AQA - A Level Economics

The national and international economy

12.1 Financial markets and monetary policy

Revision Notes

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12.1.1 The structure of financial markets and financial assets

The functions of money

With specialisation, a person or firm do not produce everything they need themselves, so they need a way to trade. The earliest form of exchange was **barter** (trading goods directly), but it had some major issues. To solve these, **money** was developed, which serves four main functions:

1. **Medium of Exchange:** Money can be used to buy and sell anything, and everyone accepts it. Barter only worked if both parties wanted what the other had (called a "double co-incidence of wants"). With money, you can trade for what you need without this hassle.

2. **Measure of Value:** Money makes it easy to compare the value of different things, like a cupboard versus a t-shirt. It also puts a value on services and labour, making it clear what things are worth.

3. **Store of Value:** Money keeps its value over time, so you can save it and use it later. However, there is inflation, so this isn't always true.

4. **Method for Deferred Payment:** Money allows people to buy now and pay later (credit or loans). This only works because money holds its value over time.

12.1.1 The structure of financial markets and financial assets

Characteristics of money

Back in the day, people traded all sorts of things (gold, seashells, even shiny stones) to get what they needed. But for something to truly **work as money**, it has to have certain characteristics.

1. Scarce

Money should be **limited in supply**, or it'll lose its value.
If everyone could pick pounds off trees like leaves, money wouldn't be worth anything.
Economists call this the principle of **scarcity** (rare things are more valuable.)

2. Acceptable

Money needs to be something that **everyone agrees to use**.
If people don't trust or recognize it, it can't work as a **medium of exchange**
Think: You wouldn't buy a sandwich with a bottle cap.

3. Hard to Fake

If money is **easy to copy**, it's game over.
We need money that's tough to forge (with watermarks, holograms, and fancy ink) to keep it secure and **trustworthy**.

4. Durable

Money should **last a long time** without falling apart.
Coins and polymer notes are tough enough to survive many hands and pockets.

5. Portable

Money must be **easy to carry around**.
Imagine trying to buy coffee using sacks of rice or gold bars, not very practical.

6. Divisible

Good money can be **split into smaller parts**, like coins or notes of different values.
Example: If a chocolate bar costs £1 and you only have a £5 note, you should get £4 back and maybe change in coins. 

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12.1.1 The structure of financial markets and financial assets

The money supply

The **money supply** is just a fancy term for the total amount of money available in an economy. But money isn't just what jingles in your pocket, it includes several different things.

Notes and Coins

These are the physical bits of money (paper notes and metal coins) that you carry in your wallet. 💡Fun fact: They make up **only about 2%** of the total money supply in the UK. So, money is mostly... not money you can touch.

🏦 **Bank Accounts**

Most of us keep our money in **bank current accounts,** these are super convenient for things like:

- Using your debit card at a shop
- Taking cash out of an ATM
- Paying bills online or via direct debit

This money still counts as part of the money supply because it can be spent almost instantly.

🚫 **Typical Mistake**

A lot of people think there's a bar of gold sitting in the Bank of England for every pound in your bank account.
🚨 Not true. We left the gold standard behind ages ago. Today's money isn't backed by gold; it's backed by trust in the system.

12.1.1 The structure of financial markets and financial assets

The money supply

🏢 **What about Savings & Building Societies?**

- **Savings accounts** may also be counted as money, but some of them make it harder to access your cash quickly.
- **Building societies** are like banks – they hold your deposits and help you pay or borrow money. Many big banks actually started off as building societies.

📈 **Other Financial Assets**

There are things that *feel* like money (such as **shares**, **bonds**, and **treasury bills)** because they can be sold for cash. But they're **not quite money**, because:

- They aren't always easy to turn into cash without losing value
- They may take time to sell

So, economists usually don't count them in the main money supply... but they do keep an eye on them.

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12.1.1 The structure of financial markets and financial assets

The money supply

📊 **Narrow vs Broad Money – What's the Difference?**

To make things easier, economists split money into two main groups:

1. Narrow Money

This includes:

- Notes and coins
- Bank and building society accounts that you can access easily (like your current account)
- 🛍️ This is the money you can spend right now!

2. Broad Money

This includes:

- Everything in narrow money
- Plus, savings accounts and other deposits held at banks and building societies

🏢 This shows a fuller picture of all the money that exists in the economy, even if it's not always ready to spend immediately.

🧠 **Why Does This Matter?**

Central banks (like the Bank of England) use this info to:

- Judge how much spending and borrowing might happen
- Decide whether to raise or cut interest rates

Manage inflation and economic growth

12.1.1 The structure of financial markets and financial assets

The financial markets

Financial markets are like giant matchmaking services, but, instead of people, they match **money**. They help shift cash from people who have **more money than they need right now** (like savers or investors) to people or businesses who need money to **spend, grow, or invest**.

These markets now operate all over the world, connecting individuals, companies, and governments from different countries.

There are **three main types of financial markets**:

- **The Money Market**
- **The Capital Market**
- **The Foreign Exchange Market**

💵 **The Money Market**

This market handles **short-term borrowing and lending,** we're talking anywhere from a few hours to a few months.

It's used by:

- **Governments** (e.g. borrowing via Treasury Bills)
- **Banks** (lending money to each other overnight)
- **Firms and individuals** needing short-term loans

📝 Think of the money market like a short-term loan shop, great for quick fixes, not for long-term needs.

12.1.1 The structure of financial markets and financial assets

The financial markets

📈 The Capital Market

This market is all about **longer-term finance** – usually more than a year.

It's where companies and governments **raise funds** for big projects by issuing:

- **Shares (equity)** – ownership in companies
- **Bonds (debt)** – long-term IOUs with interest

The capital market has **two parts**:

🔷 Primary Market

This is the "new stuff" market. It's where **new shares and bonds** are created and sold for the **first time**.
Example: When a company does an **IPO (Initial Public Offering)** and sells shares to the public for the first time.

🔷 Secondary Market

This is the "secondhand" market. It's where people buy and sell **existing** shares or bonds.
Example: Stock exchanges like the **London Stock Exchange** or **NASDAQ**.

Why it matters: The secondary market keeps money moving and gives investors the confidence they can sell assets when needed.

12.1.1 The structure of financial markets and financial assets

The financial markets

🌍 The Foreign Exchange Market (Forex)

Whenever someone travels abroad, shops online from another country, or invests overseas; **currencies must be exchanged**.

