Qurious Education

Monetary Policy Questions (MCs & Essays)

GCE A-LEVEL ECONOMICS

Qurious Education

18 Which one of the following is an example of expansionary monetary policy?
An increase in

A interest rates. ○

B the money supply. ○

C the exchange rate. ○

D government expenditure. ○

[1 mark]

Qurious Education

1 8 Which one of the following is an example of expansionary monetary policy?
An increase in

A interest rates.

B the money supply.

C the exchange rate.

D government expenditure.

[1 mark]

(c) If a government takes decisions to target a budget surplus, this is an example of:

(1)

☐ **A** contractionary monetary policy

☐ **B** discretionary fiscal policy

☐ **C** expansionary fiscal policy

☐ **D** expansionary monetary policy

(Total for Question 4 = 5 marks)

Qurious Education

(c) If a government takes decisions to target a budget surplus, this is an example of:

(1)

- A contractionary monetary policy
- B discretionary fiscal policy
- C expansionary fiscal policy
- D expansionary monetary policy

(Total for Question 4 = 5 marks)

Qurious Education

1 7 The table below shows four possible combinations of circumstances facing the UK economy. All other things being equal, which one of the following combinations is most likely to lead the Monetary Policy Committee of the Bank of England to lower Bank Rate?

	Output gap	Exchange rate	Inflation rate	
A	Negative	Falling	Above target	○
B	Negative	Rising	Below target	○
C	Positive	Falling	Below target	○
D	Positive	Rising	Above target	○

[1 mark]

1 7 The table below shows four possible combinations of circumstances facing the UK economy. All other things being equal, which one of the following combinations is most likely to lead the Monetary Policy Committee of the Bank of England to lower Bank Rate?

	Output gap	Exchange rate	Inflation rate
A	Negative	Falling	Above target
B	Negative	Rising	Below target
C	Positive	Falling	Below target
D	Positive	Rising	Above target

[1 mark]

2 0 A bank makes a new loan to a customer. All other things being equal, which combination of events, **A**, **B**, **C** or **D**, shows what will happen?

	Bank's liabilities	Bank's assets	Money supply	
A	Increase	Increase	Increases	○
B	Increase	Fall	Increases	○
C	Fall	Increase	Falls	○
D	Fall	Fall	Falls	○

[1 mark]

