AQA A-LEVEL ECONOMICS · 7136

ECONOMICS



EXAM QUESTION PACK

3.2.4.3 CENTRAL BANKS AND MONETARY POLICY

SCORE	PERCENTAGE
/749	%

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1.

The European Union Context Extract E (lines 20−22) states: '…it becomes very difficult to further stimulate domestic demand as real interest rates approach zero. On the other hand, low interest rates contributed to the Swedish currency, the Krona, falling sharply in value...'.

Explain the term 'real interest rates' **and** analyse why low interest rates may lead to a fall in the value of a currency on the foreign exchange market.

[9 marks]

2.

'It is better to do everything you can to prevent deflation before it begins, even if there is only a small chance of it occurring.'

Assess the impact on UK macroeconomic performance of a prolonged period of deflation.

[25 marks]

3.

'It is better to do everything you can to prevent deflation before it begins, even if there is only a small chance of it occurring.'

Explain how monetary policy might be used to prevent a period of deflation.

[15 marks]

4.

The European Union Context Extract D (lines 13–14) argues that it 'is not difficult to understand why the pound has fallen against the euro and other currencies'.

Explain what is meant by 'the pound has fallen against the euro and other currencies' **and** analyse **two** determinants of such a fall.

[9 marks]

5.

An economy which is enjoying rapid economic growth experiences a significant rise in the external value of its currency within a floating exchange rate system.

Evaluate the possible macroeconomic consequences for an economy of a rise in the exchange rate of its currency.

[25 marks]

6.

The deficit on the UK balance of trade in goods and services rose from £26 billion in 2003 to £44 billion in 2008.

Evaluate government policies which might bring about a reduction in the UK deficit on the balance of trade in goods and services.

[25 marks]

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7. An economy which is enjoying rapid economic growth experiences a significant rise in the external value of its currency within a floating exchange rate system.

Explain the factors which may lead to a rise in the exchange rate of a currency within a floating exchange rate system.

[15 marks]

8. 'While it is necessary to have macroeconomic policy objectives, such as price stability and full employment, they can sometimes prove difficult to reconcile.'

Discuss ways in which government economic policies can be used to try to reconcile conflicts between macroeconomic objectives.

[25 marks]

9. In November 2011, the UK inflation rate was 4.8%, the rate of unemployment was 8.3%, while Bank Rate remained at 0.5%.

To what extent are low interest rates appropriate in the UK at a time of high inflation?

[25 marks]

10. 'Oil, as a form of energy, reigns supreme but it has brought significant problems to economies in terms of inflation in particular, and the potential for economic instability in general.'

Explain the main causes of inflation.

[15 marks]

11. 'For a strong recovery there is a need to encourage spending, ideally by businesses but also by households in the short term.'

Discuss the importance of low interest rates in bringing about a recovery from recession in an economy such as the UK.

[25 marks]

12. UK exports of goods which, in 2002, were valued at £187 billion, had risen to £228 billion in 2009.
The deficit on the UK balance of trade in goods rose from £48 billion in 2002 to £82 billion in 2009.

Explain **three** possible reasons for growth in the value of an economy's exports of goods.

[15 marks]

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13. Weaknesses in the UK balance of trade in goods persist, with a deficit of £27.6 bn in the third quarter of 2011, compared, for example, to £23.3 bn in the same quarter in 2010.

Explain **three** reasons for a country such as the UK experiencing persistent deficits in the balance of trade in goods.

[15 marks]

14. 'The avoidance of price deflation must always be the major macroeconomic objective.'

Evaluate the view that the avoidance of price deflation should always be the major macroeconomic objective.

[25 marks]

15. 'When the exchange rate of a country's currency causes problems, it may be down to free market orces, but government intervention might be to blame.'

Assess the importance of a floating exchange rate to a country trying to achieve macroeconomic stability.

[25 marks]

16. **The Global Context Extract B** (lines 15−16) argues: 'An increasing global inflation problem could have serious consequences for all aspects of UK macroeconomic performance, including the balance of payments and employment.'