This market deals with **buying and selling currencies** and operates 24/7 around the globe.

There are **two types of Forex trades**:

💱 Spot Market

- You exchange currencies **on the spot;** instantly, at the current exchange rate.

📅 Forward Market

- You agree today to exchange currencies **at a future date**, at a rate you lock in now. Handy for managing risk if the currency moves.

Both markets involve **speculation** where traders try to make profits from future changes in currency values.

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12.1.1 The structure of financial markets and financial assets

The role of financial markets in the wider economy

Financial markets are like the engine room of the economy; they keep money flowing between people, businesses, and governments. They help move money from those who *have* it (savers) to those who *need* it (borrowers or investors).

Some well-known examples of financial markets are the **stock market** (where people buy and sell shares) and the **bond market** (where governments and companies borrow money from investors).

🏦 1. To Help People Save Money

Financial markets give people and businesses a safe place to store their extra cash. Think of savings accounts or government bonds. When you put money in the bank, the bank pays you **interest;** basically, a small reward for letting them hold your money.

💼 2. To Lend Money to People and Businesses

Need a loan to buy a house or open a new café? Financial markets help with that.
They move money from savers to borrowers. The funds can be used for **consumption** (like buying a car) or **investment** (like building a new office).

🔁 3. To Make Buying and Selling Easier

Ever wonder how businesses in different parts of the world trade so easily? Financial markets help with this too.
They provide systems (like payment platforms and currency exchanges) so that **buyers and sellers** can do business and transfer money, even across borders.

12.1.1 The structure of financial markets and financial assets

The role of financial markets in the wider economy

🌍 4. To Help with Currency and Commodity Trades

Financial markets also deal with **currencies** (like dollars, euros, yen) and **commodities** (like wheat, oil, and gold).

- **Currency markets** let people swap one currency for another (useful for travel or international trade).
- **Forward contracts** let people lock in a price for something now but agree to pay and deliver it later (kind of like booking concert tickets early to avoid a price hike).

This can help protect people from big price swings, but it can also lead to risky **speculation** (betting on future prices to make a profit).

📈 5. To Trade Shares (Equities)

Equity markets, also known as **stock markets**, are where people buy and sell **shares** (small parts of companies).
When you buy a share, you own a tiny piece of that business.

- Businesses use this to raise money to grow.
- Investors buy shares hoping to earn **dividends** (a slice of the profits) or sell them later for more than they paid.

It's like being part-owner of your favourite company and getting paid if it does well.

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12.1.1 The structure of financial markets and financial assets

The difference between debt and equity

🟥 **Debt – Borrow Now, Pay Back Later (with Interest)**

Debt means borrowing money (usually from a bank or lender) with the promise to pay it back later **with interest**. That's the lender's way of saying, "If I'm giving you my money, I expect a little extra when you return it."

- Think of a **student loan** or a **car loan**. You get the money upfront, use it for what you need, then pay it back over time with added interest.
- It's not very flexible: you usually have to stick to fixed monthly payments, whether your situation changes or not.

🟦 **Equity – You Own It**

Equity is all about **ownership**. When you own something (like a house or part of a company), the portion that you own **outright**, without any loans or debts attached, is your equity.

- For example, if you've paid off half your mortgage on a house, you own half the house; that's your **home equity**.
- In business, owning shares in a company means you have **equity** in that company. You're a part-owner and might earn profits (called **dividends**) if the business does well.

12.1.1 The structure of financial markets and financial assets

The inverse relationship between market interest rates and bond prices

When you buy a **bond**, you're basically lending money to a company or the government. In return, they promise to pay you back on a certain future date (called the **maturity date**) and also pay you interest (this interest payment is called a **coupon**).

👉 But here's the twist: the interest (coupon) is **fixed** when the bond is issued.

So, imagine this:

- You buy a bond today that pays **5% interest**.
- A year later, interest rates in the market rise to **7%**.
- Now your 5% bond looks kinda boring compared to newer bonds that are paying 7%.

What happens? 😕
No one wants your old, low-interest bond anymore unless… you sell it for less than its face value. That's why **bond prices go down when interest rates go up**. People won't pay full price for your bond unless it gives them a return similar to current market rates.

And the reverse is true too:
If **interest rates fall** after you buy your bond, your bond looks more attractive, so **its price goes up**!

📉 **In short**:

- Market rates go **up** → bond prices go **down**
- Market rates go **down** → bond prices go **up**

This is called an **inverse relationship**.

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12.1.1 The structure of financial markets and financial assets

The inverse relationship between market interest rates and bond prices

Key Terms You Should Know

- **Bond**: A loan you give to a company/government that pays you interest and returns the money at maturity.
- **Coupon**: The interest payment you receive for holding a bond.
- **Maturity**: The end of the bond's life when you get your original money back.
- **Inverse Relationship**: When one goes up, the other goes down (like bond prices and interest rates).

12.1.1 The structure of financial markets and financial assets

The inverse relationship between market interest rates and bond prices

How to Work Out the Yield on a Government Bond

Let's say the government releases a new **10-year bond**, also called a **gilt** (that's just a fancy word for a UK government bond).

Here's what you know:

- The **nominal** or **face value** (how much the bond will pay you back at the end): **£200**
- The **coupon payment** (what you get every year in interest): **£10**
- The **current market price** (how much it costs to buy the bond right now): **£160**

Now, let's figure out the **yield,** basically, the return you'd earn each year *based on how much you pay for the bond today*.

Step 1: Gather your numbers

- Face value = £200 *(not needed for this formula, but still useful info)*
- Annual coupon = £10
- Current market price = £160

The inverse relationship between market interest rates and bond prices

📜 **Step 2: Use the formula**

The formula for yield is:

$$Yield = \left(\frac{Annual\ Coupon}{Current\ Market\ Price}\right) \times 100$$

So, plug in the numbers:

$$Yield = \left(\frac{£10}{£160}\right) \times 100$$

Yield = 0.0625 × 100
Yield = 6.25%

✅ **Step 3: What does this mean?**

This means if you buy the bond for **£160** and it pays you **£10** a year; your return is **6.25%** annually.

Even though the bond says it pays 5% of its face value (£10 from £200), you're actually earning more because you **bought it for less**. That's why yield is based on the *current price*, not the original face value.