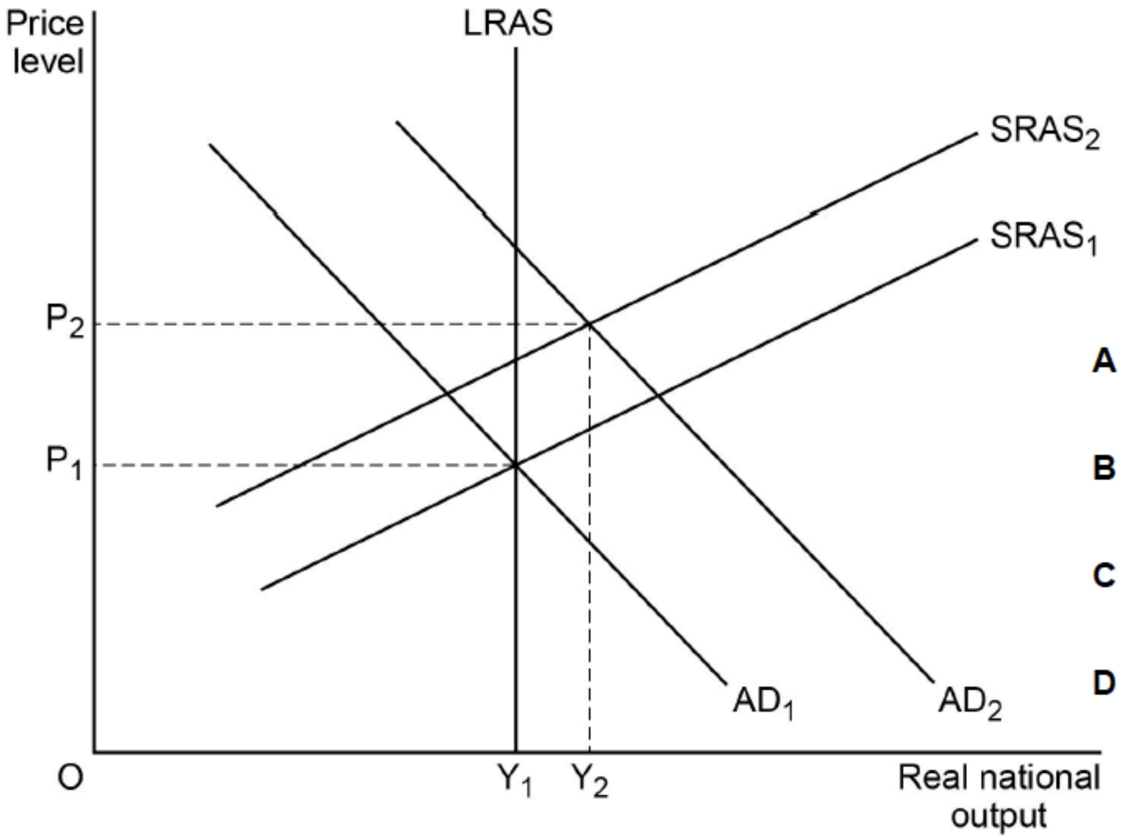
Qurious Education

2 0 A bank makes a new loan to a customer. All other things being equal, which combination of events, **A**, **B**, **C** or **D**, shows what will happen?

	Bank's liabilities	Bank's assets	Money supply
A	Increase	Increase	Increases
B	Increase	Fall	Increases
C	Fall	Increase	Falls
D	Fall	Fall	Falls

[1 mark]

2 5 The diagram below shows two aggregate demand (AD) curves, two short-run aggregate