A-LEVEL ECONOMICS • EXERCISE SHEET

# 5.3 Monetary policy

Name: ____________ Class: ________ Date: __________ **Total: 26 marks**

**KEY WORDS** interest rate 利率 • monetary policy 货币政策 • central bank 中央银行 • exchange rate 汇率 • money supply 货币供给

## Objective

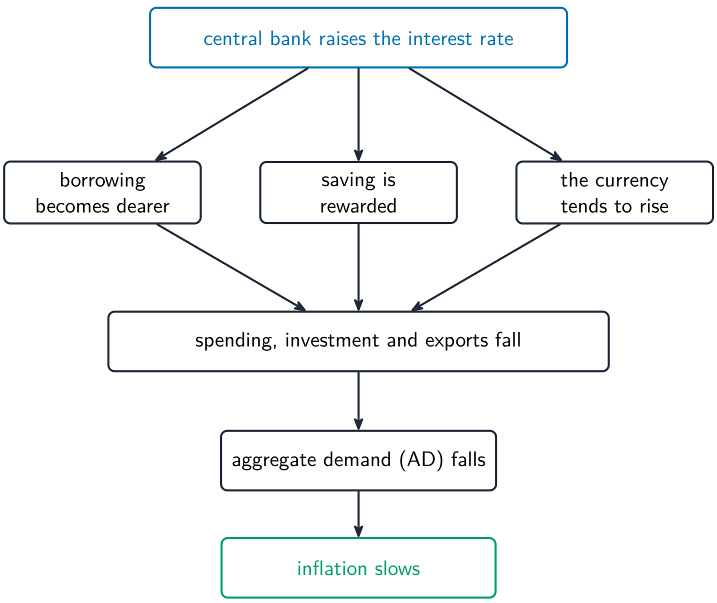
Build the skills to answer exam questions on **monetary policy** 货币政策 — the **central bank** 中央银行, the **interest rate** 利率, the **transmission mechanism** 传导机制, and the effectiveness of monetary policy.

**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

## 1 Worked examples

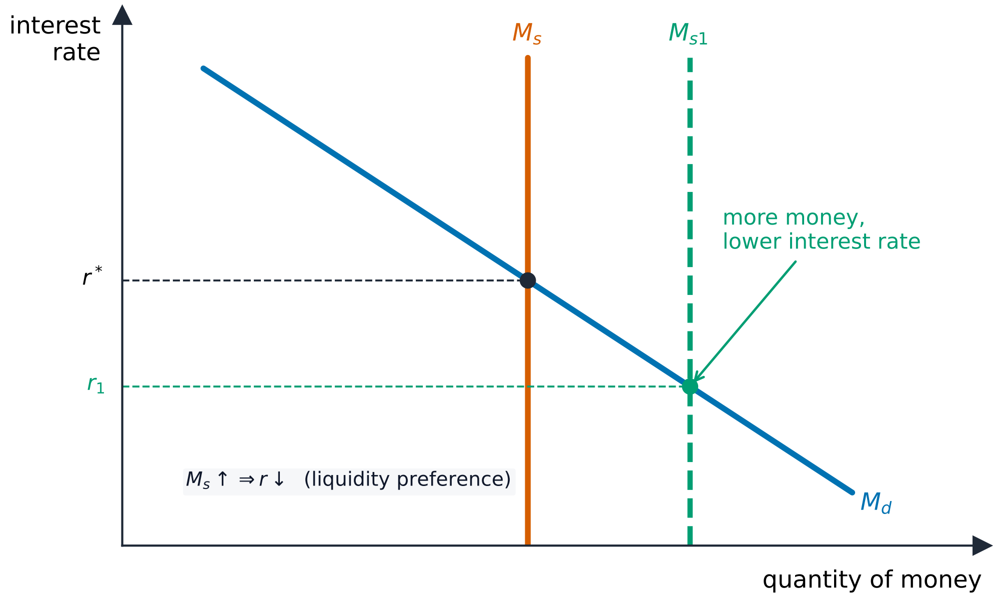
### ■ The transmission mechanism




*A rate rise cuts spending, investment and exports — slowing inflation*

- **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.




*The money market: the central bank changes the interest rate that drives the transmission mechanism*

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

## 2 Practice

**2.1** Define the term *monetary policy.* [2]

**2.2** State the main tool of monetary policy. [1]

**2.3** State two ways a higher interest rate reduces aggregate demand. [2]

## 3 Exam-style questions

**3.1** To reduce demand-pull inflation, a central bank should: [1]

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

**3.2** Explain how a rise in the interest rate works through the economy to reduce inflation. [8]

**3.3** Discuss whether monetary policy is always effective in controlling inflation. [12]

## Solutions

Economics answers are marked by **level of response** against the assessment objectives: award **AO1** knowledge, **AO2** application, **AO3** analysis and **AO4** evaluation.

**2.1** 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).

**2.2** the interest rate (1).

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

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

**3.2** *[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.

**3.3** *[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.