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The inverse relationship between market interest rates and bond prices

Figuring Out a Government Bond's Current Market Price

A government issued a 20-year bond last year with a face value of **£100** and an annual **coupon payment** of **£8**. At the time, the long-run market interest rate was **6%**. Interest rates have now fallen to **3%**.

a) Using the formula below, calculate the current market price of the bond. Show your working.

$$Yield = \left(\frac{Annual\ Coupon}{Current\ Market\ Price}\right) \times 100$$

b) Explain why the market price of the bond has changed.
(You may refer to the relationship between bond prices and interest rates.)

Answer:

Step 1: Identify the Key Info

- 💸 **Annual coupon payment** = £8
- 📈 **Old interest rate** = 6%
- 💰 **Face value (maturity value)** = £100
- 🔻 **Current interest rate** = 3%

The inverse relationship between market interest rates and bond prices

Step 2: Use the Formula

To calculate a bond's market price based on its yield, we use:

$$Yield = \left(\frac{Annual\ Coupon}{Current\ Market\ Price}\right) \times 100$$

Since we know the new market yield (3%) and the coupon payment (£8), we can rearrange to solve for the **Market Price**:

$$3 = \left(\frac{£8}{Current\ Market\ Price}\right) \times 100$$

Rearrange the equation:

$$Current\ market\ Price = \left(\frac{£8}{3}\right) \times 100 = £266.67$$

Step 3: What Does This Mean?

💡 Because interest rates have fallen, this bond is **worth more** than before. It's now worth around **£266.67** in the market even though its face value is just £100.

Why? Investors are still getting that juicy £8 coupon, which is now **more attractive** compared to the new 3% market rate.

12.1.1 The structure of financial markets and financial assets

How do companies raise money

Firms often need money to grow, launch new products, or buy new buildings. They can raise this money in a few ways:

1. 💰 Issuing Shares

- Firms sell a piece of the business to investors.
- These investors become **shareholders** and may earn **dividends** (a share of the firm's profit).
- It's cheap for firms (no repayment needed), but they must share ownership and give up some control.

2. 🏢 Issuing Corporate Bonds

- These are like IOUs.
- Firms borrow money from the public (investors) and agree to repay with interest.
- It's great for **big projects** like building factories, launching new products, or acquiring another business.
- Bonds can be traded like shares and often offer **fixed or variable** interest payments.

3. 🏦 Borrowing from Banks

- This gives quick access to funds.
- But loans come with **interest** and fixed repayment terms, which can be hard for small firms to manage.

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12.1.2 Commercial and investment banks

The difference between a commercial bank and an investment bank

Commercial Banks – The Banks You Use Every Day

Commercial banks (aka "high-street banks") are the ones we all know like Barclays, Lloyds, or Santander. They're the banks people use to:

- **Deposit money** (e.g. through a current or savings account),
- **Borrow money** (e.g. through loans, overdrafts, or mortgages).

Even if you do all your banking through an app and never step inside a branch, you're still using a commercial bank.

Think of commercial banks as the banks that deal with the public (individuals and small businesses.)

Investment Banks – The Banks Behind the Big Business

Investment banks like JPMorgan Chase, Goldman Sachs, or Citigroup work a little differently. They don't take deposits from the general public. Instead, they help **businesses and governments raise money** by:

- **Issuing shares** (giving out ownership in a company),
- **Issuing bonds** (borrowing money from investors).

They also help manage things like:

- Mergers and acquisitions (when companies buy other companies),
- Large-scale **privatisations** (like when the government sells a national company to the private sector).

12.1.2 Commercial and investment banks

The difference between a commercial bank and an investment bank

💡 **Example:** An investment bank might help a tech company raise millions by launching a new share issue on the stock market.

Investment banks also buy and sell:

- **Shares and bonds** in the secondary markets,
- **Foreign currencies**, which can be used for international investments or trading.

This trading helps them (and their clients) make a profit.

🔄 **The Dual Role of Banks – One Bank, Two Hats?**

Some banks (like HSBC) do both commercial and investment banking. This is called the **dual role** of banks.

While this can be efficient, it also raises concerns especially when risky investment activities are mixed with the public's everyday savings. Many economists believe this mix contributed to the **2008 financial crisis**.

To stop that from happening again, many countries now require banks to **"ring-fence"** their operations. That means a bank's commercial activities (like your savings account) must be kept completely separate from its investment side (like trading in foreign currencies).

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12.1.2 Commercial and investment banks

The main functions of a commercial bank

Think of a **commercial bank** as a giant financial middleman. It connects people who have extra money with those who need to borrow it.

Here are the **main things a commercial bank does**:

💰 **1. Accepting Deposits**

This is one of the bank's most basic jobs.

When you **deposit money** into your bank account (like your student loan or part-time job income), the bank keeps it **safe**, **secure**, and **accessible**. You can withdraw it anytime using a card, app, or ATM.

🟫 **Think of it like:** A digital piggy bank, but way more secure, and it might even pay you a bit of interest.

🏢 **2. Lending to Economic Agents**

An **economic agent** is just a fancy term for anyone who makes financial decisions like **individuals** (you, me, or your parents) or **businesses**.

When someone needs to **borrow money**, the bank steps in. It offers:

- **Loans** – e.g. for buying a car,
- **Overdrafts** – short-term help when your account dips below £0,
- **Mortgages** – big, long-term loans for buying a house.

💡 **Example:** A small business might borrow £10,000 to buy equipment. A family might take out a mortgage to buy a home.

12.1.2 Commercial and investment banks

The main functions of a commercial bank

💳 **3. Making Payments Easy**

Banks make it super easy to pay for things. They provide:

- **Debit cards** for everyday shopping,
- **Bank transfers** for paying rent,
- **Direct debits** for things like Netflix,
- Even **cheques** (yep, they still exist, ask your grandparents).

This means people can **buy stuff**, **pay bills**, and **send money** quickly and safely.

🚀 **Example:** Imagine buying a coffee; your contactless payment instantly moves money from your bank to the café's.hy654

12.1.2 Commercial and investment banks

The structure of a commercial bank's balance sheet

Think of a **balance sheet** like a financial snapshot of a bank. It shows:

- **What the bank owns** (called **assets** ✅)
- **What the bank owes** (called **liabilities** ❌)

💰 Assets = What the Bank Owns

Assets are everything the bank owns or is owed; things that help the bank make money. They're usually listed in order of **liquidity** (how quickly they can be turned into cash).

