

8 Financial markets and monetary policy

Case studies

Case study 8.1

- 1 Writing for the IMF in 2012, Irena Asmundson and Ceyda Oner argued that:

if there were no money, we would be reduced to a barter economy. Every item someone wanted to purchase would have to be exchanged for something that person could provide. For example, a person who specialized in fixing cars and needed to trade for food would have to find a farmer with a broken car. But what if the farmer did not have anything that needed to be fixed? Or what if a farmer could only give the mechanic more eggs than the mechanic could reasonably use? Having to find specific people to trade with makes it very difficult to specialize. People might starve before they were able to find the right person with whom to barter.

But with money, you don't need to find a particular person. You just need a market in which to sell your goods or services. In that market, you don't barter for individual goods. Instead you exchange your goods or services for a common medium of exchange — that is, money. You can then use that money to buy what you need from others who also accept the same medium of exchange. As people become more specialized, it is easier to produce more, which leads to more demand for transactions and, hence, more demand for money.

- 2 This question relates to the 'store of value' function of money. People can store their personal wealth in the form of money. The main advantage is the instant liquidity it gives to the holder of money, i.e. they can spend money immediately if they wish to. The disadvantages are the loss of the interest and possible capital gains that could be earned or made if they held their wealth in other forms, and the vulnerability to theft or sudden loss of money.

Case study 8.2

- 1 Equity is what you own. Debt is what you owe. Many people are lucky enough to be able to enjoy positive equity — what they own is greater than what they owe. However, some households are trapped in negative equity because what they owe (their mortgage) is greater than what they own (the current market value of their house). They are trapped in this situation because the escape route (a large increase in the value of their properties or a very large increase in income) is not really open to them.
- 2 Immediately before property prices peaked in 2007, young people were taking out 100% mortgages on houses, fearing that if they did not get on to the property ladder they would not be able to afford to become owner occupiers. Property prices then fell by 16% in a year, leaving many new home owners in a state of negative equity. No other income group was as badly affected.

Case study 8.3

- 1 An asset is something we own which has value. It is the opposite of a liability, which is something we owe. Assets divide into non-marketable assets and marketable assets. Because they can't be bought and sold, non-marketable assets don't have prices. By contrast,

marketable assets do have prices, which are determined either by private negotiation between buyer and seller (e.g. a house price) or on a market such as the stock exchange (e.g. share prices). For shares and bonds, there is an inverse relationship between their prices and interest rates. When interest rates rise, share and bond prices tend to fall. Likewise, when interest rates fall, share and bond prices tend to rise. See pages 233–34 in the textbook for further explanation.

- 2 A fall in interest rates is likely to cause a capital outflow in the balance of payments. International speculators move the funds they own out of the pound sterling and into other currencies such as the US dollar and the euro. Selling of the British currency causes the pound's exchange rate to fall and this increases import prices in the UK.

Case study 8.4

- 1 In the first instance, a change in Bank Rate affects short-run interest rates, but there is also an effect on long-run interest rates. Mortgage lenders such as banks and building societies usually take an increase in Bank Rate as a signal that the Bank of England wants higher interest rates, in order to dampen aggregate demand within the economy. And for the banks and building societies, their own cost of borrowing has increased. To maintain their profit margins, they pass this on to their customers by raising the mortgage interest rates they charge. This affects variable interest rate mortgages, but not in the first instance fixed interest rate mortgages which have already been negotiated.
- 2 At the time of writing this answer in January 2016, UK Bank Rate has remained at 0.5%, the rate at which it was set by the Bank of England in 2009. The latest figures on the state of the UK economy caused financial markets to doubt whether Bank Rate would be raised in the near future. The 12-month LIBOR stood at 1.05588% on 22 December 2015, though the LIBOR for shorter time periods was lower (e.g. the overnight rate was 0.48063%). The overnight LIBOR had remained around this level since March 2015.

Case study 8.5

- 1 Microprudential regulation attempts to control risks within financial institutions such as banks, reducing but not eliminating the possibility of failure. Microprudential regulation involves enforcing standards such as capital adequacy rules on individual banks. But microprudential regulation cannot prevent systemic risks to the financial system as a whole. One way of addressing this problem is to concentrate on the costly externalities that the actions of one financial institution impose on other institutions and markets, using macroprudential regulatory tools.

An example of a macroprudential regulatory tool is a counter-cyclical buffer, which allows regulators to increase capital requirements imposed on banks when there is a heightened risk of financial instability, with credit growth high relative to GDP. Such macroprudential counter-cyclical regulation aims to prevent financial crises from occurring by reining in lenders before an asset price bubble forms.

- 2 The Financial Policy Committee (FPC) of the Bank of England has a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks in the UK financial system, with a view to protecting and enhancing the system's resilience to outside shocks and credit bubbles. The FPC has a secondary objective to support the economic policy of the government.

By contrast, the main function of the Bank's Monetary Policy Committee (MPC) is to set Bank Rate at a level which will help the government's inflation rate target to be met. The MPC is responsible for implementing monetary policy, whereas the FPC is responsible for maintaining the stability of the overall financial system.

Test yourself

Test yourself 8.1

A unit of account is a measurement used to value goods and services and to record the value of debts. If a car is advertised for sale at a price of £25,000, money is not, as yet, changing hands, but it is functioning as a unit of account. If a deal is done at this price and the car is paid for with the use of money, money would then function as a medium of exchange (means of payment). If the potential purchaser decided against buying the car, the £25,000 could be kept as a store of personal wealth. And finally, if the buyer and seller agreed that the deal would take place in a month's time, at the £25,000 price agreed now, money would be functioning as a standard for deferred payment.