supply (SRAS) curves, and the long-run aggregate supply (LRAS) curve for an economy.



The increase in the price level from P_1 to P_2 raises the rate of inflation above the target rate set by the government. In an attempt to bring inflation back to its target rate, the central bank announces a change in interest rates. Other things being equal, this is most likely to

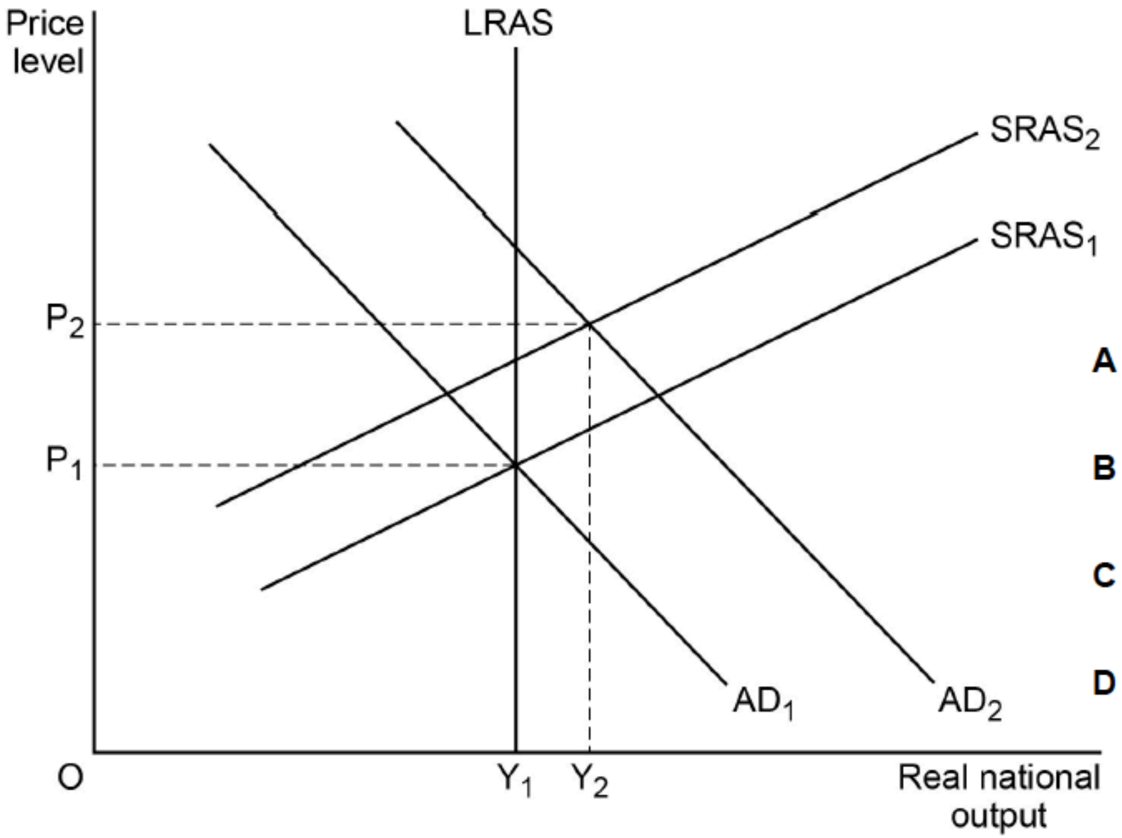
A create upward pressure on the exchange rate.

