THE ECON GUIDE

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By Zac Galan · theeconguide.com · 2026 exams

What happens when the Bank of England raises interest rates?

Most common Paper 2 chain · 8 marks

1. **The price of borrowing goes up**
   The Bank of England votes to raise its base rate — the price it charges banks to borrow. Banks pass this on immediately: your mortgage, credit card and business loan all get more expensive overnight.

2. **People with mortgages have less to spend**
   8 million UK households have a mortgage. If your monthly payment jumps from £800 to £1,100, that is £300 less every month on food, clothes and going out. Multiply by millions and you remove a huge amount of spending.

3. **Businesses borrow less and invest less**
   A company weighing a new warehouse needs a loan. At 2% it makes sense; at 6% it does not. The project is cancelled. Machines aren't bought. Workers aren't hired.

4. **The economy slows — prices rise more slowly**
   Fewer people spending and fewer firms buying equipment means firms cannot keep raising prices. Inflation slows toward the Bank's 2% target.

5. **But it takes 12–18 months to fully work**
   Rate rises don't cool the economy immediately — mortgage deals reprice slowly and investment is delayed. The Bank is steering by the rear-view mirror.

6. **The big problem: it only fixes one type of inflation**
   It works on demand-pull inflation. In 2022–23, UK inflation hit 11% mainly because energy prices exploded after Russia invaded Ukraine — a supply shock. Raising rates there just caused a recession.

★ MODEL EXAM PARAGRAPH

Higher interest rates make borrowing more expensive, reducing consumer spending (C) and business investment (I), shifting AD left. Demand-pull inflation falls as the output gap closes. However, there is a 12–18 month transmission lag, and rate rises cannot fix cost-push inflation without causing an unnecessary recession.

Why does inflation make people poorer — even when wages are rising?

Inflation and living standards · 6 marks

1. **Wages up 3%, prices up 10%**
   If your pay rises 3% but everything costs 10% more, your £103 buys less than your old £100. You're richer on paper but poorer in reality — falling real wages.

2. **People on fixed incomes suffer most**
   A pensioner on £12,000 can't renegotiate mid-year. When prices rise 10%, their fixed income buys 10% less. The wealthiest ride it out; the most vulnerable cannot.

3. **Businesses become afraid to plan ahead**
   If a builder doesn't know whether steel will cost £500 or £800 next year, he can't quote for a two-year job. Uncertainty makes investment impossible, so firms delay or cancel.

4. **UK goods become too expensive abroad**
   If UK inflation is 10% but Germany's is 4%, UK goods get relatively dearer each year. Foreign buyers switch away, exports fall and manufacturing jobs are threatened.

5. **The cure causes its own pain**
   To bring inflation down the Bank raises rates — curing prices but causing unemployment. In 2022–24 the UK raised rates 14 times in a row, the fastest in 40 years, causing a technical recession.

6. **Not everyone loses — debtors win**
   Borrow £200,000 with 10% inflation and the real value of your debt shrinks by £20,000 in a year. Homeowners with big mortgages are partially protected — their debts get cheaper in real terms.

★ MODEL EXAM PARAGRAPH

Inflation above wage growth reduces real wages and purchasing power — especially for those on fixed incomes. It creates uncertainty that discourages investment and reduces export competitiveness. The Bank's monetary response can itself cause recession — fighting inflation creates its own costs.

Why do factories pollute too much? Negative externalities, simply.

Market failure · 6 marks

1. **The factory only pays for what IT uses**
   A coal power station pays for coal, workers and machinery. But it pumps CO_2 and toxic particles into the air for free — residents get asthma, fish die, crops are damaged. It pays nothing for any of it.

2. **If you don't pay for the damage, you cause too much**
   Because it doesn't pay for the health damage, it ignores that cost and produces as cheaply as possible. This is an externality — a cost imposed on others without their consent.

3. **Society's true costs are far higher**
   Private costs (coal, workers) PLUS health costs, environmental damage and lost tourism = the social cost — far higher than the firm accounts for.

4. **Too much electricity, too much pollution**
   Ignoring external costs, the firm produces more than is good for society. If it had to pay for the damage, it would produce less or invest in cleaner technology.