Test yourself 8.2

Statements B, C and D have all decreased the need to hold money on one's person and quickened the move towards a 'cashless' economy. Holding a credit card means that many people now use credit cards rather than cash — for example, when buying a round of drinks in a pub. People also settle debts by transferring ownership of a bank deposit rather than by making a cash payment. Finally, because they know they can get cash from an ATM machine at any time of day or night, people choose to hold less cash on their person or at home. This leaves statement A as the correct answer: with a high rate of inflation, goods become more expensive, so more money is needed to pay for them.

Test yourself 8.3

The definition of a highly liquid asset is that it can be converted into a means of payment easily without loss of value. This means that the correct answer is provided by statement C. All the other statements describe situations in which assets become less liquid rather than more liquid.

Test yourself 8.4

Given that the coupon paid annually to bond holders is £10, the bond's current market price will convert the £10 into a yield equal to the current long-term interest rate of 6%.

$$\frac{\text{£}10}{\text{current market price}} = \frac{6}{100} \text{ or current market price} = \frac{\text{£}1,000}{6} = \text{£}166.67$$

£166.00 is therefore the best approximation (answer E). The calculation illustrates the inverse relationship between bond prices and rates of interest. Given that the bond pays an annual coupon of £10, the bond's current market price has to rise above its maturity value of £100 to convert the guaranteed £10 interest payment into a yield of 6%.

Questions

- 1 Money is anything acceptable as a means of payment and performing the functions of a medium of exchange and a possible store of wealth or value. The Bank of England creates money when it issues Bank of England notes and when it credits the accounts of institutions which hold accounts at the Bank with newly created bank deposits. Privately owned banks create money when they lend to their customers by crediting customers' accounts with newly created deposits.
- 2 Changes in Bank Rate affect the price at which commercial banks borrow from the Bank of England and the rate of interest the banks earn on any deposits they hold at the Bank of England. Changes in Bank Rate also signal to commercial banks and other financial

institutions about the direction in which the Bank of England would like interest rates to move. Higher interest rates increase the cost of borrowing in the economy, thereby deterring investment by firms. However, higher interest rates encourage household saving. Lower interest rates have the opposite effects.

- 3 According to the Bank of England's explanatory leaflet, if interest rates are very low and the Bank's Monetary Policy Committee expects inflation to fall below the government's 2% target, it can inject money directly into the economy to boost spending. This is quantitative easing (QE).

The Bank of England creates new money electronically to buy financial assets like government bonds. This cash injection lowers the cost of borrowing and boosts asset prices to support spending and get inflation back to target. If inflation looks like being too high, the Bank of England can sell these assets to reduce the amount of money and spending in the economy.

While QE has not been reintroduced in the UK since its suspension in 2012, and the total stock of assets purchased has been held at £375 billion, it lasted longer in the USA and a QE programme has been started by the European Central Bank in the eurozone. Over the last few years, the US economy has stabilised and unemployment has fallen steadily. According to the BBC, some credit QE for the recovery, at least in part. And European Central Bank governor Mario Draghi said in June 2015 that the policy had 'contributed to a broad-based easing in financial conditions, a recovery in inflation expectations and more favourable borrowing conditions for firms and households'. QE pushes up the market price of government bonds and reduces the yield paid out to savers, who have to pay more to get the same income.

The USA's QE programme has kept the value of the dollar lower than it might otherwise have been — a factor unwelcomed in emerging market economies. Since the end of QE in the USA and with the prospect of interest rate rises there, the dollar has regained strength. The ECB's QE has led to a weakening of the euro.

The Bank of England has resisted calls to purchase more assets, arguing that there are better ways to operate monetary policy.

- 4 When reviewing the effectiveness of UK monetary policy since 2009, in July 2014 the *Economist* magazine commented that UK GDP was around 11.7% higher than it had been in the first quarter of 2009, which turned out to be the bottom of the recession. However, the data on unemployment was less impressive. Joblessness was 7.2% in the first quarter of 2009 and it was 7.2% early in 2014. (It has since fallen below this figure.) Inflation was 2.9% on the CPI measure in March 2009; it was 1.9% (having risen as high as 5.2%) early in 2014. Since then it has fallen closer to 0%, but given that the Bank of England's remit is still to achieve a 2% inflation target, this cannot really be counted as a success for monetary policy.

However, we cannot separate the impact of fiscal policy from that of monetary policy. Might the Bank's medicine have worked better if the government had not aimed for austerity?

- 5 Capital markets are financial markets in which long-term financial assets such as shares, corporate bonds and government bonds are bought and sold. Capital markets divide into primary markets, where shares and bonds are issued to raise funds for the medium- to long-term financing of PLCs and governments, and secondary markets, such as the London Stock Exchange, where shares and bonds are traded 'second-hand' between financial institutions and members of the general public.

By contrast, money markets provide a means for lenders and borrowers to satisfy their short-term financial needs. Assets that are bought and sold on money markets are short term, with maturities ranging from a day to a year, and normally are easily convertible into cash. The

term 'money market' is an umbrella that covers several markets, including the markets for Treasury bills and commercial bills.

Capital markets in particular provide a source of finance for PLCs which enables companies to undertake long-term investment in capital equipment and in expansion. And by selling new issues of gilt-edged securities on the capital market, the UK government borrows the funds needed to finance its budget deficit. This also helps in the management of the National Debt.

Although it is a second-hand market, the Stock Exchange performs a useful economic function. Without the Stock Exchange, the general public would be reluctant to buy shares that could not easily be resold. An important source of funds necessary to finance the growth of a firm would be denied to public companies. Secondary capital markets increase the liquidity of second-hand securities (bonds and shares), making it easier for buyers to manage their investments and sell these securities when required. This in turn makes it more likely that those with surplus funds will be willing to buy new issues of shares and bonds, thus facilitating the economic activity of PLCs and the government.