The money transmission mechanism:

When the Bank of England changes the official interest rate it is attempting to influence the overall level of expenditure in the economy. When the amount of money spent grows more quickly than the volume of output produced, inflation is the result. In this way, changes in interest rates are used to control inflation.

The Bank of England sets an interest rate at which it lends to financial institutions. This interest rate then affects the whole range of interest rates set by commercial banks, building societies and other institutions for their own savers and borrowers. It also tends to affect the price of financial assets, such as bonds and shares, and the exchange rate, which affect consumer and business demand in a variety of ways. Lowering or raising interest rates affects spending in the economy.

A reduction in interest rates makes saving less attractive and borrowing more attractive, which stimulates spending. Lower interest rates can affect consumers' and firms' cash-flow – a fall in interest rates reduces the income from savings and the interest payments due on loans. Borrowers tend to spend more of any extra money they have than lenders, so the net effect of lower interest rates through this cash-flow channel is to encourage higher spending in aggregate. The opposite occurs when interest rates are increased.

Lower interest rates can boost the prices of assets such as shares and houses. Higher house prices enable existing home owners to extend their mortgages in order to finance higher consumption. Higher share prices raise households' wealth and can increase their willingness to spend.

Changes in interest rates can also affect the exchange rate. An unexpected rise in the rate of interest in the UK relative to overseas would give investors a higher return on UK assets relative to their foreign-currency equivalents, tending to make sterling assets more attractive. That should raise the value of sterling, reduce the price of imports, and reduce demand for UK goods and services abroad. However, the impact of interest rates on the exchange rate is, unfortunately, seldom that predictable.

Changes in spending feed through into output and, in turn, into employment. That can affect wage costs by changing the relative balance of demand and supply for workers. But it also influences wage bargainers' expectations of inflation – an important consideration for the eventual settlement. The impact on output and wages feeds through to producers' costs and prices, and eventually consumer prices.

We cannot be precise about the size or timing of all these channels. But the maximum effect on output is estimated to take up to about one year. And the maximum impact of a change in interest rates on consumer price inflation takes up to about two years. So interest rates have to be set based on judgments about what inflation might be – the outlook over the coming few years – not what it is today.

(1) Read the text about how the Bank of England can use interest rates to influence inflation. Explain each of the arrows on the chart – how does the change come about, what is the direction of change?

(2) Why, in reality, might these changes not always occur in the way theory might predict?

(3) Why do "interest rates have to be set based on judgments about what inflation might be – the outlook over the coming few years – not what it is today."

(4) What factors should the Bank of England be thinking about when setting interest rates?

Figure 1: From interest rates to inflation - the transmission mechanism of monetary policy