

Monetary policy

Monetary policy is the attempt by the government or central bank to manipulate the money supply, supply of credit, interest rates or any other monetary variables to achieve the fulfilment of policy goals such as price stability.

The government has four key macroeconomic policy objectives; to have low and stable inflation, low unemployment, high and stable economic growth and to maintain a current account equilibrium.

To achieve these objectives in the UK economy the Bank of England manipulates interest rates and the money supply.

The impact of low interest rates on the economy

Aggregate demand, in the short run:

Consumption increases as credit is more available, discretionary income increases and saving is less attractive to consumers. Investment will also increase as the opportunity cost of investment is lower. Government spending is likely not to change as much spending is planned in advance however low interest rates make payments on the national debt lower so will give the government a budget surplus.

If the rate of interest in the UK is lower than in other economies hot money will flow out of the UK which will cause depreciation in the value of the pound. This will make exports more expensive and exports cheaper abroad. This will cause net exports to increase, although imports are likely to decrease by a proportionally small value as imports to the UK are price inelastic.

Aggregate supply, in the long run:

As investment becomes more attractive in the short run for businesses in the long run the economy should benefit from this by increasing the productive capacity of the economy.

Link between economic growth and interest rates

Since 1997 the goal of monetary policy has been solely price stability. The target of 2.5% inflation \pm 1% is the goal the government sets the Bank of England.

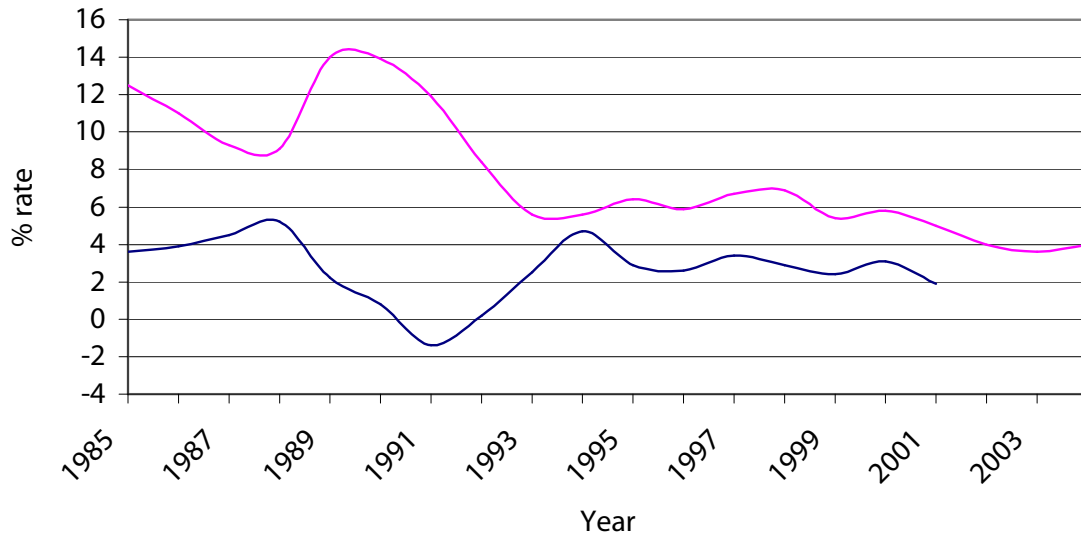
Year	GDP Growth	Base rate of interest
1985	3.6	12.5
1986	3.9	11.0
1987	4.5	9.3
1988	5.2	9.1
1989	2.2	14.0
1990	0.8	13.9
1991	-1.4	11.9
1992	0.2	8.4
1993	2.5	5.6
1994	4.7	5.6
1995	2.9	6.4
1996	2.6	5.9
1997	3.4	6.7
1998	2.9	6.9
1999	2.4	5.4
2000	3.1	5.8
2001	1.9	5.0
2002		4.0
2003		3.6
2004		4.0

During the UK's time in the ERM the goal was to maintain the exchange rate within the restrictions of the ERM. Before the ERM the main goal was to maintain the availability of credit. To do this the government can limit the proportion of their funds banks can lend out.

Has the economy been more stable since the Bank of England took over monetary policy in 1997?

The goal the Bank of England has been set by the government is price stability – to control inflation has been achieved. Whereas when the government was in control of interest rates typically an expansionary fiscal policy would be used before an election to improve political popularity during the governments term a deflationary policy would need to be implemented to curb the inflation resulting from the earlier policy this is no longer true. It has been suggested that the government control caused instability in the business cycle however now interest rates are controlled by an independent body this should not be the case.

GDP and interest rates



Lower darker line represents year on year increase in GDP per annum, upper lighter line represents base rate of interest.