🟦 Assets	£bn	What it means
Notes and coins	15	Cash on hand — think of the physical money in tills and vaults.
Balance at the Bank of England	10	Money held by the bank at the central bank — a secure parking spot for cash.
Money at call & short notice	12	Emergency funds — short-term loans to other banks, quickly accessible.
Commercial & Treasury bills	20	Short-term investments (IOUs from the government and companies).
Investments	30	Long-term investments like shares in companies or bonds.
Advances	90	Loans to customers — e.g. mortgages, overdrafts, business loans.
Tangible non-current assets	13	The bank's buildings, computers, ATMs — all physical stuff they own.
Total Assets	**190**	

12.1.2 Commercial and investment banks

The structure of a commercial bank's balance sheet

❌ What Are Liabilities?

Liabilities are what the bank owes; money it needs to pay back to other people.

🔴 Liabilities	£bn	What it means
Share capital	25	Money raised by selling shares in the bank — like permanent funding.
Reserves (retained profits)	15	Profits the bank kept instead of paying out to shareholders — to help it grow.
Long-term borrowing	20	Money borrowed via long-term bonds or loans — often from other banks.
Short-term borrowing	10	Quick loans from money markets — to cover daily needs.
Deposits	120	Money from customers — savings and current accounts that the bank must honour.
Total Liabilities	**190**	

✅ It's called a **balance** sheet because total assets = total liabilities (£190bn = £190bn). It *has to* balance.

🧠 Why This Matters

Banks use the money they borrow (liabilities like deposits or share capital) to fund their activities (buying assets like loans or investments). They aim to make a **profit** from the difference, for example, charging more interest on a loan than they pay on savings accounts.

12.1.2 Commercial and investment banks

The objectives of a commercial bank

A commercial bank's main mission? **Make money and keep shareholders happy,** all while staying safe and reliable for its customers. But that mission breaks down into three key goals:

💧 1. Liquidity

Liquidity means having enough cash (or assets that can be quickly turned into cash) to meet customer demands, like when they withdraw money or transfer funds.

Think of it like running a café: you can't tell a customer, "Sorry, we can't give you coffee today because all our milk is tied up in cheese." If a bank runs low on cash, it might have to borrow from other banks or financial markets and that costs interest.

📌 *Example:* If 500 people suddenly withdraw £500 each in one day, the bank must have £250,000 ready to go without scrambling for emergency funds.

💰 2. Profitability

Holding piles of cash in the vault is safe but boring; it doesn't earn money. Banks want to **lend** that money to customers, charging interest in return.

📌 *Example:* If a bank lends £10,000 to a small bakery to buy a new oven and charges 6% interest, it earns £600 a year from that loan.

The aim is to make enough profit to pay shareholders (owners of the bank's shares) and keep the business growing.

12.1.2 Commercial and investment banks

The objectives of a commercial bank

🔒 3. Security

Security is all about protecting the bank's money from risky loans that might not be repaid. The riskier the loan, the higher the interest rate because the bank wants compensation for taking that risk.

📌 *Example:* Lending £5,000 to someone with a steady job is less risky than lending £5,000 to someone who just started a circus in their garage. That's why the second loan would likely have a higher interest rate.

🏦 The Role of the Central Bank

The country's **central bank** (like the Bank of England) acts as a **lender of last resort,** basically the bank's "safety net" in emergencies. If a commercial bank runs out of short-term cash, the central bank can lend to it… but for a fee, and only if the bank isn't being reckless with its loans.

⚖️ Conflict Between the Objectives

Here's the big dilemma:

- To be **profitable**, banks lend money long term (like mortgages for 25 years).
- But to stay **liquid**, they need cash ready at short notice.

The problem? Most banks borrow short term (like customer deposits they can withdraw anytime) and lend long term.

📌 *Example:* Imagine if everyone in your town came to withdraw their savings on the same day. The bank can't just knock on a homeowner's door and say, "Hey, about that 25-year mortgage, could you repay it today?"

This mismatch is why banks can be fragile and why the central bank sometimes steps in to keep things stable.

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How banks create credit

Banks know that customers don't usually take out all their money at once. You might have £2,000 in your account, but you probably only withdraw a bit here and there.

This gives banks an opportunity: they can **lend out** some of the money you've deposited to someone else who needs it, like a business buying new equipment or a family getting a car loan. The bank earns **interest** (extra money borrowers pay back on top of the loan), and voilà, PROFIT.

♻️ The Money Cycle

Here's where it gets clever:

1. You deposit £1,000 in the bank.
2. The bank keeps, say, £100 in cash (just in case) and lends £900 to someone else.
3. That person spends the £900, and the seller deposits it into their bank.
4. That bank then keeps £90 and lends out £810… and the cycle repeats.

This process (where banks hold only a fraction of deposits in actual cash and lend out the rest) is called **fractional banking**. It allows the same £1,000 to support much more lending in the economy.

🏢 How Much Can They Lend?

A bank's lending power depends on **reserves** (the cash it decides to keep available.) The smaller the reserve ratio (percentage of deposits kept in cash), the more new credit the bank can create.

📌 *Example:* If the reserve requirement is only 5%, a bank can lend out 95% of all new deposits, making it a powerful credit-creation machine.

12.1.2 Commercial and investment banks

How banks create credit

⚠️ The Risk – Bank Runs

Of course, this only works as long as customers don't all demand their money back at once.
If everyone rushed in asking for their deposits, the bank wouldn't have enough cash on hand. This panic is called a **run on the bank,** like in old movies where people line up outside, shouting to get their savings.

Ironically, sometimes just the **fear** that a bank might fail is enough to cause a run, making the problem real.

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12.1.3 Central banks and monetary policy

Main functions of a central bank

Central Banks are the **guardians of the financial system**. They help keep the economy running smoothly, protect your savings, and even play a part in how expensive your shopping trip feels each month.

Let's look into their 4 main roles:

1. 💰 Implementation of Monetary Policy

Monetary policy means managing interest rates and the money supply to keep things like inflation, unemployment, and growth under control.

- If prices are rising too fast (**inflation**), the central bank can raise interest rates to slow things down.
- If the economy is slowing down, it can lower rates to encourage borrowing and spending.

🧠 **Example:** If the central bank like the Bank of England (BoE) increases interest rates, your loan becomes more expensive but saving money earns you more interest. That's monetary policy in action. During COVID-19, like the BoE cut interest rates to near 0% to keep money flowing.