Using the data and your economic knowledge, discuss the possible impact on the UK balance of payments of an increasing rate of inflation throughout the global economy.

[25 marks]

17. 'Economic shocks can bring with them significant consequences for macroeconomic performance, as the UK knows only too well.'

Using at least **one example of each**, explain how demand-side and supply-side shocks might harm a country's economic growth.

[15 marks]

18. Savings often provide the funds for investment. In 1997, the UK saving ratio stood at 13%, at the beginning of the financial crisis in 2007 it was only 5% and by 2014 it had risen slightly to 7%.

Evaluate the likely impact of a fall in the saving ratio on the performance of the UK economy.

[25 marks]

19. **The Global Context Extract C** (lines 12−13) states that the Quantity Theory of Money 'predicts a direct relationship between increases in the money supply and increases in the price level'.

Explain the term 'price level' **and** analyse how increases in the money supply of an economy may bring about increases in the price level in that economy.

[9 marks]

20. **THE GLOBAL CONTEXT**

Extract B: Inflation never quite goes away

Governments around the world seeking a cure for inflation accept that such a cure may never be achieved. They recognise, therefore, that the next best thing is effective control in order to secure economic stability and sustained economic growth. Even then, past experience suggests that inflation will never be fully under control. Governments recognise that there may be both national and international forces at work which have a bearing on prices. International causes of inflation are inevitably going to be more difficult, or impossible, for a country to control than those whose origins are from within that country.

Some economists might argue that a weak global economy can help to suppress inflation but this weakness, if it persists, will have costs in terms of jobs and living standards. In any case, there may still be pessimism about inflation in the long term. As growth strengthens both in emerging and advanced economies, consumer demand, energy costs, primary commodity prices and wage costs are certain to rise. Agricultural commodity prices, for example, have fallen in recent decades but a significant upward trend could occur. Such a trend will be reinforced by the growth of a global population, now over 7 billion. An increasing global inflation problem could have serious consequences for all aspects of UK macroeconomic performance, including the balance of payments and employment. It breeds uncertainty for government, consumers and businesses and raises expectations of future inflation. Because it affects competitiveness and can disrupt trade and investment flows, the impact on both the current and the capital accounts of the balance of payments needs to be assessed. It is also likely that worsening inflation can halt any hesitant recovery. Overall, economic instability can be expected.

Source: news reports, 2012

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21. **THE GLOBAL CONTEXT**

Extract C: Is money the root of all evil in the UK?

In September 2011, UK inflation, as measured by the CPI, was 5.2%. By June 2012, it was down to 2.4%. This fall has resulted from reductions in global energy and food prices, as well as a stronger pound and significant price reductions by retailers. The fear of some economists is that these factors will be of a temporary nature, especially when recovery gets under way nationally and globally, and inflation will prevail once more.

Such fears have led these economists to criticise the Bank of England for continuing with its loose monetary policy of low interest rates and quantitative easing. They accept that this policy was pursued in good faith in order to generate economic recovery and prevent deflation, but point to continuing disappointing performance. They fear that the main consequence will be inflation and point to the Bank's own view in its Inflation Report of August 2012 that 'considerable uncertainty surrounds the inflation outlook'.

The Quantity Theory of Money is relevant here. It predicts a direct relationship between increases in the money supply and increases in the price level. Increases in the money supply can begin to influence such factors as interest rates and the exchange rate, as well as business and consumer confidence. When the feared impact of increases in the money supply is added to the anticipated global inflationary forces, it is argued that UK inflation will inevitably rise. As for the global economy, rising inflation could also be a major obstacle to any UK economic recovery.

Source: news reports, 2012

22. Savings often provide the funds for investment. In 1997, the UK saving ratio stood at 13%, at the beginning of the financial crisis in 2007 it was only 5% and by 2014 it had risen slightly to 7%.

Explain why the saving ratio may fall.

[15 marks]

23. Globalisation and outsourcing of manufacturing provides several potential benefits to economies. However, some countries, such as the UK, continue to suffer persistent trade deficits but are unable to resort to import controls.

Explain how the UK Government could reduce a balance of payments deficit on the current account, other than through the use of import controls.

