Monetary Policy

AQA A-Level Economics

Bank of England · MPC · Bank Rate · Transmission Mechanism · QE & QT · Exchange Rates · Evaluation

What is Monetary Policy?

Definition:

Using interest rates, the money supply and credit conditions to influence AD and inflation.

UK target: CPI inflation of 2% — set by the government, delivered by the Bank of England

Key features of the UK framework:

The Bank of England & MPC

The Bank has been operationally independent since 1997. Its Monetary Policy Committee (9 members) meets 8 times a year to set Bank Rate by majority vote.

e.g. Independence aims to make policy credible and free from political pressure before elections.

The Inflation Target

2% CPI inflation, while supporting growth and jobs. If inflation misses by more than 1 percentage point, the Governor writes an open letter to the Chancellor.

e.g. Andrew Bailey wrote a series of open letters in 2022–23 as inflation peaked at 11.1%.

The Main Instruments

Bank Rate (the interest rate paid on commercial banks' reserves); quantitative easing (QE) and tightening (QT); and forward guidance about future policy.

e.g. Bank Rate was held at 3.75% in September 2026, after a series of cuts from its 5.25% peak.

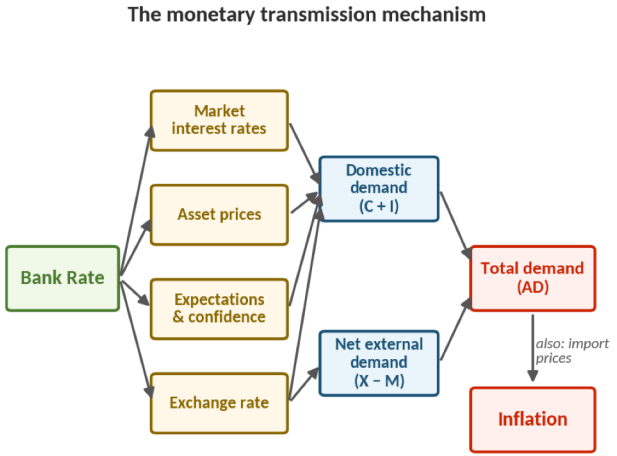
The Transmission Mechanism

Definition:
The transmission mechanism is the process by which a change in Bank Rate affects aggregate demand and, eventually, inflation.

Four main channels:
Market interest rates: banks change rates on loans, mortgages and savings. Asset prices: house and share prices change, causing wealth effects. Expectations: confidence and inflation expectations shift. Exchange rate: capital flows move the value of the £.

Effects on demand:
These channels change domestic demand (C and I) and net external demand (X – M) — so total AD changes, affecting output, employment and inflation.

Time lags:
The full effect of a rate change on inflation takes around 18–24 months.



Real-World Example

The MPC raised Bank Rate from 0.1% (Dec 2021) to 5.25% (Aug 2023). CPI fell from 11.1% to around 2% by mid-2024, allowing rate cuts to begin in August 2024.

How Higher Interest Rates Affect AD

A rise in Bank Rate is contractionary — it reduces AD through several routes:

Consumption Falls

Borrowing becomes more expensive and mortgage payments rise, reducing disposable income and spending.

e.g. Millions of UK homeowners faced higher repayments as fixed deals ended in 2023–24.

Saving Becomes More Attractive

Higher returns on savings encourage households to save rather than spend — the MPC falls.

e.g. Easy-access savings rates rose above 4% in 2023.

Investment Falls

Higher borrowing costs reduce the number of profitable projects, so firms invest less.

e.g. Commercial property and housebuilding slowed sharply in 2023.

Asset Prices Fall

Higher rates reduce house and share prices, creating a negative wealth effect on consumption.

e.g. UK house prices fell modestly in 2023 as mortgage rates rose.

Exchange Rate Appreciates

Higher rates attract 'hot money' into the UK, raising the value of the £ — exports fall, imports rise.

e.g. A stronger £ also lowers import prices, directly reducing inflation.

Expectations & Confidence

Rate rises signal the Bank's commitment to low inflation, anchoring expectations of future price rises.

e.g. Credible policy prevents a wage–price spiral.

Monetary Policy on the AD/AS Diagram

Contractionary (tight) monetary policy:

Raising Bank Rate or reducing the money supply shifts AD left — reducing the price level (inflation) but also real GDP, and raising unemployment.