2. 🏦 Banker to the Government

The government has its own massive "bank account" with the central bank. This bank:

- Manages all **tax income and government spending** (like paying teachers or NHS staff).
- Holds **foreign currency reserves** and even **gold**.
- May lend money to the government by buying its bonds (aka public debt).

12.1.3 Central banks and monetary policy

Main functions of a central bank

3. 🏢 Banker to the Banks – Lender of Last Resort

Commercial banks (like HSBC or Barclays) can get into trouble if they suddenly don't have enough cash; this is called a **liquidity problem**.

Luckily, the central bank is their **backup plan**.

- It can lend money to keep banks afloat.
- It stops one bank's failure from causing a domino effect and crashing the entire system.

Why this matters:
If a big bank fails, it could cause chaos as people might lose savings, businesses could collapse, and confidence in the system would drop like a stone.

📉 **Example:** In the 2007-08 Financial Crisis, central banks stepped in to stop banks from collapsing when their mortgage-backed assets lost value.

4. 🛡 Role in Regulation of the Banking Industry

The financial system can be risky if left unmonitored. Central banks **set rules to stop dodgy behaviour**, protect consumers, and avoid another crisis.

They watch over:

- How much money banks must keep in reserve (**liquidity ratios**)
- Banning scammy or super risky products
- Stopping **market rigging**
- Ensuring fair access to loans and banking services

One big tool:
They use **reserve ratios** [rules on how much money banks must keep in reserve (and not lend out)].

- **Higher ratio = less money flowing in the economy**
- **Lower ratio = more money flowing**

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12.1.3 Central banks and monetary policy

The objectives of monetary policy

Definition:
Monetary policy is all about how a country's central bank controls the **cost** and **availability of money** in the economy. It's like the thermostat for the economy, turning the heat up or down depending on what's needed.

Key tools include:

- **Interest rates** – The percentage charged for borrowing money or earned on savings.
- **Money supply** – How much money is flowing around the economy.
- **Availability of credit** – How easy or hard it is to borrow money.
- **Exchange rate** – The value of your country's currency compared to others.

In the UK:
The Bank of England takes the lead on monetary policy. Since 1997, it has been mostly independent, meaning politicians don't get to directly set interest rates, although the government still gives it targets and can step in during emergencies (like the 2008 financial crisis).

Objectives of Monetary Policy – The Game Plan

The UK's **main aim** is to keep inflation (the general rise in prices) at around **2% per year** (give or take 1%).

- Inflation is measured by the **CPI** (Consumer Prices Index), which tracks how much everyday goods and services cost.

Why 2%?

- Too high = your money loses value quickly.
- Too low = risk of stagnation or deflation (falling prices).

The Bank of England's Monetary Policy Committee meets every month to decide whether to raise, lower, or keep interest rates the same to hit that inflation target.

12.1.3 Central banks and monetary policy

The objectives of monetary policy

Other important goals:

- Keep people in jobs (low unemployment).
- Support steady economic growth.
- Make sure the financial system is stable.

Fun Example:
If the economy is "too hot" (prices rising too quickly), the Bank might raise interest rates, making loans for things like cars or houses more expensive, so people spend less, and prices cool down.
If the economy is "too cold" (slow growth or falling prices), it might lower interest rates, making borrowing cheaper to encourage spending and investment.

While interest rates do change how much you earn on savings, in economics the bigger deal is **how they affect borrowing costs**. Cheaper borrowing can speed up the economy; expensive borrowing can slow it down.

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12.1.3 Central banks and monetary policy

The Monetary Policy Committee (MPC)

Definition:
The **Monetary Policy Committee (MPC)** is a group within the Bank of England that decides the UK's **interest rates**. Their main goal is to keep inflation at a healthy, stable level.

🔍 What the MPC Thinks About Before Changing Rates

Before deciding whether to turn the interest rate dial up or down, the MPC looks at a variety of clues about the economy, such as:

- 🛒 **Consumer spending** – Are people shopping or saving?
- 👷 **Jobs market** – Are people finding work easily or struggling?
- 🏭 **Business investment** – Are companies building, hiring, and expanding?
- 🛢️ **Commodity prices** – Are oil, gas, and food prices rising or falling?
- 💼 **Government spending & taxes** – Is the government boosting or slowing the economy?
- 💱 **Exchange rate** – Is the pound strong or weak compared to other currencies?

⚖️ How They Decide

The MPC predicts what the economy might look like over the next **two years**.

- If inflation looks set to **rise too much**, they might **increase interest rates**.
  - Higher rates make borrowing more expensive and saving more rewarding → people spend less → demand cools down → prices rise more slowly.
- If inflation looks set to **fall too low**, they might **cut interest rates**.
  - Lower rates make borrowing cheaper and saving less attractive → people spend more → demand rises → prices increase.

12.1.3 Central banks and monetary policy

The Monetary Policy Committee (MPC)

Example – Raising the Bank Rate

Imagine the Bank of England increases interest rates:

- 💰 **People save more** – because savings accounts pay better interest.
- 🏠 **Mortgage payments rise** – especially for those on variable rates.
- 💳 **Borrowing costs go up** – buying a car or taking out a loan becomes pricier.
- 🏭 **Businesses invest less** – as loans for new projects cost more.
- 💷 **The pound gets stronger** – making UK exports pricier abroad but imports cheaper.

All of this leads to **lower demand in the economy**, which can reduce inflation, but it may also slow growth and increase unemployment.

Rising rates shift the demand curve left (AD1 → AD2) ↔ price levels drop, but output (GDP) falls too.

⏳ The Time Lag

Interest rate changes are **not instant magic**. It can take **12–24 months** for the effects to ripple through the economy.
This is called a **time lag;** the MPC has to think ahead like chess players about where inflation will be in the future.

12.1.3 Central banks and monetary policy

The effect of interest rates

Sometimes, using **interest rates** (the cost of borrowing money, set by the central bank) to fight inflation can cause problems elsewhere in the economy.
When interest rates go up, people and businesses tend to spend less; this is called **lower aggregate demand** (the total spending in the economy).

