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

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