Exercise walk-through

Monetary policy ▪ 4.3

eXercise

You must be able to

- define monetary policy and the interest rate
- explain how higher and lower interest rates affect the economy
- analyse the use of monetary policy

Method — Interest rates

- **Monetary policy 货币政策**: the **central bank 中央银行** changes the **interest rate 利率**.
- **Lower rates:** borrowing cheaper → more spending and **investment 投资** → more growth and jobs (but maybe inflation).
- **Higher rates:** borrowing dearer → less spending → less inflation (but maybe more unemployment).

Answer shapes: K + App + An + Ev (a justified judgement, for discuss questions).

Method — Interest rates

The central bank runs monetary policy

Method — Interest rates

Demand-pull	**Cost-push**
total demand grows faster than supply → "too much money chasing too few goods"	firms' costs rise (wages, materials) → they raise prices to cover them

Exam: demand-pull = AD excess; cost-push = rising costs (wages, oil, imported inputs)

Demand-pull comes from too much spending; cost-push from rising costs

Practice 2.1 ▪ 2 marks

Define the term *monetary policy*.

Solution 2.1

Method: Interest rates

Worked steps

the central bank changing interest rates (and the money supply) to manage the economy (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 1 mark

State the effect of a **fall** in interest rates on consumer spending.

Solution 2.2

Method: Interest rates

Worked steps

consumer spending rises (1).

Practice 2.3 ▪ 1 mark

State who sets the interest rate in an economy.

Solution 2.3

Method: Interest rates

Worked steps

the central bank (1).

Exam-style 3.1 ▪ 1 mark

To reduce inflation, a central bank should:

A lower interest rates

B raise interest rates

C raise government spending

D cut income tax

Solution 3.1

Method: Interest rates

A lower interest rates

B raise interest rates ✓

C raise government spending

D cut income tax

Worked steps

B. Higher interest rates reduce spending and so reduce inflation.

Exam-style 3.2 ▪ 4 marks

Explain how a rise in interest rates could reduce inflation.

Solution 3.2

Method: Interest rates

Worked steps

[4] K 1 + An up to 3 — a higher interest rate makes borrowing dearer and saving more rewarding → people and firms spend and invest less → total demand falls → with lower demand, firms raise prices less → inflation falls.

Exam-style 3.3 ▪ 6 marks

Analyse the effects on an economy of a large cut in interest rates.

Solution 3.3

Method: Interest rates

Worked steps

[6] K/App/An — a large cut in interest rates makes borrowing cheaper and saving less rewarding $\rightarrow$ households and firms borrow and spend more, and firms invest more $\rightarrow$ total demand rises $\rightarrow$ output and jobs rise (more growth and lower unemployment) $\rightarrow$ but if demand grows faster than supply, prices may rise $\rightarrow$ so it can cause higher inflation.