But with lower spending, we also get side effects:

- 🐢 **Slower short-term economic growth** – Less demand means the economy grows more slowly.
- 💸 **Lower tax revenue** – With less economic activity, the government collects less in taxes.
- 📉 **More unemployment** – Fewer purchases mean fewer sales, so businesses may cut jobs.
- 🏭 **Weaker supply-side growth** – Businesses invest less in new machinery or technology, limiting long-term productivity.
- 🌎 **Fewer exports** – Higher interest rates often push up the currency value, making UK goods more expensive abroad.

⚠️ **Limitations of Interest Rates in Controlling the Economy**

While raising interest rates is great for cooling spending, it's less effective for stopping **cost-push inflation** (price rises caused by higher costs like oil prices or imported goods).

For example: In 2012, UK inflation went above 5% because oil prices and the cost of imports shot up. The Bank of England didn't raise rates because it wouldn't have fixed the real problem.

12.1.3 Central banks and monetary policy

The effect of interest rates

Other limitations include:

- 🚫 **Low-rate limits** – If rates are already low, you can't cut them much more.
- 🤷 **Uncertainty** – We can't always predict exactly how people will react.
- 📏 **Small changes = small effects** – Most rate changes are tiny (like ±0.25%), so they may not be enough.
- ⏳ **Time lag** – Changes can take 12–24 months to fully affect the economy.

🌐 **Interest Rates and the Exchange Rate**

Changing interest rates also affects the **exchange rate** (how much a currency is worth compared to others).

- If UK interest rates rise, investors from around the world may want to put their money here to earn more interest. This demand for pounds pushes the value of the pound up.
- A stronger pound means imports become cheaper 🛒, which helps reduce inflation.
- But… UK exports become more expensive for other countries, which can hurt British businesses selling abroad.

Fun fact: This flow of short-term investment money chasing higher interest is sometimes called **"hot money"** 🔥.

Typical Mistake to Avoid:
People often assume the exchange rate will only change after interest rates go up. In reality, markets often *expect* changes and adjust early, so the pound's value can rise *before* the actual rate change.

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Impacts of exchange rate on AD and macroeconomic policy objectives

First, what's an **exchange rate**?
It's the price of one currency compared to another. For example, if £1 = $1.20, that's the exchange rate.

Changes in the exchange rate (whether caused by interest rate changes or other factors) can affect the economy in lots of ways:

- 📈 **When the exchange rate rises** (the pound gets stronger), UK exports become more expensive abroad, making them less competitive. For example, British cheese might cost more in France, so fewer people there buy it.
- 📉 **When the exchange rate falls** (the pound gets weaker), UK exports become cheaper abroad, which can boost demand and create more jobs in industries like manufacturing and tourism.
- 💸 A weaker pound also makes **imports** (goods bought from abroad) more expensive. If we import electronics, clothes, or oil, prices could rise, which can cause **inflation** (general rise in prices).
- ⚖️ **Unstable exchange rates** (big ups and downs) make it hard for UK exporters to plan production. For instance, a car manufacturer selling overseas might not know how much money they'll actually make after converting sales back into pounds. This uncertainty can also put off foreign buyers unless UK companies absorb the cost by cutting into their profits.

12.1.3 Central banks and monetary policy

Impacts of exchange rate on AD and macroeconomic policy objectives

💡 **Typical Mistake to Avoid:**
A weaker pound makes imports more expensive, but that doesn't mean UK shoppers will instantly stop buying them. In the short run, people often still buy their favourite imported goods, even at higher prices. For example, someone who loves Italian coffee might still buy it, even if it costs 20p more per cup.

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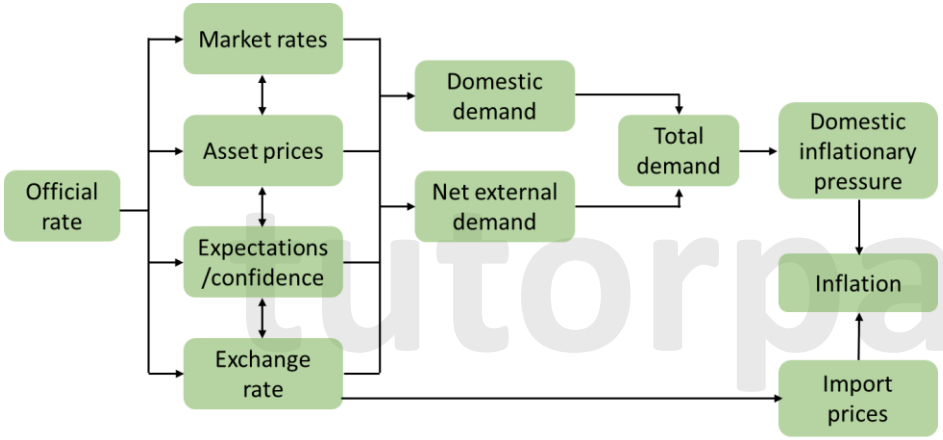
12.1.3 Central banks and monetary policy

The monetary policy transmission mechanism

Monetary policy = how the central bank (in the UK, the Bank of England) uses tools like **interest rates** to influence spending, borrowing, and inflation in the economy.
Think of it as a chain reaction: change one thing (like the official interest rate) → lots of other things shift in response → the economy speeds up or slows down.



📊 **How it works (step-by-step):**

When the **Bank of England's Monetary Policy Committee (MPC)** changes the **official interest rate**:

- **Banks change their rates** 💳
  Within hours or days, banks adjust the rates they charge borrowers (loans, mortgages, credit cards) and the rates they pay savers.
  - Higher rates → borrowing is more expensive (less demand for loans) and saving is more rewarding.
  - Lower rates → borrowing is cheaper (more spending) and saving looks less attractive.

12.1.3 Central banks and monetary policy

The monetary policy transmission mechanism

- **Asset prices react** 📈
  Things like shares, bonds, and house prices can shift.
  - If rates go up, bond prices usually fall.
  - Falling asset values can make people feel "poorer", so they might spend less (called the **wealth effect**).
- **Confidence changes** 😕
  Expectations matter. If people think higher rates mean tougher times ahead, they might spend less. If rates are cut, they might feel more optimistic and splash out.
- **Exchange rate moves** 💱
  Higher rates can attract foreign investors chasing better returns (**hot money**), making the pound stronger. A stronger pound makes UK exports more expensive abroad and imports cheaper.
- **Domestic demand shifts** 🏠
  For example, households with variable-rate mortgages will see payments change; higher rates mean bigger monthly bills, leaving less money for other spending.
- **Business investment changes** 🏭
  If it costs more to borrow, fewer businesses will invest in new projects. Lower rates can encourage expansion.
- **Export & import prices change** 🚢
  Exchange rate movements affect trade; stronger pound = more expensive exports (less competitive) but cheaper imports.

