# 4.6 Demand management: monetary policy

Name: _____ Class: _____ Date: _____ **Total: 16 marks**

**KEY WORDS** central bank • monetary policy • policy interest rate • open market operations • quantitative easing • real interest rate

## Objective

Build the skills to answer exam questions on **monetary policy** : the goals and tools of central banks, the money market, how interest rate changes affect the economy, and the strengths and limits of the policy.

**You must be able to:**

- outline the goals of central banks and the tools of monetary policy
- explain how interest rates are set in the money market
- explain how expansionary and contractionary monetary policy affect AD, output and inflation
- evaluate monetary policy, including its limits in a deep recession

## 1 Key knowledge and worked examples

### ■ Monetary policy

**Central banks** (e.g. the European Central Bank, the US Federal Reserve) usually aim for **low and stable inflation** (often about 2%), plus low unemployment, stable growth and a stable financial system. Many are **independent** of the government, so decisions are not driven by elections.



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**Tools:**

| tool | how it works |
|---|---|
| **policy interest rate** (the rate the central bank charges commercial banks) | changes all borrowing and saving rates |
| **open market operations** | buying government bonds adds money to banks; selling bonds removes it |
| **minimum reserve requirements** | the share of deposits banks must keep; lower reserves allow more lending |
| **quantitative easing (QE)** | large-scale buying of bonds to push long-term interest rates down when the policy rate is already near zero |

**Money market:** the interest rate is set where the **demand for money** (downward sloping) meets the **supply of money** (vertical, fixed by the central bank). More money supply lowers the interest rate.

**Expansionary** (easy) policy cuts interest rates → borrowing is cheaper and saving less attractive → **consumption and investment rise**; the currency may fall, so **net exports rise** → **AD shifts right** → higher real GDP, lower unemployment, some inflation. **Contractionary** (tight) policy does the opposite to fight inflation.

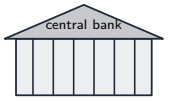
**Strengths:** small, quick, step-by-step changes; independent central bank; no direct effect on the budget.

**Limits:** **time lags** (often 1–2 years for the full effect); in a deep recession low confidence means people do not borrow even at very low rates (rates cannot go much below **zero**); it cannot fix **cost-push** inflation without hurting output; high rates hurt borrowers and can push up the exchange rate.

**Answer shapes:** money market diagram → interest rate change → the transmission to $C$, $I$ and $(X - M)$ → AD/AS result → evaluation.

## 2 Practice

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



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




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

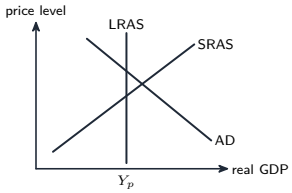



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## 3 Exam-style questions

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

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




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

[[drawlines:6]]



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