5. **The government fixes it with a carbon tax**
   Charge £80 per tonne of CO_2 (a Pigouvian tax) and the damage is now in the firm's costs. The rational response: produce less or go cleaner. The tax makes the polluter pay.

6. **But it's incredibly hard to price**
   What is one tonne of CO_2 worth? A child's asthma? Almost impossible to measure. Too low and they overproduce; too high and you harm industry. Getting it exactly right is one of the hardest problems in economics.

★ MODEL EXAM PARAGRAPH

Negative externalities cause MSC > MPC — firms overproduce because they ignore external costs imposed on third parties. The free-market output (Qm) exceeds the social optimum (Qs), creating a deadweight-loss triangle. A Pigouvian tax equal to the marginal external cost can restore the optimum, but accurate valuation is extremely difficult in practice.

Why do nurses get paid less than their work is worth? (Monopsony)

Labour markets and market power · 6 marks

1. **Normally, competition keeps wages fair**
   If three factories all want welders, they bid wages up. The welder goes to the highest bidder. Competition forces employers to pay close to the true value created.

2. **The NHS has virtually no competition for nurses**
   A nurse in most UK towns has one main employer: the NHS. No second hospital next door bidding wages up. One major buyer of a type of labour is a monopsony — the labour-market version of a monopoly.

3. **The NHS uses its dominance to pay less**
   With limited alternatives for nurses, the NHS needn't offer competitive wages. It can pay below the competitive level. Not necessarily deliberate — it's just how buyer power works.

4. **Nurses are also 'stuck'**
   Nursing takes 3 years to train; you can't become a software engineer tomorrow. Low occupational mobility reduces bargaining power — they can't credibly threaten to leave.

5. **A minimum wage can INCREASE employment here**
   The counterintuitive result: in a competitive market a minimum wage above equilibrium cuts jobs. But a monopsonist was suppressing BOTH wages and employment — force wages up and it actually hires MORE, toward the social optimum.

6. **The UK evidence supports this**
   As the National Living Wage rose repeatedly 2016–2024, employment in low-wage sectors did NOT fall significantly — consistent with widespread monopsony power. Perfect competition would have predicted job losses.

★ MODEL EXAM PARAGRAPH

Monopsony allows a single dominant employer (e.g. the NHS) to pay nurses below their MRP and restrict employment below the competitive level. Low occupational mobility reduces workers' ability to threaten exit. Counterintuitively, a minimum wage above the monopsony wage raises both wages and employment. UK NLW evidence is consistent with widespread monopsony in low-wage sectors.

POLICY

What is QE, and why did the Bank create nearly a trillion pounds?

Monetary policy beyond interest rates · 8 marks

1. **Rates hit zero and the Bank ran out of road**
   By March 2009 the Bank had cut rates to 0.5% — almost zero. You can't meaningfully cut below zero. Its main weapon, cheaper borrowing, was exhausted.

2. **The Bank created new electronic money**
   It created new money electronically and used it to buy UK government bonds (gilts) from pension funds, insurers and banks. UK QE eventually reached £895 billion.

3. **The sellers invested their new cash**
   Pension funds that sold gilts now held cash, which earns nothing — so they bought corporate bonds and shares instead, pushing up asset prices across the board.

4. **Asset owners felt wealthier and spent more**
   If your pension pot is worth £300,000 instead of £250,000, you feel richer and spend more. This 'wealth effect' stimulates the economy.

5. **Long-term rates fell — investment encouraged**
   Buying bonds pushes their price up and their yield down. Lower long-term rates make it cheaper for firms and government to borrow, encouraging investment.

6. **The big problem: it mainly helped the wealthy**
   QE benefits asset-owners — shares, property, bonds — who are mostly older and richer. Young renters gained nothing and faced ever-pricier housing. The Bank's own research confirmed QE worsened wealth inequality.

★ MODEL EXAM PARAGRAPH

QE involves the central bank creating new money to buy government bonds, raising asset prices, reducing long-term yields, and stimulating investment and consumption via the wealth effect. It bypasses the zero lower bound. However, QE primarily benefits asset-holders, worsening wealth inequality, and the exit strategy (QT) carries significant financial risk.

You've got 5. There are *27 more.*

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