Past-paper walk-through

Money and banking ▪ 9.4

eXercise

Questions in this set

- 9708/31 N25 Q14 ▪ 1 mark
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Question 14

9708/31 N25 ▪ Q14 ▪ 1 mark

14 Which statement about the quantity theory of money is correct?

A It suggests changes in liquidity preference lead to proportional changes in the price level.

B It suggests changes in the money supply lead to proportional changes in the price level.

C It suggests changes in the price level lead to proportional changes in liquidity preference.

D It suggests changes in the price level lead to proportional changes in the money supply.

Solution 14

Answer: **B**

Why

- The quantity theory is $MV = PQ$.
- Assuming velocity and real output are constant, a change in the money supply changes the price level proportionately.
- So it predicts that monetary growth causes inflation – it is about M and P, not about liquidity preference.

Question 15

9708/31 N25 ▪ Q15 ▪ 1 mark

15 What is a part of Keynesian economic analysis?

A a liquidity trap below which interest rates are ineffective

B an equilibrium price that always clears the market

C a small value for the government expenditure multiplier

D a vertical short-run aggregate supply curve

Solution 15

Answer: **A**

Why

- Keynes argued that at very low interest rates people hold money rather than bonds – the liquidity trap.
- Monetary policy then cannot lower rates any further, so it becomes ineffective.
- Markets always clearing, and full employment as the norm, are *classical* propositions instead.

Question 21

9708/31 N25 ▪ Q21 ▪ 1 mark

21 A fall in domestic investment leads to an increase in unemployment.

Which other economic problem is likely to occur as a result?

A an increase in interest rates on loans for house purchases

B an increase in the current account balance of payments deficit

C an increase in the government budget deficit

D an increase in the rate of price inflation

Solution 21

Answer: **C**

Why

- Lower investment means lower aggregate demand and so lower output.
- That reduces incomes and tax revenue while raising benefit payments.
- So the budget deficit worsens, and less investment also reduces future productive capacity.

Question 13

9708/32 N25 ▪ Q13 ▪ 1 mark

13 What is likely to reduce the domestic money supply?

A Banks being allowed to hold a lower liquidity ratio.

B Individuals choosing to hold more money in the form of idle balances.

C The government financing its budget deficit by borrowing from the banking sector.

D The government increasing its borrowing from other countries.

Solution 13

Answer: **B**

Why

- The money supply falls when banks lend less or when money is withdrawn from circulation.
- Holding money as *idle* balances rather than spending it reduces the money actually circulating.
- A *lower* required liquidity ratio would let banks lend more, which increases the money supply.

Question 19

9708/32 N25 ▪ Q19 ▪ 1 mark

19 What would cause an individual's demand curve for an active money balance to move to the left?

A an increase in the frequency of income payments

B an increase in the general price level

C an increase in the individual's income

D an increase in the rate of interest

Solution 19

Answer: **A**

Why

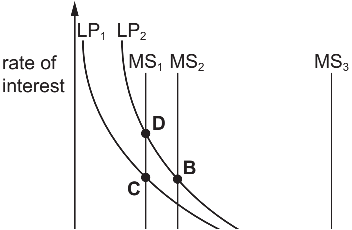
- The active (transactions) demand for money depends on the value and frequency of transactions.
- Being paid more often means less needs to be held between pay days, so demand falls.
- A higher price level would raise the money needed for the same real transactions, shifting demand right.

Question 14

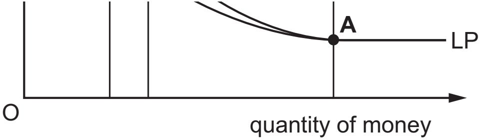
9708/33 N25 ▪ Q14 ▪ 1 mark

14 Sometimes monetary policy is ineffective. The supply of money (MS) is assumed to be controlled by the central bank. The demand for money is LP. There has been an increase in real income in the economy.

Which position on the diagram makes expansionary monetary policy ineffective?



Question 14



Solution 14

Answer: **A**

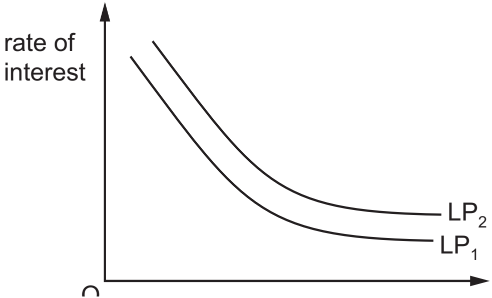
Why

- An increase in the money supply lowers the interest rate along the liquidity preference curve.
- But in a liquidity trap the LP curve is horizontal, so the rate cannot fall further.
- Monetary policy is then ineffective, however much money is added.

Question 20

9708/34 N25 ▪ Q20 ▪ 1 mark

20 The diagram shows two liquidity preference curves LP_1 and LP_2.



Question 20

quantity
of money

What would cause the liquidity preference curve to shift from LP_1 to LP_2?

A There has been a fall in national income.

B There has been a rise in the general price level.

C There has been an increase in government borrowing.

D There has been an increase in the rate of interest.

Solution 20

Answer: **B**

Why

- The liquidity preference curve shifts when the demand for money changes at every interest rate.
- A higher price level or higher national income raises the transactions demand for money.
- So the curve shifts right; a change in the interest rate alone just moves along it.

Question 22

9708/11 J25 ▪ Q22 ▪ 1 mark

22 A government decides to raise most of its revenues from indirect taxes.

What would increase the effectiveness of this policy?

A an increasing trend towards bartering of goods

B increasing interest rates on household savings

C increasing occurrence of informal markets in the economy

D placing taxes on goods and services which have a price-inelastic demand

Solution 22

Answer: **D**

Why

- Indirect taxes are collected when goods and services are bought and sold.
- So the policy works best when transactions are recorded and pass through formal markets.
- Bartering and an informal economy both hide transactions, which would *reduce* the revenue collected.