Exercise walk-through

Monetary policy ▪ 5.3

eXercise

You must be able to

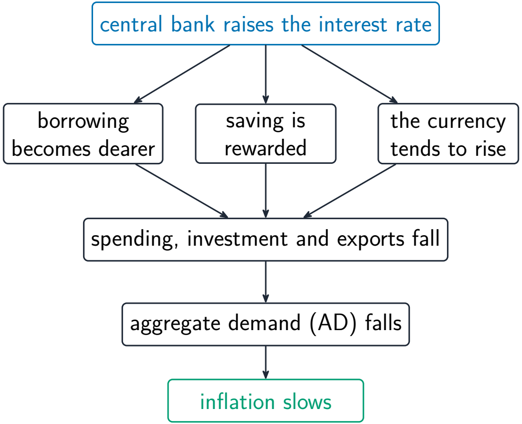
- define monetary policy and name its main tool
- explain the transmission mechanism of an interest-rate change
- analyse the effectiveness of monetary policy

Method — The transmission mechanism

- **Monetary policy 货币政策** is run by the **central bank 中央银行**; its main tool is the **interest rate 利率**.
- A **higher** rate: borrowing dearer → less spending/investment; saving rewarded → less spending; currency rises → fewer exports → **AD falls**, slowing inflation.
- A **cut** does the opposite, raising AD.

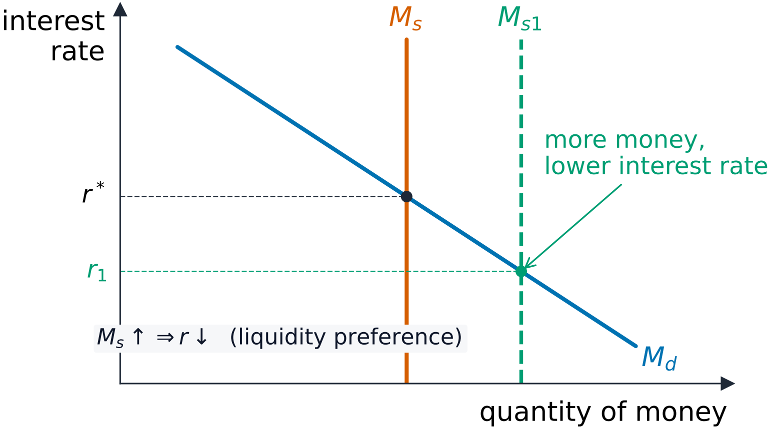
Answer shapes: an **Explain [up to 8]** answer should trace the transmission mechanism (AO3); **Discuss [12]** adds a judgement (AO4).

Method — The transmission mechanism



A higher interest rate works through three channels to lower AD

Method — The transmission mechanism



The central bank sets the interest rate where money demand meets money supply

Practice 2.1 ▪ 2 marks

Define the term *monetary policy*.

Solution 2.1

Method: The transmission mechanism

Worked steps

the use by the central bank of the interest rate (and the money supply or exchange rate) to influence aggregate demand (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 1 mark

State the main tool of monetary policy.

Solution 2.2

Method: The transmission mechanism

Worked steps

the interest rate (1).

Practice 2.3 ▪ 2 marks

State two ways a higher interest rate reduces aggregate demand.

Solution 2.3

Method: The transmission mechanism

Worked steps

any two of: borrowing is dearer so spending/investment falls; saving is rewarded so consumption falls; the currency rises so exports fall $(1 + 1)$.

Exam-style 3.1 ▪ 1 mark

To reduce demand-pull inflation, a central bank should:

A lower the interest rate

B raise the interest rate

C raise government spending

D cut income tax

Solution 3.1

Method: The transmission mechanism

- **A** lower the interest rate
- **B** raise the interest rate ✓
- **C** raise government spending
- **D** cut income tax

Worked steps

B. A higher interest rate lowers AD and slows demand-pull inflation.

Exam-style 3.2 ▪ 8 marks

Explain how a rise in the interest rate works through the economy to reduce inflation.

Solution 3.2

Method: The transmission mechanism

Worked steps

[8] AO1 1 + AO3 up to 7 (the transmission mechanism) — a higher rate makes borrowing dearer (less consumption and investment) and saving more attractive, and tends to raise the currency (fewer exports, more imports) → all three lower aggregate demand → with lower demand, firms raise prices less → inflation slows.

Exam-style 3.3 ▪ 12 marks

Discuss whether monetary policy is always effective in controlling inflation.

Solution 3.3

Method: The transmission mechanism

Worked steps

[12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **For:** the rate is flexible and can be changed quickly, directly affecting borrowing and demand. **Against:** long time lags (a year or more), and in a deep slump even very low rates may not encourage worried firms and households to borrow (a liquidity trap); it cannot fix cost-push inflation easily. Judgement: monetary policy is effective against demand-pull inflation in normal times, but weaker in a slump or against cost-push inflation — it depends on confidence and the cause of inflation.