Expansionary (loose) monetary policy:

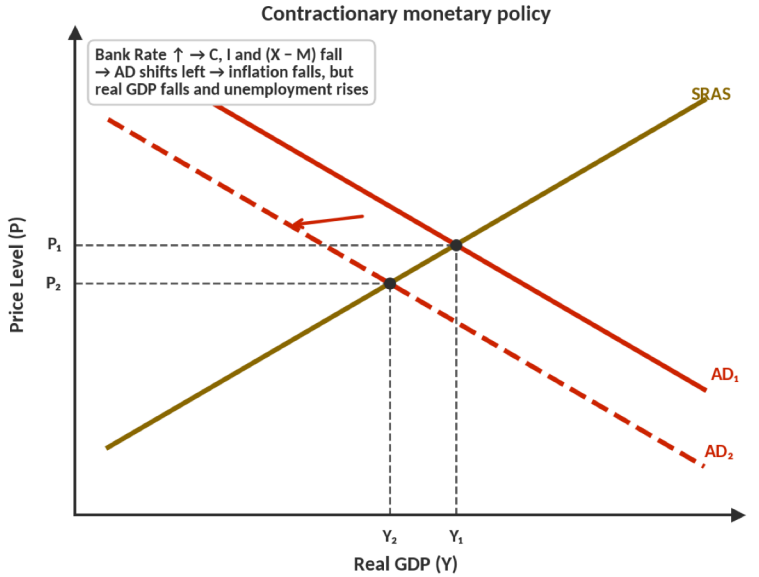
Cutting Bank Rate or using QE shifts AD right — raising real GDP and employment, but with a risk of higher inflation, especially near full capacity.

The size of the effect depends on:

The level of spare capacity; the share of mortgages on fixed rates; household and business confidence; and how far banks pass on rate changes.

Demand-pull vs cost-push:

Monetary policy is best at tackling demand-pull inflation. With cost-push inflation, rate rises reduce inflation only by cutting output — a painful trade-off.



Real-World Example

2022–24: sharp rate rises helped bring UK inflation down — but growth was weak and unemployment rose from around 3.6% to over 4%.

Quantitative Easing (QE)

Definition:
QE is when the central bank creates new money electronically to buy assets — mainly government bonds (gilts) — from financial institutions.

When is it used?
When Bank Rate is close to zero (the zero lower bound) and cannot be cut further, but more stimulus is needed.

How it works:
Buying gilts pushes up their price and lowers long-term interest rates. Sellers receive cash, which they use to buy other assets (portfolio rebalancing) — raising asset prices, wealth and lending. This boosts C and I, raising AD.

Evaluation:
Prevented deeper recessions in 2009 and 2020. ✗ Raised asset prices, increasing wealth inequality. ✗ Risk of inflation if not reversed in time. ✗ Banks may hoard reserves rather than lend.

Quantitative Tightening (QT)

The reverse of QE: the Bank sells gilts or lets them mature without reinvesting — reducing the money supply. The Bank began QT in 2022.

Forward Guidance

Signalling the future path of interest rates to shape expectations — e.g. 'rates will stay higher for longer'.

Real-World Example

The Bank of England bought £895bn of assets through QE between 2009 and 2021 — mainly government bonds — to support the economy after the financial crisis and during COVID.

Interest Rates & the Exchange Rate

The link:

Higher UK interest rates make it more attractive to hold £ deposits and UK assets. Foreign investors buy £ to invest ('hot money' flows), so demand for £ rises and the exchange rate appreciates.

Effects of a stronger £:

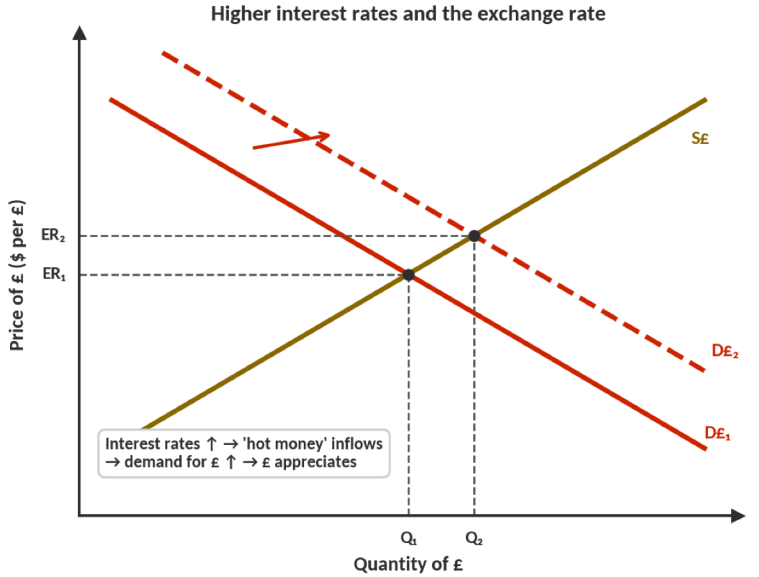
UK exports become more expensive abroad and imports cheaper — so (X − M) falls, reducing AD. Cheaper imports also directly reduce inflation.

