

5.3 Monetary policy

Name: _____ Class: _____ Date: _____

Total: 24 marks

Objective

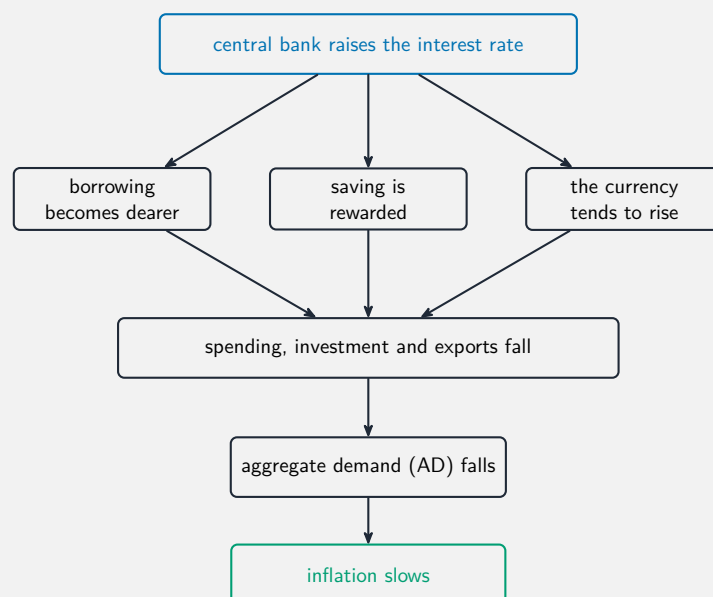
Build the skills to answer exam questions on **monetary policy** 货币政策—the **central bank** 中央银行, the **interest rate** 利率, the **transmission mechanism** 传导机制, and the effectiveness of monetary policy.

You must be able to:

- define monetary policy and name its main tool
- explain the transmission mechanism of an interest-rate change
- analyse the effectiveness of monetary policy

1 Worked examples

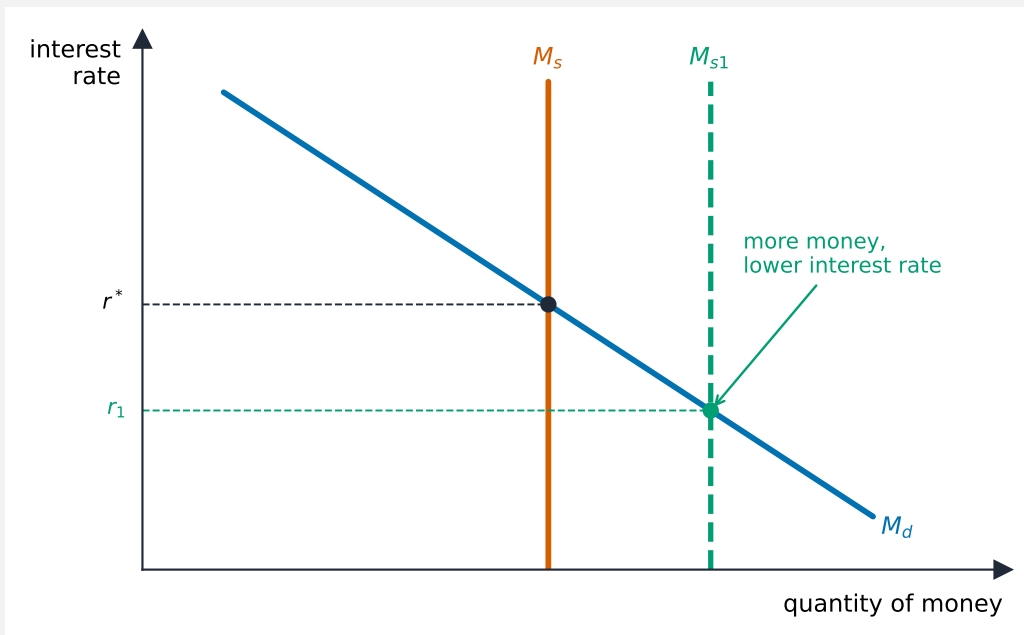
■ The transmission mechanism



A rate rise cuts spending, investment and exports —slowing inflation

- **Monetary policy** 货币政策 is run by the **central bank** 中央银行; its main tool is the **interest rate** 利率.
- A **higher** rate: borrowing dearer → less spending/investment; saving rewarded → less spending; currency rises → fewer exports → **AD falls**, slowing inflation.

- A **cut** does the opposite, raising AD.



The money market: the central bank changes the interest rate that drives the transmission mechanism

Answer shapes: an **Explain** [up to 8] answer should trace the transmission mechanism (AO3); **Discuss** [12] adds a judgement (AO4).

2 Practice

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]

3 Exam-style questions

3.1 To reduce demand-pull inflation, a central bank should: [1]

- **A** lower the interest rate
 - **B** raise the interest rate
 - **C** raise government spending
 - **D** cut income tax
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3.2 Explain how a rise in the interest rate works through the economy to reduce inflation. [8]

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

4 Go further

You are now ready for the real exam questions on this subtopic. Open the **5.3 Monetary policy** past-paper sheet in the Library, or try these in **Practice mode**:

- 9708/11 N25 —Q23 (monetary policy)
- 9708/12 N25 —Q19 (interest rates)
- 9708/12 N25 —Q21 (transmission mechanism)

Solutions

Economics answers are marked by **level of response** against the assessment objectives: award **AO1** knowledge, **AO2** application, **AO3** analysis and **AO4** evaluation.

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 the interest rate (1).

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).

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

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.

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.