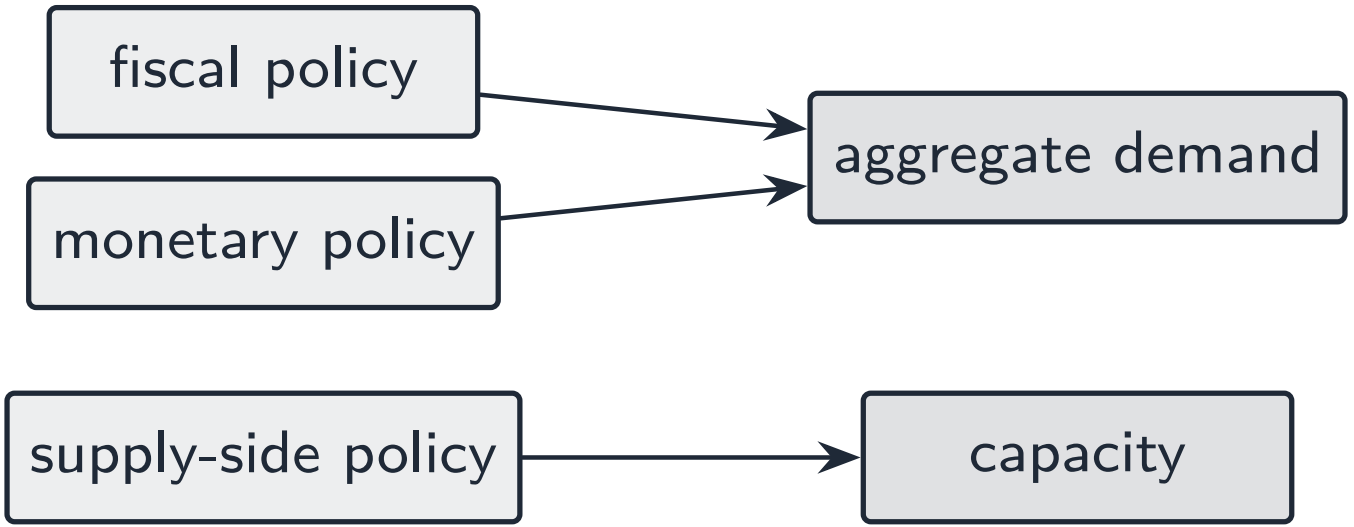
Exercise walk-through

4.6
Demand management: monetary policy

International Baccalaureate · IB Diploma · Economics · SL

Figure: Macroeconomic activity, objectives and policy



- Fiscal and **monetary policy** act on demand; supply-side on capacity
- Match each part of the diagram to the text.

Supply-side policies

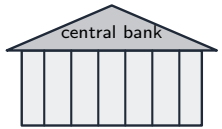
- **Supply-side policies** aim to raise the economy's productive capacity, shifting LRAS to the right.
- **Worked example.** LRAS shifts from 85 to 105 along AD $P = 90 - Y/2$.
- The price level falls from $90 - 85/2 = 47.5$ to $90 - 105/2 = 37.5$ while real GDP rises by 20.
- Unlike demand-side policy, this gives growth without **inflation**.

Key terms (2)

- **Natural rate of unemployment**: the rate of unemployment when the labour market is in equilibrium, made up of frictional, structural and seasonal unemployment.
- **Monetary policy**: the **central bank**'s use of interest rates and the **money supply** to influence **aggregate demand**.
- **Supply-side policy**: policy that aims to increase the economy's productive capacity (LRAS).

Exercises 2.1·2.2

2.1 Outline **two** tools of monetary policy. [2]

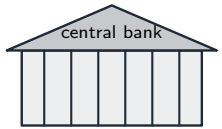


2.2 Explain why many central banks are made independent of government. [2]



Exercises 2.1·2.2

2.1 Outline **two** tools of monetary policy. [2]



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 Explain why many central banks are made independent of government. [2]

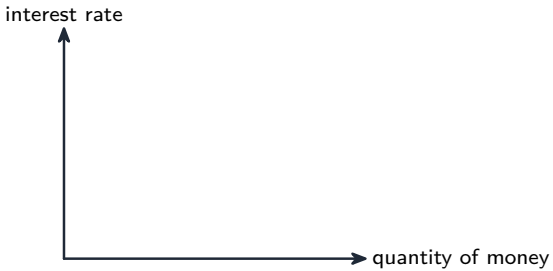


2.2

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

Exercise 2.3

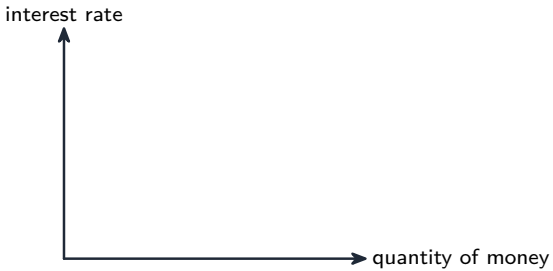
2.3 Using a money market diagram, explain how an increase in the money supply affects the interest rate. [4]



[[drawlines:4]]

Exercise 2.3

2.3 Using a money market diagram, explain how an increase in the money supply affects the interest rate. [4]



[[drawlines:4]]

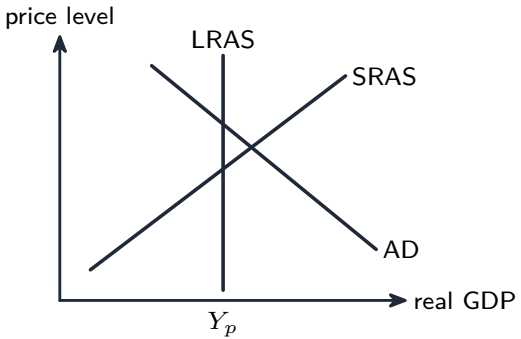
2.3

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

Exercise 3.1 (a)

3.1 Inflation has risen to 7%, well above the central bank's target of 2%.

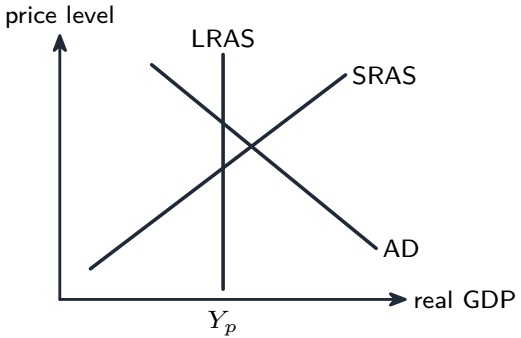
(a) Define **contractionary monetary policy**. [2]



Exercise 3.1 (a)

3.1 Inflation has risen to 7%, well above the central bank's target of 2%.

(a) Define **contractionary monetary policy**. [2]



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

Exercise 3.1 (b)

3.1 Inflation has risen to 7%, well above the central bank's target of 2%.

(b) Using an AD/AS diagram, explain how raising interest rates could bring inflation down. [6]

[[drawlines:6]]

Exercise 3.1 (b)

3.1 Inflation has risen to 7%, well above the central bank's target of 2%.

(b) Using an AD/AS diagram, explain how raising interest rates could bring inflation down. [6]

[[drawlines:6]]

(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 $\mathrm{AD}_1 \rightarrow \mathrm{AD}_2$ with lower P and Y