Effects of a weaker £:

Cutting rates can cause the £ to depreciate, boosting exports but raising import prices — adding to inflation.

Other factors:

Exchange rates are also affected by interest rates abroad, confidence in government policy, and trade flows — so the effect of a rate change is uncertain.



Real-World Example

September 2022: the 'mini-budget' shook confidence in UK policy — the £ fell to a record low of around $1.04, and the Bank had to intervene to stabilise the gilt market.

Evaluating Monetary Policy

Monetary policy is the UK's main tool for controlling inflation — but it has important limitations:

Strengths

Independent and credible — anchors inflation expectations. Flexible: rates can be changed quickly, 8 times a year. Avoids the political pressures and long delays of fiscal policy.

Time Lags & Uncertainty

It takes 18–24 months for rate changes to fully affect inflation, so the MPC must forecast — and forecasts can be wrong. More fixed-rate mortgages have made lags longer.

Supply Shocks

Rate rises cannot fix cost-push inflation caused by global energy or food prices. They reduce inflation mainly by cutting demand and output — raising unemployment.

The Zero Lower Bound

When rates are near zero, they cannot be cut much further — a liquidity trap. The Bank must rely on QE and forward guidance, whose effects are less certain.

Distributional effects: rate rises hurt borrowers and help savers; QE raises asset prices, benefiting wealthier households — monetary policy is not neutral in who it affects.

★ Bonus: Did the Bank Act Too Late in 2021–22?

The criticism:
Inflation rose sharply in 2021, but the MPC initially judged it 'transitory' — caused by temporary supply problems after COVID. Rates stayed at 0.1% until December 2021.

The defence:
Much of the inflation came from energy and food price shocks, especially after Russia's invasion of Ukraine — which interest rates could not have prevented.

The Bernanke Review (2024):
Former US Fed chair Ben Bernanke reviewed the Bank's forecasting. He found its forecasting models and processes were out of date, and recommended major reforms to how it communicates uncertainty.

Evaluation:
Highlights the forecasting problem caused by time lags. ✗
Hindsight is easy — other central banks made similar judgements.

Transitory vs Persistent

Temporary price rises don't need a policy response — but if they feed into wages and expectations, inflation becomes persistent.

Second-Round Effects

Workers demand higher wages to keep up with prices, raising firms' costs — creating a wage–price spiral.

Real-World Example

Most major central banks — including the US Federal Reserve and the ECB — also called the 2021 rise in inflation 'transitory' and raised rates later than critics now say they should have.

Summary: Key Terms & Relationships

Key Term	Meaning
Monetary policy	Using interest rates, the money supply and credit to influence AD and inflation.
Monetary Policy Committee	9-member Bank of England committee that sets Bank Rate, 8 times a year.
Inflation target	2% CPI. Open letter to the Chancellor if inflation misses by more than 1 percentage point.
Bank Rate	The Bank of England's key interest rate — 3.75% as of September 2026.
Transmission mechanism	How Bank Rate changes affect market rates, asset prices, expectations and the £ → AD → inflation.
Contractionary policy	Raising rates / reducing money supply → AD falls → lower inflation, lower output.
Expansionary policy	Cutting rates / QE → AD rises → higher output, risk of inflation.
Quantitative easing (QE)	Creating money to buy gilts — lowers long-term rates and raises asset prices.
Quantitative tightening (QT)	Reversing QE by selling or not replacing gilts — reduces the money supply.
Forward guidance	Communicating the likely future path of interest rates to shape expectations.
Hot money	Short-term capital flows attracted by higher interest rates — cause the £ to appreciate.
Zero lower bound	Interest rates cannot be cut much below zero — limits conventional policy.
Time lag	18–24 months for rate changes to have their full effect on inflation.