Define, Describe and Determine the UK's Monetary Policy

Monetary policy involves the manipulation of interest rates and the money supply to influence the rate of growth of aggregate demand and inflation. Changes in the interest rates can also affect the exchange rate.

The Measurement on Money

There is not one way of measuring money because it is used in a number of different ways. The two main measures of money are M0 and M4, and these are recorded by the Bank of England.

M0 (Narrow Money) – This consists of all notes and coins in circulation outside the Bank of England, plus the operational balances of commercial banks at the Bank of England. It is thought that each adult has around £100 per week for traction purposes. It is a measure of the cash base in the economy. Most economists think that changes in the level of M0 have little effect on total output and inflation. Although it can be thought to be a coincident indicator of consumer spending and retail sales. Thusly, M0 reflects changes in the economic cycle, but does not cause them.

M4 (Broad Money) – This consists of all notes and coins and deposits held at UK financial institutions by the private sector. It includes deposits held by the private sector (households and firms) for transactions and savings at banks and building societies. It also includes new money created by lending in the form of loans and overdrafts.

The Determinants of Banks Commercial Lending

A commercial bank must hold sufficient cash to meet the daily needs of its customers. The remainder of its cash can be lent out, but if this cash base is reduced that the banks ability to lend decreases and vice versa. This is explained by the **credit multiplier**, which is defined as the inverse of the cash ratio.

Example: *A bank has to hold a 20% cash ratio. This would mean that its credit multiplier would be 5, meaning that it can support deposits up to five times the size of its cash base. So, if the bank was to receive a cash deposit of £100, it allows them to create £400 in advances over a period of time and support total deposits of £500. This is assuming that there is demand for credit and all advances are returned to the banking system.*

If the cash ratio increases, or if there is a fall in the cash base then the bank's ability to lend is reduced. The Bank of England can reduce the ability of commercial banks to lend through the use of the following policies:

1. Raise the cash ratio (which is currently at 0.4%)
2. Special deposits – the Bank of England can force banks to place deposits with them, and so reduces the banks' cash bases and so their ability to lend. Though this has not been used since 1979
3. Quantitative and qualitative ceilings – limits can be placed on the rate of growth of lending. Alternately, the Bank of England can suggest guidelines or apply moral persuasion on the banks to restrict their lending activities
4. Funding policy – if the aim of the Bank of England is to have a neutral impact on the money supply, then they will fund a PSBR by issuing debt to the non bank private sector. If the government does this, the initial effect will be a transfer of cash from the banks to the Bank of England and the money supply will be reduced. However, when the government then spends the cash it receives from the debt sales, the net impact on money will be zero. If the PSBR is funded by sales of debt to the banking sector this gives banks assets against which they can undertake further lending. As a result, the money supply will increase

All of these policies attempt to control the supply of credit. An alternative approach would be to reduce the demand for credit by increasing interest rates – this was done in the late 1980s. However, as demand for credit is interest inelastic (it takes time for interest rates to have a noticeable effect on the level of demand in an economy), this approach was relatively unsuccessful. The inflation which occurred in the late 1980s is largely blamed on the explosion of M4.

Interest Rates

There is not one rate of interest in an economy; there are literally hundreds of different rates on offer. But in general, **interest rates** measure the rate of return on saving and the cost of borrowed money. All rates are similar, and tend to rise or fall together and they can have a large effect on the economy.

The main interest rates are:

1. Base interest rate (set by the Bank of England)
2. Repo rate – the rate at which the Bank of England lends to the money market
3. Interest rate in long-term government bonds
4. Mortgage interest rates for homeowners
5. Saving rates on specific Bank and Building Society Accounts
6. The real rate of interest (the rate of interest adjusted for the rate of inflation)
7. The real net rate of interest is the rate of interest on savings after taking into account inflation and taxation of interest