[15 marks]

24. Since the start of the financial crisis of 2007−2008, the UK, the Eurozone and the USA have adopted quantitative easing (QE) in an attempt to stimulate their economies.

To what extent do you agree that maintaining inflation at the target rate of 2% should be the top priority of UK macroeconomic policy? Justify your answer.

[25 marks]

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25. THE EUROPEAN UNION CONTEXT

Extract E: Sweden's economic fortunes

Only a few years ago, the Riksbank (the central bank of Sweden) was the envy of the world. The Swedish economy was a star performer early in the global recovery following the 2008 economic crisis. Sweden's economy grew three times faster than the Eurozone's in 2010. Even better, the Riksbank felt confident enough in recovery to start raising interest rates. Its main interest rate reached 2% by July 2011, while rates in most other rich economies stayed nearer to zero.

However, some economists argue that, from the beginning, Sweden's interest rate increases looked premature. When the first rate increase came, unemployment stood at 8.2%, while the inflation rate was 1.1%, well below the central bank's target. Concerns about financial stability influenced the decision to maintain higher interest rates, even though economic conditions deteriorated. The Riksbank was worried that rising household borrowing and soaring house prices could lead to adverse consequences in the long run. Yet the strategy did not go as planned and no doubt contributed to deflation in 2013.

Unemployment in Sweden has remained high and private sector debt as a share of GDP is higher now than it was in 2010 but, at the same time, house prices have continued to climb. In October 2014, the Riksbank announced it was cutting its main interest rate to zero in an effort to stimulate the economy.

However, the effectiveness of the central bank's ability to respond to avoid deflation is a concern because it becomes very difficult to further stimulate domestic demand as real interest rates approach zero. On the other hand, low interest rates contributed to the Swedish currency, the Krona, falling sharply in value, which helped exports and provided some cushion against weak global demand and further deflation.

Source: news reports, 2014

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1. **Extract C** (lines 2 – 4) asks: 'Is it time the UK considered manipulating its currency directly and managing its exchange rate in order to reduce the ever-increasing trade deficit and to help improve its performance?'

Using the data and your knowledge of economics, evaluate the view that the UK should focus its monetary policy on managing the exchange rate in order to improve macroeconomic performance.

[25 marks]

2. Which one of the following is the most likely consequence of a central bank engaging in quantitative easing?

	Bond Prices	Long-term interest rates	
A	Rising	Rising	⬭
B	Falling	Rising	⬭
C	Rising	Falling	⬭
D	Falling	Falling	⬭

[1 mark]

3. In May 2014, the European Central Bank (ECB) President, Mario Draghi, warned that there was a risk of deflation across economies in Europe.

Evaluate the view that the UK government should give higher priority to preventing deflation rather than controlling inflation.

[25 marks]

4. Since the start of the financial crisis of 2007−2008, the UK, the Eurozone and the USA have adopted quantitative easing (QE) in an attempt to stimulate their economies.

Explain how the process of quantitative easing in the UK might increase the rate of inflation.

[15 marks]

5. **Government policy Extract F** (lines 14−17) states 'Investment forecasts are being revised downward and on top of speculation of interest rate rises and criticism of the UK's quantitative easing programme, the outlook is not looking as good as forecasts first indicated.'

Using the data in the extracts and your economic knowledge, evaluate the effectiveness of monetary policy in achieving macroeconomic stability in the UK.

[25 marks]

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6. After a period of inflation below the target rate, the Consumer Price Index (CPI) inflation rate was recorded as −0.1% in early 2015. The Governor of the Bank of England wrote: 'A temporary period of falling prices, driven by large adjustments in a few specific components of the CPI, is a fundamentally distinct phenomenon from 'deflation'...The UK is not experiencing 'deflation'.'

Evaluate the possible consequences for the performance of the UK economy of the actual rate of inflation being below the Monetary Policy Committee's (MPC's) target rate.

[25 marks]

7. **Extract E** (lines 15–17) states: 'Policies were put in place to reduce the money supply and reduce government spending. The control of inflation became the main target of UK government macroeconomic policy.'

