2.15 Central Banks and the Tools of Monetary Policy: Test Pack

Total Marks

AQA 7136 · Calculators not allowed · about 15 minutes

Name: _____ Date: ____ / ____ / _____

Answer all questions. Write full sentences for the 25-mark question and for any explanation worth more than 2 marks. Time guidance: 15 minutes.

1 Function of the central bank in a UK-style economy: explain the role of the central bank as 'banker to the government' in the context of public finance operations.

(Total for Question 1 is 2 marks)

2 Issuer of currency: define the central bank's role as the issuer of legal tender and explain one implication for the money supply in the economy.

(Total for Question 2 is 2 marks)

3 Forward guidance: define forward guidance as a policy tool and state one way the central bank might phrase guidance to influence expectations about future policy.

(Total for Question 3 is 2 marks)

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4 State three reasons the MPC might choose to use forward guidance rather than further cuts to Bank Rate when inflation is below target.

(Total for Question 4 is 3 marks)

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5 Scenario: inflation is below target and long-term yields are low despite previous rate cuts. Which main monetary policy tool would the MPC most likely use next from the list {Bank Rate change, quantitative easing, forward guidance} to try to raise inflation expectations and influence long-term yields? Name the tool and give one brief reason.

(Total for Question 5 is 2 marks)

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Mark scheme · 2.15 Central Banks and the Tools of Monetary Policy: Test Pack

Question 1

holds the government's accounts and processes payments on behalf of the government, such as receiving tax receipts and making public spending payments — **B1**

manages the government's short-term liquidity and facilitates settlement of government debt issuance and operations with the Treasury — **B1**

Answer: The central bank operates the government's accounts, processing receipts and payments and helping to manage short-term liquidity and debt settlement.

Question 2

is the official authority that issues banknotes and coins which are legal tender in the jurisdiction — **B1**

this power means the central bank controls the monetary base and can influence money supply via note issuance and reserve requirements — **B1**

Answer: The central bank issues banknotes and coins as legal tender; this gives it control over part of the monetary base and a lever to influence the overall money supply.

Question 3

forward guidance is when the central bank communicates its likely future policy path to influence expectations of households, firms and markets — **B1**

an example phrasing is committing to keep Bank Rate at a low level until unemployment falls below a specified threshold or until inflation is forecast to reach the target — **B1**

Answer: Forward guidance is communicating the likely future policy path; it might say that Bank Rate will remain low until unemployment falls below a specified level or until inflation reaches target.

Question 4

to influence expectations of households and firms without changing the current policy rate, for example if Bank Rate is already near zero — **B1**

to provide clearer conditionality about the future policy path and therefore reduce uncertainty about when rates will rise, supporting forward-looking spending decisions — **B1**

to avoid further reducing Bank Rate which may have limited effect if rates are constrained, or to avoid signalling an indefinite low-rate commitment that could have side effects — **B1**

Answer: Forward guidance can influence expectations without lowering the current Bank Rate further, useful near the effective lower bound, and it gives conditional clarity about the future path of rates to reduce uncertainty for decision makers. It also avoids further cuts to Bank Rate, which may have limited effect when rates are already close to their lower bound.

Question 5

names quantitative easing (allow forward guidance if the emphasis is on changing expectations rather than directly altering yields, provided the reason given supports it) — **B1**

gives one valid reason for the tool named, e.g. QE directly purchases long-dated assets, lowering their yields and encouraging portfolio rebalancing, which can raise asset prices and stimulate spending, and it can also signal easier policy; for forward guidance, a reason linking the commitment to the expected path of Bank Rate, long-term yields or inflation expectations — **B1**

Answer: Quantitative easing, because it targets long-dated asset purchases to influence long-term yields and raise inflation expectations; forward guidance could be acceptable if justified as targeting expectations.

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