Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

2.1

any two: changing the policy interest rate; open market operations: buying or selling government bonds; changing minimum reserve requirements; quantitative easing

2.2

governments may want lower interest rates before elections, even if this causes inflation; an independent bank can take unpopular decisions to keep inflation low, so its targets are more credible

2.3

diagram: interest rate on the vertical axis, quantity of money on the horizontal; downward-sloping D_m and vertical S_m; the central bank increases the money supply: S_m shifts right; at the old rate there is excess money supply, so people buy bonds and the interest rate falls; new equilibrium at a lower interest rate

2.4

real rate $\approx 4 - 6 = \mathbf{-2}\%$; savers' money grows by less than prices rise; so the purchasing power of their savings falls

2.5

multiplier $= 1 \div 0.1 = 10$; maximum money $= \mathbf{\$10\,000}$; any one: banks keep extra reserves; people hold some cash; firms and households may not want to borrow

3.1

(a) action by the central bank to reduce aggregate demand; e.g. raising interest rates / reducing the money supply

(b) higher rates make borrowing dearer and saving more attractive; consumption and investment fall; the currency may rise, so net exports fall; AD shifts left; the price level rises more slowly / inflation falls, but real GDP falls too; correctly labelled diagram showing $\text{AD}_1 \to \text{AD}_2$ with lower P and Y

3.2

award up to [8]: low rates should make borrowing cheaper and raise C and I; but in a deep recession confidence is very low: firms do not invest and households save to pay off debt; banks may be unwilling to lend after losses; rates cannot be cut much below zero (the zero lower bound); QE can lower long-term rates and raise asset prices; but the benefits go mainly to asset owners, raising wealth inequality; fiscal policy may be more effective here: government spending enters AD directly; judgement: monetary policy is weaker in a deep recession and works best with fiscal policy

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