

Exercise walk-through

5.3

Monetary policy

A-Level Economics

Choose a monetary tool, then explain its route

Monetary policy central bank influences monetary and credit conditions through the .

Tool	Expansionary direction	Why demand might rise
Interest rate	Lower policy rates, passed on to borrowers.	Cheaper credit may support consumption and investment.
Money supply	Increase available money in the simplified model.	With money demand unchanged, lower interest rates can support spending.
Credit regulation	Ease restrictions on lending.	More eligible borrowers may finance spending.

Contractionary changes work in the opposite direction. Banks' willingness to lend and customers' willingness to borrow affect the result.

Turn an interest-rate change into a borrowing cost

Illustrative variable-rate loan; one year, no repayments or fees

A £10000 loan's annual rate rises from 6% to 7%. Calculate interest before and after. Why might this discourage a new investment? What if an existing loan's rate is fixed?

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$$\text{annual interest} = \text{principal} \times \text{annual rate}$$

$$\text{interest}_0 = £10000 \times 0.06 = £600/\text{year}$$

$$\text{interest}_1 = £10000 \times 0.07 = £700/\text{year}$$

The annual cost rises £100; some projects become less attractive. A fixed-rate contract need not change immediately. Policy-rate changes influence commercial rates; they are not automatically identical.

Credit rules can matter even if the rate is unchanged

Hypothetical lending limit, not an actual country's rule

A borrowing limit falls from four times annual income to three times. Income is £40000/year. Calculate the old and new maximum loan. Explain why this is contractionary even with the interest rate unchanged.

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Hypothetical lending limit, not an actual country's rule

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maximum loan = income multiple $\times$ annual income

$$L_0 = 4 \text{ years} \times \text{£}40000/\text{year} = \text{£}160000$$

$$L_1 = 3 \text{ years} \times \text{£}40000/\text{year} = \text{£}120000$$

Some borrowers face a £40000 smaller borrowing ceiling, limiting purchases they can finance. Those who did not need the extra credit may not change spending. Easing the rule reverses this restriction; it does not force borrowing.

Exercises 2.1-2.3

2.1 Define the term *monetary policy*.

[2]

2.2 State the main tool of monetary policy.

[1]

2.3 State two ways a higher interest rate reduces aggregate demand.

[2]

Exercises 2.1-2.3

2.1 Define the term *monetary policy*. [2]

2.1

- the use by the central bank of the interest rate (and the money supply or exchange rate) to influence aggregate demand (2 for a clear definition; 1 for a partial idea)

2.2 State the main tool of monetary policy. [1]

2.2

- the interest rate (1)

2.3 State two ways a higher interest rate reduces aggregate demand. [2]

2.3

- any two of: borrowing is dearer so spending/investment falls; saving is rewarded so consumption falls; the currency rises so exports fall (1 + 1)

Exercises 3.1-3.2

3.1 To reduce demand-pull inflation, a central bank should:

[1]

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A lower the interest rate

B raise the interest rate

C raise government spending

D cut income tax

3.2 Explain how a rise in the interest rate works through the economy to reduce inflation.

[8]

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- B raise the interest rate
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3.1 B

- A higher interest rate lowers AD and slows demand-pull inflation

3.2 Explain how a rise in the interest rate works through the economy to reduce inflation. [8]

3.2

- [8] AO1 1 + AO3 up to 7 (the transmission mechanism) – a higher rate makes borrowing dearer (less consumption and investment) and saving more attractive, and tends to raise the currency (fewer exports, more imports)
- all three lower aggregate demand
- with lower demand, firms raise prices less
- inflation slows

Exercise 3.3

3.3 Discuss whether monetary policy is always effective in controlling inflation. [12]

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3.3

- [12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **For:** the rate is flexible and can be changed quickly, directly affecting borrowing and demand. **Against:** long time lags (a year or more), and in a deep slump even very low rates may not encourage worried firms and households to borrow (a liquidity trap); it cannot fix cost-push inflation easily. Judgement: monetary policy is effective against demand-pull inflation in normal times, but weaker in a slump or against cost-push inflation – it depends on confidence and the cause of inflation