B increase bond prices.

C make business loans more affordable.

D reduce the cost of servicing the national debt.

2 5 The diagram below shows two aggregate demand (AD) curves, two short-run aggregate supply (SRAS) curves, and the long-run aggregate supply (LRAS) curve for an economy.



The increase in the price level from P_1 to P_2 raises the rate of inflation above the target rate set by the government. In an attempt to bring inflation back to its target rate, the central bank announces a change in interest rates. Other things being equal, this is most likely to

A create upward pressure on the exchange rate.

B increase bond prices.

C make business loans more affordable.

D reduce the cost of servicing the national debt.

Qurious Education

*(c) With reference to the information provided and your own knowledge, to what extent might monetary policy help the UK government achieve its macroeconomic objectives?

(30)

Extract 2
Inflation

Recessions are normally associated with falling inflation rates. However, since the recession started in 2008 the Bank of England's Monetary Policy Committee (MPC) has overseen several periods in which inflation has exceeded the upper limit of the target inflation rate's tolerance. There have been four sources of inflationary pressure. First, oil prices rose sharply because of popular unrest in many Arab nations which led to the development of uncertainty around the security of supply. Secondly, a period of bad weather resulted in harvest failure in many areas and wheat prices soared. In addition, the sterling exchange rate has weakened and since 2008 it has fallen by around 25% against the U.S. dollar. A final factor was the increase in VAT from 15% to 17.5% in January 2010 and then in January 2011 it was raised to 20%.

The monetary tools available to the MPC of the Bank of England have most impact on the demand side of the economy, which has been weak and was not the source of the inflationary shocks. The danger with raising interest rates to achieve the inflation target in the short term is that they might weaken the economy further.

(Based on a variety of media sources)

Question Number	Indicative content	Mark
(c) QWC i-iii	Up to 6 marks • Identification of a macroeconomic objective (maximum 2 marks) o Economic Growth o Low and stable inflation o Reduction in unemployment o Reduction of the deficit on the current account of the balance of payments Accept o Reduction of the national debt or balancing the budget o Making the distribution of income more equal o Protection of the environment • Define monetary policy (2) • Diagram showing AD shift and/or AS shift consistent with analysis; axes labelled (1), equilibria labelled (1), AD/AS lines labelled (1), correct shift (1). No marks for diagram if shift inconsistent with analysis. Explanation of how the monetary policies might help achieve government objectives 12 marks (3 x 4 marks or 2 x 6 marks); Marks could be obtained as follows: Link between interest rates and an objective (2) and transmission mechanism explained (2/4). Must be link between monetary policy and objective. • Fiscal Policy constrained by austerity promises because of national debt • MPC remains independent with control of interest rates and free of political interference. This helped prevent inflation named target has been clear 2% inflation (+/-1%) and transparency and openness maintained (open letters to chancellor from 2007) These led to reduced inflationary expectations which is self-fulfilling to some extent. This helps growth, reduce the balance of payments deficit, unemployment and price stability	(30)