Using the data in the extracts and your knowledge of economics, evaluate the view that achieving a low and stable rate of inflation should be the main economic objective of governments.

[25 marks]

8. **Government policy Extract E** (lines 4−6) states 'the UK may soon be growing at an annual rate of between 3 and 4% and the Bank could not be certain when it might need to tighten policy.'

With the help of a diagram, explain why interest rates may need to rise if growth rates increase.

[9 marks]

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9. Government policy

Extract F: Austerity remains

The Chancellor, George Osborne, has ruled out the possibility that the UK's improving economy will lead to immediate tax cuts or spending increases when he said reducing the budget deficit would be the priority of his Autumn Statement. The Chancellor said that the UK was still borrowing too much and that any increase in tax revenues generated from faster growth would be used to reduce the budget deficit and the national debt.

The move comes as no surprise, with the Chancellor stating, "I would just remind everyone that I still sit down at the table at the G20 with one of the highest budget deficits. The UK still continues to have some very serious public finance challenges that need to be addressed."

This week, the IMF revised up its forecasts for UK growth in both 2013 and 2014, six months after its chief economist, Olivier Blanchard, warned Osborne that he might cause more damage with his austerity plan. However, Osborne responded, “We have a clear plan and we are sticking to that plan."

The Chancellor's announcement may not be good for UK firms. It is common for business investment to lead the way when emerging from recession, but not this time. Investment forecasts are being revised downward and, on top of speculation of interest rate rises and criticism of the UK's quantitative easing programme, the outlook is not as good as forecasts first indicated.

In explaining its forecast downgrades for net investment over the last three years, the Office for Budget Responsibility (OBR) cites two main factors. Firstly, problems in credit markets have made it difficult for firms to borrow to invest. This may have particularly affected small and medium-sized firms that tend to be more reliant on bank financing. This will only be made worse if interest rates rise. Secondly, the uncertainty generated by the eurozone crisis and other events has stifled investment.

Source: News reports, 2013

10. **Government policy**

Extract E: Rising rates?

The Bank of England warned that interest rates might rise as early as next year as its chief economist said the desire to keep borrowing costs low for several years could be damaged by stronger than expected growth. Spencer Dale, one of the nine members of the interest rate-setting Monetary Policy Committee, said the UK may soon be growing at an annual rate of between 3 and 4% and the Bank could not be certain when it might need to tighten policy.

Following guidance issued by the Bank in August, the City is expecting interest rates to remain on hold at their record low of 0.5% until at least 2015. But Dale said that in certain circumstances an increase could happen as soon as 2014. "The big message is that monetary policy is going to remain loose for a considerable period of time. I can't be sure whether that means it will be tightened in 2015 or 2016."

The Bank said in August that, unless there was a risk from inflation or an over-heating property market, it would only start thinking about raising interest rates when unemployment had come down to 7% from 7.7% currently, something it did not expect until 2016. But the recovery in the economy, seen since the spring, has left many in the City convinced that the Bank will be forced to take action before then.

Dale said he welcomed the fact that the housing market was recovering, and saw no immediate threat of a house price bubble. It was 'great' for the construction sector that more houses were being built, and the increase in mortgage approvals would boost demand for professional services and lead to greater labour mobility. "It is good for consumption, because there is quite strong evidence that when people move home they go out and change the carpets and buy new furniture."

