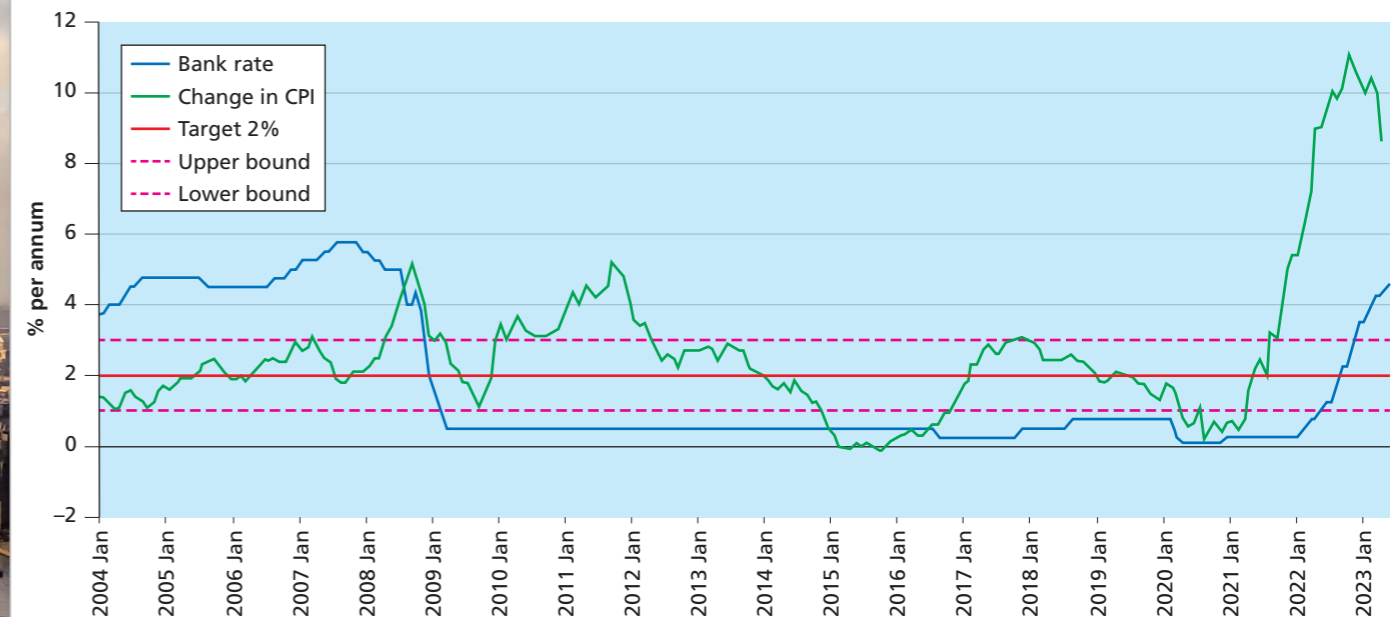


Source: Bank of England

Figure 1 The interest rate transmission mechanism. For simplicity, this figure does not show all interactions between variables, but these can be important

## Quantitative easing

- Figure 2 shows CPI inflation since 2004 together with the bank rate.
- At the time of the financial crisis of 2008–09, the bank rate was reduced to 0.5% in spite of rising inflation during 2010.
- This was an attempt to ensure a sufficient flow of credit in the economy, but this was insufficient to achieve that goal.
- A new process known as quantitative easing was introduced.
- The bank created central bank reserves electronically, using these to purchase high-quality financial assets to provide additional liquidity.
- This was essentially an attempt to expand money supply, improving firms' access to credit.



Source: ONS, Bank of England

Figure 2 UK bank rate and CPI inflation since 2004

## The environment

- Figure 2 suggests that monetary policy seemed to be working quite well until the economy was hit by the financial crisis and other later external events.
- After the financial crisis, inflation slowly returned to its target range.
- In the Covid-19 pandemic that hit the economy in 2020, inflation fell below its target range, and the bank rate was reduced to its lowest ever level of 0.1% in an attempt to protect aggregate demand.
- Russia's invasion of Ukraine brought a very different problem, with major disruption to supply chains and an acceleration of inflation — which can be seen in Figure 2.
- This cost-of-living crisis presented challenges for monetary policy, because although changing interest rates can influence aggregate demand, and thus help to tackle demand-pull inflation, it has much less influence in times of cost-push inflation.
- The bank rate was increased, reaching 5.25% by September 2023.

## The effectiveness of monetary policy

- When government expenditure exceeds its revenue, the government needs to borrow.
- The accumulation of government debt over time is known as the national debt.
- The size of the national debt relative to GDP rose substantially at the time of the financial crisis of the late 2000s and during the Covid-19 pandemic.
- Servicing the debt may not be too onerous when interest rates are relatively low.
- During the cost-of-living crisis that began in 2022, interest rates rose rapidly.
- This raised questions about the sustainability of public sector debt.

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