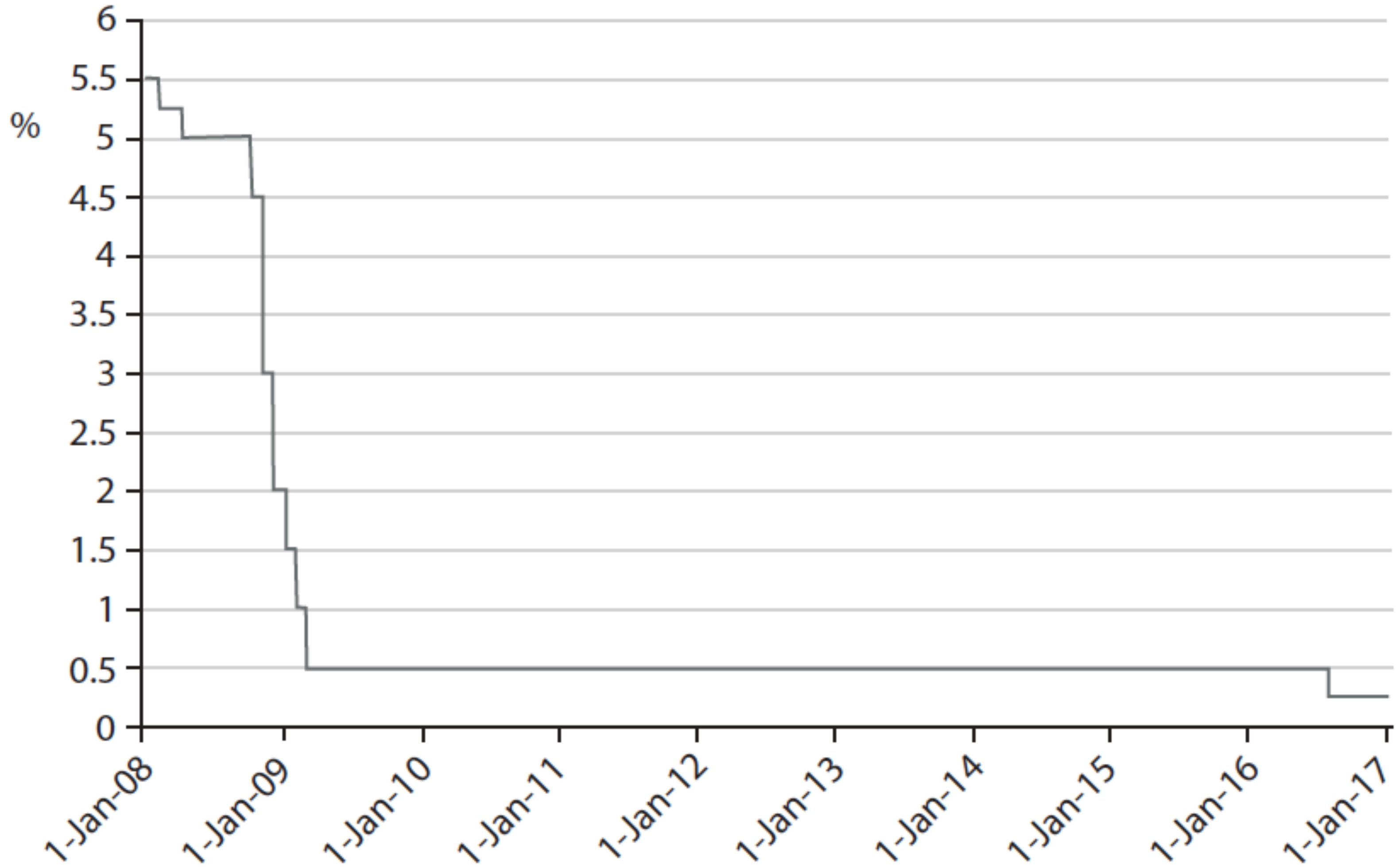
Qurious Education

• An increase in interest rates designed to reduce rate of inflation; lower AD improving export price competitiveness • Low interest rates and/or quantitative easing help prevent deflation, high unemployment and low growth • Maintained financial stability in the banking sector helping growth and reduce unemployment and improve price stability • Low interest rates and/or quantitative easing encourage investment, growth, reduce the deficit on the current account of the balance of payments and reduce unemployment • Low interest rates and/or quantitative easing encourage consumption and growth and reduce unemployment

Evaluation 12 marks (2 x 6 marks or 3 x 4 marks or 6 + 4 + 2 marks); Fluctuating state of the economy had inevitable effect on inflation

- Fluctuating state of the economy had inevitable effect on inflation
- Inflation in the recession has been caused by cost push inflation outside the Bank of England's control
- Looking at Figure 1, out of tolerance but not out of control
- Changed target to CPI which was more stable than RPI possibly because of absence of volatile housing market and mortgage interest payments
- Financial stability to some extent has taken priority and the MPC has had loose monetary policy while fiscal policy remained tight
- Uncertainty of effect of Quantitative Easing
- Vicious cycle of deflation was avoided in 2009
- Other factors such as cheap imports in the early 2000s
- Weak unions have prevented the wage-price spiral
- Other issues were neglected such as exchange rate stability to promote trade
- Conflicts of objectives

3 UK base interest rate, January 2008 to January 2017



(Source: Bank of England, http://www.bankofengland.co.uk/boeapps/iadb/Repo.asp)

(a) With reference to the chart above, explain **one** factor that the Monetary Policy Committee (MPC) of the Bank of England may have considered when reducing the base interest rate.

(3)

(g) Evaluate demand-side policy responses to the Global Financial Crisis of 2008.

(20)

Extract A

Britons should not fear rise in interest rates

The Monetary Policy Committee (MPC) of the Bank of England is prepared to raise interest rates "in the near future" if inflation increases, one of its senior policymakers has warned.

Kristin Forbes, a member of the MPC, said a rise in borrowing costs would also be necessary should household debt reach unhealthy levels. However, she stressed that this was not yet a cause for concern.

With the UK's base rate of interest at 0.5% and inflation at a record low and expected to be negative, the MPC is currently under no pressure to raise interest rates, despite Britain's economic recovery.

UK inflation is being driven lower by the slump in global oil prices, which have roughly halved since summer 2014, and the Bank's governor Mark Carney warned earlier this month that a strong domestic economy would translate into higher UK inflation over the medium term. "The most likely next move in monetary policy is an increase in interest rates. The message is clear," Carney said.

Forbes said that "even the more lagged effects of the rise in the value of the pound will likely peak in the first part of this year and also gradually fade. Inflation will then most likely bounce back.

"Since interest rates take well over a year to be fully effective, they should be adjusted to respond to inflationary risks at that time horizon – when all of these effects have diminished – rather than respond to today's inflation."