Source: News reports, 2013

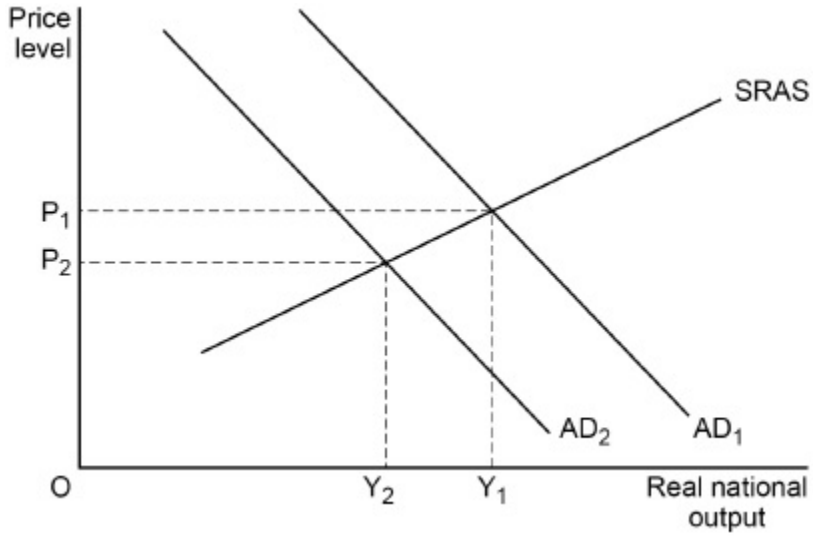
11. **Extract F** (lines 4 – 6) states: ‘some are now arguing that further improvements in the unemployment statistics can only be gained through improvements in the supply-side of the economy, rather than relying on demand.’

To what extent do you agree that a further reduction in the UK’s unemployment rate is most likely to be achieved by improvements in the supply-side rather than the demand-side of the economy? Use the data and your own knowledge of economics, to justify your answer.

[25 marks]

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12. The diagram below shows two aggregate demand (AD) curves and the short-run aggregate supply (SRAS) curve for an economy.



All other things being equal, the change in real national output from Y_1 to Y_2 is most likely to have been caused by an increase in the

A government's budget deficit. ⬭

B level of interest rates. ⬭

C size of the labour force. ⬭

D volume of exports. ⬭

[1 mark]

13. It is now nearly a decade since the financial crisis caused a recession in the UK. In March 2009, the Monetary Policy Committee (MPC) set the UK Bank Rate at 0.5%, which was a record low, in order to stimulate economic growth.

Discuss the importance of low interest rates in bringing about sustained economic growth in an economy such as the UK.

[25 marks]

14. The UK has seen significant changes in its pattern of trade with the rest of the world in terms of what we trade and with whom. The UK's current account deficit widened from £29.1bn in 2011 to £100.2bn in 2015. The deficit in 2015 was 5.4% of GDP, the largest annual deficit as a percentage of GDP since records began in 1948.

Evaluate the measures that might be taken to reduce a deficit on the current account of the UK's balance of payments.

[25 marks]

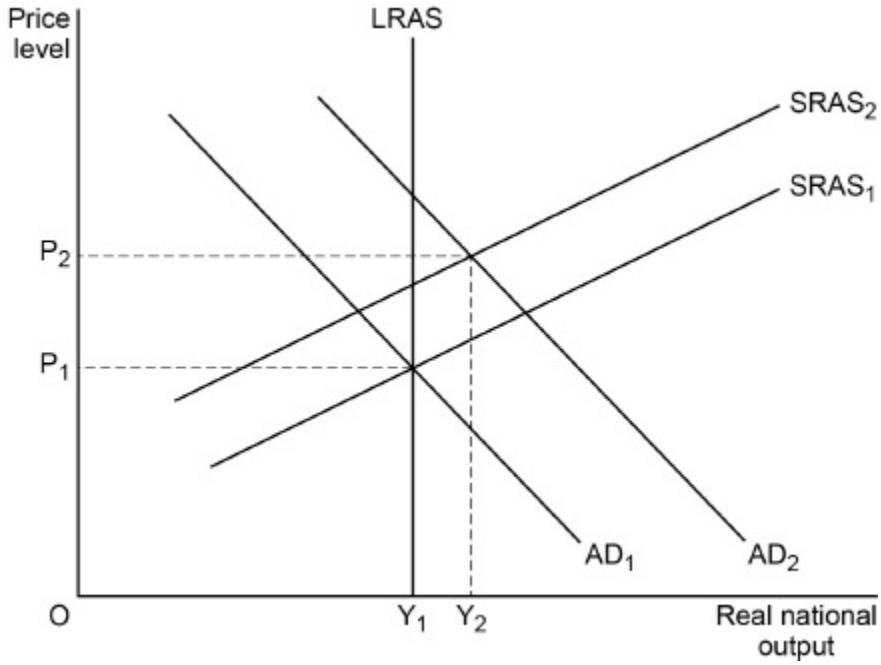
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15. **Extract F** (lines 19–20) states 'What is not clear is what should be done if low inflation turns to bad deflation.'