The term **stance** describes the overall "mood" of monetary policy:

- **Expansionary stance** → encouraging growth (lower rates, cheaper borrowing).
- **Contractionary stance** → slowing growth (higher rates, discourage borrowing).

⏳ **Time lag warning:**
It can take up to 2 years for the full effects of a rate change to ripple through the economy. So, the MPC must think ahead, like steering a cruise ship, not a speedboat.

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12.1.3 Central banks and monetary policy

The Bank of England and the money supply

The **money supply** = all the money circulating in the economy (notes, coins, and bank deposits).
If the money supply grows too fast, it can cause **inflation** (prices rising quickly). If it shrinks too much, it can signal an economic slowdown or even a recession.

The **Bank of England** can't directly control every pound in circulation, but it *can* influence it through tools like interest rates. Lower interest rates usually make borrowing more attractive (people and businesses take out loans, spend more), while higher rates slow borrowing and spending.

Aside from changing rates, the Bank also has other tricks up its sleeve to keep the economy stable and encourage growth. Let's discuss them 👇

💷 **Quantitative Easing (QE) – AKA "Boosting the Economy When Rates are Stuck"**

Definition: Quantitative easing is when the Bank of England creates new money to buy government bonds or other assets from investors.

Why do it?

- It gives investors extra cash, which they might spend on other investments, like buying company shares or lending to businesses.
- It makes borrowing cheaper and encourages spending.

Example:
The Bank buys £50 billion worth of bonds from insurance companies. Those companies use the cash to help fund a massive renewable energy project, hiring thousands of workers and boosting spending in the economy.

Fun fact: QE was introduced in the UK in 2009 after the financial crisis, when interest rates were already super low and couldn't be cut much further.

12.1.3 Central banks and monetary policy

The Bank of England and the money supply

💡 **Funding for Lending Scheme (FLS) – "Helping Banks Help You"**

Definition: A scheme launched in 2012 to make it easier for banks to lend money to people and businesses.

How it works:

- Banks swap assets (like loans they've made) with the Bank of England for **Treasury bills** (safe, short-term government IOUs).
- Treasury bills can be used to borrow more money cheaply from other markets.

Why it matters:

- Cheaper funding for banks = more incentive to lend at low rates.
- Helps boost business activity and consumer spending.

Example: If a bank can borrow at 0.5% instead of 3%, it might offer small business loans at 2% instead of 5%, encouraging more businesses to invest and grow.

📣 **Forward Guidance – "Telling the Future… Sort Of"**

Definition: When the Bank of England tells everyone what it *plans* to do with interest rates in the future, to help guide borrowing and investment decisions.

Why it matters:

- If people know rates will stay low, they might be more confident about taking a mortgage or investing in their business.
- It reduces uncertainty, which encourages spending.

Example: The Bank says, "We won't raise interest rates for at least 18 months." A tech company hears this and decides it's the perfect time to take out a loan to build a new office, knowing repayments will stay manageable for a while.

12.1.4 The regulation of the financial system

Regulation of the financial system in the UK

Why regulate at all?
Think of the financial system like a busy motorway. Without traffic rules, you'd have chaos, accidents, and some seriously grumpy drivers. In finance, *regulation* means creating rules to make sure banks, insurers, and investment firms don't take dangerous risks that could cause massive problems for the economy.

In the past, a lack of strong rules led to risky loans, bad investments, and huge losses for banks. After financial disasters (like the 2008 crisis), the UK decided to step up its game. The **Bank of England** now keeps a closer eye on the financial world to ensure:

- **Financial stability** — keeping the system steady and safe.
- **Protection** for everyday people — making sure your savings aren't in danger because of someone else's bad gamble.

The Key Players in UK Financial Regulation:

1. The Prudential Regulation Authority (PRA)

The PRA is like the safety inspector for banks, insurance companies, and co-ops. Its main job? Make sure these organisations are strong enough to survive tough times and don't go bankrupt.

How they do it:

- Set rules banks must follow (like keeping enough money aside for emergencies).
- Check regularly that these rules are followed.

Example:
Imagine a large UK bank starts lending too much to risky tech start-ups. The PRA might step in and say,
"Hey, slow down! Keep more backup cash so you don't collapse if those start-ups fail." After the 2008 crash, the PRA told some banks to sell parts of their business, cut costs, and reduce risky loans.

12.1.4 The regulation of the financial system

Regulation of the financial system in the UK

2. The Financial Policy Committee (FPC)

The FPC is like the economy's "big picture" safety net. It spots problems in the financial system and tries to fix them before they get serious.

How they do it:

- Run **stress tests** on banks (like a financial fire drill) to check they can survive big economic shocks, for example, a sudden fall in house prices.
- Set rules on how much people can borrow, based on their income, to stop things like housing bubbles.

Example:
If house prices are rising too fast and people are taking massive mortgages they can't afford, the FPC might say, "Banks, you can only lend up to 4.5 times a person's salary, let's cool things down."

3. The Financial Conduct Authority (FCA)

The FCA is the referee of the UK's financial markets. It makes sure companies treat customers fairly, don't mislead people, and follow the rules.

How they do it:

- Investigate dodgy behaviour by banks, insurance companies, and investment firms.
- Fine companies or force changes if they're not playing fair.

Example:
If an investment app promised "guaranteed profits" but was actually just gambling with people's money, the FCA could step in, shut it down, and get customers their money back.
In one real case, they ordered a payday loan company to refund millions to borrowers it had overcharged.

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12.1.4 The regulation of the financial system

Why a bank might fail

Banks, like people, can make mistakes. But when they do, the consequences can be huge, not just for them, but for the whole economy. Here are some common reasons why banks hit trouble:

1. High-Risk Loans 🎯

When a bank hands out too many risky loans (money lent to people or businesses that may not be able to pay it back), it's like playing financial roulette.

Example: Imagine a bank giving lots of loans to new businesses with no proven track record, hoping they'll all succeed. If many fail, the bank is left with unpaid debts.

- A real-world example was **Lehman Brothers** in the U.S., which invested heavily in risky mortgages before the 2008 crash. When borrowers couldn't pay, Lehman collapsed.
- This can cause a **"run on the bank",** when customers panic and rush to withdraw their money, worried the bank might go under.