(Source: adapted from http://www.theguardian.com/money/2015/feb/24/ britons-should-not-fear-rise-in-interest-rates- when-they-come-says-boe-member)

Question Number	Indicative content	Mark
6 (g)	**Knowledge 4, Application 4, Analysis 6,** • Understanding of demand-side policies to include monetary and/or fiscal policy • Understanding of Global Financial Crisis of 2008 in UK and/or other countries • AD/AS diagram may be used to aid effective analysis Examples of demand-side policies that students may discuss. These need to be clearly linked to responding to a financial crisis: • Reduction of interest rates to boost aggregate demand in a recession. • Quantitative easing to increase liquidity • Bailout of banks • Increase in government spending e.g. infrastructure • Cut in taxation	**(14)**

Qurious Education

Question Number	Indicative content	Mark
6 (g) continued	**Evaluation 6** • Short run/long run issues, e.g. interest rates take at least a year to have a full effect • Interest rates cannot be cut much further; relative interest rates are important • The uncertainty of the impact of QE, e.g. do banks pass on the credit, is it inflationary? • Size of the multiplier • Problems in financing government deficit/fiscal austerity issues • Impact of different tax cuts, e.g. income tax vs. VAT • Relative success of US or other country's policies in response to the crisis compared to the UK	**(6)**

(d) Discuss the likely success of the ECB's quantitative easing programme in moving Eurozone inflation closer to 'the central bank's ceiling of 2%' (Extract A, line 17).

(12)

Extract A

European Central Bank disappoints markets with weaker than expected stimulus

Mario Draghi, president of the European Central Bank (ECB), surprised financial markets in November 2015 with a less ambitious package of monetary stimulus than many had anticipated.

The ECB cut its base interest rate by 0.1% to minus 0.3% in order to encourage private banks to lend funds to companies and households rather than deposit them at the central bank. The central bank agreed to extend its €60 billion (£45 billion) monthly bond-buying quantitative easing (QE) programme for a further six months. The ECB's €1.1 trillion QE scheme had originally been due to end in September 2016.

"We are doing more because it works," Mr Draghi said. Yet the ECB did not increase the size of its monthly asset purchases and also disappointed those expecting that it would cut interest rates more aggressively.

The euro rose almost 3% against the dollar to $1.08 after the announcement. Italian and Spanish bond yields both jumped by 0.27% to 1.62% and 1.72% respectively.

The ECB's economists reduced their inflation forecasts for the next two years. They now predict consumer prices in the Eurozone rising by just 1% in 2016 and 1.6% in 2017 – still below the central bank's ceiling of 2%. In November 2015, the inflation rate was just 0.1% and core inflation, excluding volatile items such as fuel and food, dropped to 0.9%.

Mr Draghi stressed again that monetary policy alone could not restore the Eurozone to economic health. He called for looser fiscal policy among member states to support aggregate demand and more rapid implementation of supply-side reforms. "In order to reap the full benefits from our monetary policy measures, other policy areas must contribute decisively," he said.

(Source: http://www.independent.co.uk/news/business/news/ecb-disappoints-traders-with-weaker-than-expected-stimulus-a6759786.html, 4th December 2015)

Question Number	Indicative content	Mark
6(d)	**Knowledge 2, Application 2, Analysis 4,** ECB QE programme is effective: • Explanation of process of QE • should encourage banks to increase lending and thus hopefully increase consumption/investment • Inflation/GDP may well have been much lower without QE • Confidence of markets would have been much lower without QE • QE programme to be extended for a further 6 months • Lower interest rates encourages consumption/investment, thus increasing AD and therefore inflation • Low government bond yields for Eurozone countries • Depreciation of the Euro affecting X-M NB One side of this argument should count as KAA and the opposing argument as Evaluation	**(8)**

Question Number	Indicative content	Mark
6(d) continued	**Evaluation 4** ECB QE programme isn't effective: • Inflation likely to remain below target into at least 2017 • Low inflation is largely down to factors outside the central bank's control (e.g. oil prices) • Lack of confidence among firms and consumers meaning they are not responding as the ECB would like to the QE programme • Banks are still reluctant to lend money to firms and consumers • Time lags • Extension of QE programme suggests that it hasn't worked • Other policies may be more effective NB One side of this argument should count as KAA and the opposing argument as Evaluation	**(4)**