Using the data in the extracts and your knowledge of economics, evaluate the view that monetary policy is the most effective way of tackling deflation in developed economies such as the UK and Japan.

[25 marks]

16. 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. ⬭

[1 mark]

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17. In recent years, several central banks around the world have implemented a policy of quantitative easing (QE). All other things being equal, which one of the following combinations **A**, **B**, **C** or **D**, is most likely to be the result of this policy?

	Bank liquidity	Bond prices	Long-term interest rates	
A	Decrease	Fall	Rise	⬭
B	Increase	Fall	Rise	⬭
C	Decrease	Rise	Fall	⬭
D	Increase	Rise	Fall	⬭

[1 mark]

18. Despite its central bank operating a policy of quantitative easing for several years, an economy has rising unemployment and a rate of inflation significantly below the target rate set by the government. All other things being equal, which one of the following actions is the central bank most likely to take in order to meet the target for inflation?

A A policy leading to an appreciation of the exchange rate. ⬭

B An increase in its base rate of interest and the reversal of its quantitative easing policy. ⬭

C Providing forward guidance indicating that the bank will continue with its programme of quantitative easing. ⬭

D Selling some of its stock of government bonds to other financial institutions. ⬭

[1 mark]

19. All other things being equal, if the velocity of circulation is constant, the quantity theory of money based on Fisher's equation of exchange, MV=PQ, predicts that an x% increase in the money supply will always cause an x%

A decrease in the rate of interest. ⬭

B increase in nominal national income. ⬭

C increase in real national income. ⬭

D increase in the rate of economic growth. ⬭

[1 mark]

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20. The table below shows different combinations of changes in the rate of interest and the government's budget position. The economy has a negative output gap. All other things being equal, which one of the combinations of policies, **A**, **B**, **C** or **D**, is most likely to reduce the economy's negative output gap?

	Rate of interest	Government's budget position	
A	Increase	Decrease in surplus	⬭
B	Decrease	Increase in surplus	⬭
C	Increase	Decrease in deficit	⬭
D	Decrease	Increase in deficit	⬭

[1 mark]

21. In the past few years, CPI inflation has often differed by more than 1% from its 2% target. In the winter of 2015 the UK experienced a brief period of deflation but, more recently, inflation has been over 3%.

Evaluate the view that inflation is always preferable to deflation.

[25 marks]

22. Since 1998, the Bank of England has had responsibility for the operation of monetary policy and maintaining price stability. In response to the financial crisis of 2007–08, the Financial Services Act 2012 gave the Bank of England overall responsibility for financial stability. This was designed to reduce systemic risk and the impact on the real economy of problems that arise in financial markets.

Explain how the monetary policy transmission mechanism works when the Monetary Policy Committee (MPC) raises Bank Rate.

[15 marks]

23. In the past few years, CPI inflation has often differed by more than 1% from its 2% target. In the winter of 2015 the UK experienced a brief period of deflation but, more recently, inflation has been over 3%.

Explain the main causes of a rise in inflation.

[15 marks]

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24. All other things being equal, in which one of the following circumstances is the Bank of England most likely to raise Bank Rate to maintain financial stability?

A A fall in bank liquidity and capital ratios following several years of rapid growth in bank lending and a boom in house prices ⬭

B An increase in the government's target for the rate of inflation following a significant increase in the rate of productivity growth ⬭

C An increase in the savings ratio as the economy recovers from a recession ⬭

D A rise in share prices on global stock markets due to the growth in world trade ⬭

[1 mark]

25. Between 2014 and 2018, the pound fell by more than 20% against the dollar and euro. Some argued that this would benefit the UK's macroeconomic performance, but others claimed that a lower exchange rate will cause problems.

Explain why the value of a currency may fall in a floating exchange rate system.

[15 marks]

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