2. Asymmetric Information 🤔

This happens when one side of a deal knows much more than the other and uses it to their advantage. In banking, sellers of financial products often have more knowledge than buyers.

Example:

- A bank might sell complex investment products that sound safe but are actually very risky and customers wouldn't know until it's too late.
- In the 2008 crisis, banks bundled risky home loans and sold them as "safe" investments. Investors didn't realise how risky they actually were until the market collapsed.

12.1.4 The regulation of the financial system

Why a bank might fail

3. Breaking the Rules 📜

Banks must follow strict regulations, like rules on preventing fraud, money laundering, and interest rate manipulation. Ignoring these rules can mean heavy fines or even closure.

Example: Suppose a bank doesn't check where large deposits come from. If that money turns out to be linked to illegal activities, the bank can be in serious trouble.

- In 2012, **Standard Chartered Bank** was fined for failing to follow anti–money laundering laws when dealing with certain foreign transactions.

4. Speculation & Market Bubbles 📈

If there's too much easy money floating around, people and banks may invest in risky assets, pushing prices up beyond their real value. This creates **bubbles**, which eventually burst.

Example: Before the dot-com crash (2000), banks pumped money into internet companies with no profits and when reality hit, stock prices collapsed.

- Bubbles can also form in housing, cryptocurrencies, or even collectibles like rare trading cards.

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Liquidity and capital ratios

Back in 2007, the world had a big financial mess (a.k.a. the global financial crisis). One major lesson we learned? Banks can't just take wild risks without having a safety net.
Now, banks must meet *capital* and *liquidity* requirements, basically, prove they have enough resources to survive sudden money problems (think of it like carrying an umbrella just in case a storm hits ⚡).

💧 **Liquidity Ratio – Your "Rainy Day" Readiness**

Definition: The liquidity ratio measures how easily a bank can get its hands on cash to cover short-term needs.
It compares what the bank *could quickly turn into cash* (like cash in the vault or money in very safe investments) to what it *owes soon* (like customer withdrawals).

💡 **Example:** Imagine you run a café. You have £1,000 in your cash register and £2,000 worth of milk, coffee, and sugar in stock (easy to sell if needed). If you owe your suppliers £2,500 next week, your liquidity ratio tells you whether you can pay them without borrowing money.

✅ A higher liquidity ratio = the bank is more ready for sudden "cash now" situations.

💎 **Capital Ratio – The Bank's Safety Cushion**

Definition: The capital ratio measures how much of a bank's own money (profits, reserves, or money raised from selling shares) it has compared to how much it has lent out or invested.

💡 **Example:** If your friend borrows your bike, you'd feel safer if you have a spare bike at home. That spare is your *capital cushion*. In banking, it means if loans go bad, the bank has its own funds to absorb the losses without collapsing.

✅ A higher capital ratio = the bank can handle more bad-loan "oopsies" without needing a bailout.

12.1.4 The regulation of the financial system

Moral hazard

Definition: *Moral hazard* is when someone takes bigger risks because they know someone else will bail them out if things go wrong.

Since 2008's financial crisis 💣, moral hazard has been on the rise in the banking world. Why? Because governments keep stepping in to save struggling banks 🏢 when they're about to fail (for example, RBS in the UK).

Here's what happens:

- 🏢 **"Too big to fail"** – Big banks know they're so important that the government can't let them collapse. So, if they take wild risks and lose, taxpayers end up picking up the tab 💸.
- 🥷 **Questionable comeback** – After being bailed out, some banks go back to making super-risky investments, kind of like a student who crams at the last minute, barely passes, and then repeats the same bad study habits.
- 📊 **Investor hype gone wrong** – These false success stories got people excited, drove up stock prices temporarily, and made some investors rich… until the truth came out. Then prices crashed, and a lot of everyday people lost serious money 💔.

💡 **Everyday example:**
Picture your friend borrowing your brand-new skateboard 🛹. They decide to try a crazy stunt because they know if it breaks, *you* will replace it. That's moral hazard, risking big when you're not the one paying for the damage.

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12.1.4 The regulation of the financial system

Systemic risk

Definition: *Systemic risk* is the danger that problems in one part of the financial system spread like dominoes 🁣🁣🁣, knocking everything over. It's not just one bank or company struggling, it's the *entire* financial sector feeling the pain.

💥 **How it happens:**
After a long period of economic growth, people can get a little too confident and start making risky investments; think housing bubbles or overpriced tech stocks. Banks often help fuel this by lending money for those risky bets.

When the bubble bursts 💣:

- Banks may suffer **liquidity problems** (fancy term for "we're short on cash") and become less willing to lend.
- Businesses and households can't borrow easily, which means less spending, less hiring, and higher unemployment 📉.
- Confidence in the economy drops, leading to even less borrowing and spending, a vicious cycle.

Key point: Financial instability and economic instability are tightly linked like tangled earbuds 🎧, it's hard to tell where one starts and the other ends.

✅ **Solution:** Stronger regulation can help prevent a crisis from spreading. But… regulation has its own headaches (see below).

12.1.4 The regulation of the financial system

Systemic risk

🏛 **Issues with Regulation – Good Intentions, Tricky Results**

Regulation is like adding safety rules to a playground. It makes things safer, but it can also slow down the fun.

The challenges:

- 🌎 **Jobs may move overseas** – Tough rules can push financial services to countries with looser regulations.
- 🪪 **Penalties need to be meaningful** – Fines or punishments must be strong enough to keep banks in line, or they'll just shrug them off.
- ⏳ **It's time-consuming and costly** – Designing, enforcing, and monitoring regulations takes a lot of planning, money, and people.
- 📉 **Less lending = slower economy** – If banks have stricter rules and lend less, fewer people buy homes, start businesses, or expand companies.
- 🥷 **Unexpected side effects** – Over-regulation can push risky activities into the "shadow banking" sector (unregulated financial operations), where it's harder to monitor.

💡 **Everyday analogy:**
Systemic risk is like a power outage ⚡ in a city (one failure can black out everything. Regulation is the electrician fixing the wiring) necessary, but sometimes the repairs slow things down or make people look for unofficial, riskier power sources.

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Please see the '12.2 Financial markets and monetary policy Worked Examples' pack for exam style questions.

For more revision notes, tutorials, worked examples and more help visit www.tutorpacks.com