ECO.MAC13 Central Banks and the Tools of Monetary Policy

Total Marks

AQA 7136 · Calculators not allowed · about 60 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: 60 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 Function of the central bank in a UK-style financial system: state and explain the meaning of the central bank acting as 'lender of last resort' for commercial banks during a liquidity crisis.

(Total for Question 2 is 2 marks)

3 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 3 is 2 marks)

4 Monetary Policy Committee independence: state the main purpose of giving the Monetary Policy Committee (MPC) operational independence in setting Bank Rate in the UK-style system.

(Total for Question 4 is 2 marks)

5 Bank Rate as a policy tool: explain how a change in the Bank Rate directly affects commercial banks' behaviour, naming one immediate effect on banks' costs or prices.

(Total for Question 5 is 2 marks)

6 Quantitative easing (QE): define QE as used by a modern central bank and state one type of asset the central bank typically purchases when conducting QE.

(Total for Question 6 is 2 marks)

7 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 7 is 2 marks)

8 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 long-term yields? Name the tool and give one brief reason.

(Total for Question 8 is 3 marks)

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9 Explain one limitation of describing the central bank only as 'guardian of financial stability' and not mentioning its other functions such as issuing currency or operating as banker to the government.

(Total for Question 9 is 2 marks)

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

(Total for Question 10 is 3 marks)

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11 Explain two reasons why a central bank might choose to buy long-term government bonds rather than short-term bills when conducting quantitative easing.

(Total for Question 11 is 3 marks)

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12 Context: In a UK-style system the Monetary Policy Committee (MPC) is operationally independent and has a remit to meet a specified inflation target. Discuss whether this independence is the best way to ensure the inflation target is met, considering incentives, accountability, time horizons, and possible trade-offs with democratically accountable fiscal policy. If you would use a diagram, describe it rather than drawing it.

Evaluate the view that giving the Monetary Policy Committee operational independence is the best way to ensure inflation is kept at the official target. In your answer, analyse reasons in favour and against independence, include at least one institutional or political consideration, and give a supported judgement. Draw or describe any diagram you would use to support your reasoning.

(Total for Question 12 is 25 marks)

Mark scheme · ECO.MAC13 Central Banks and the Tools of Monetary Policy

Question 1

- **B1** 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
- **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

- **B1** provides emergency short-term loans to solvent but illiquid commercial banks to prevent bank runs and wider systemic failure
- **B1** this support stabilises the banking system by supplying liquidity while longer-term solutions are arranged, reducing contagion risk
- **Answer: The central bank lends short term to solvent but illiquid banks to prevent runs and limit systemic collapse, stabilising the banking system.**

Question 3

- **B1** 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
- **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 4

- **B1** to allow decisions on Bank Rate to be based on economic evidence and inflation forecasts rather than short-term political pressures
- **B1** to help anchor inflation expectations by committing the MPC to an explicit inflation target
- **Answer: Independence lets the MPC set Bank Rate based on economic evidence rather than politics, helping to anchor inflation expectations around the inflation target.**

Question 5

- **B1** a rise in Bank Rate increases the cost for commercial banks of borrowing from the central bank and generally pushes up short-term market interest rates
- **B1** banks typically respond by raising lending rates and deposit rates, changing incentives to borrow and save
- **Answer: A higher Bank Rate raises banks' funding costs and short-term market rates, so banks usually raise lending and deposit rates, affecting loan demand and saving incentives.**

Question 6

- **B1** QE is when the central bank creates central bank reserves or money to buy financial assets in order to increase the monetary base and lower long-term yields
- **B1** a common asset purchased is government bonds, especially long-dated sovereign debt
- **Answer: QE is creating central bank money to buy assets and increase the monetary base; the central bank typically buys government bonds.**

Question 7

- **B1** 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
- **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 8

- **B1** quantitative easing
- **B1** because 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
- **B1** alternative acceptable answer: forward guidance if the emphasis is on changing expectations rather than directly altering yields, with a correct reason
- **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.**

Question 9

- **B1** identifies that the central bank has multiple functions beyond financial stability, such as issuing currency and acting as banker and lender of last resort
- **B1** explains that focusing only on stability understates roles in payment systems, government finance and monetary policy implementation
- **Answer: Calling the central bank only the guardian of financial stability omits its roles in issuing currency, running the payments system and acting as banker and lender of last resort, so it understates how it manages money and supports government and banks.**

Question 10

- **B1** 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
- **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.**

Question 11

- **B1** buying long-term bonds directly lowers long-term yields, which are more influential for investment and mortgage rates than short-term rates
- **B1** long-term purchases change the term structure and encourage portfolio rebalancing by investors into riskier assets, amplifying broader financial conditions
- **B1** buying short-term bills mainly increases reserves and affects very short-term rates, which may already be near the policy rate and have smaller effects on long-term borrowing costs
- **Answer: Long-term government bond purchases reduce long-term yields that affect mortgages and business finance and encourage portfolio rebalancing into riskier assets, whereas short-term bill purchases mainly affect short-term rates and reserves which may have limited impact on longer-term borrowing costs.**

Question 12

- **Level 1** (1-5): Basic statements about central bank independence with limited development, little or no use of institutional detail or argument, and no clear judgement. May include one or two brief points about how independence could reduce political interference.
- **Level 2** (6-10): Clear explanations of reasons for and against MPC independence, including economic mechanisms such as anchoring expectations and time inconsistency. Some institutional or political factors are discussed, but analysis is not fully developed and the judgement may be tentative.
- **Level 3** (11-15): Well developed analysis weighing benefits and limitations of operational independence, including discussion of accountability, conflicts with fiscal policy, distributional consequences, and examples of institutional safeguards. Contains a reasoned and supported judgement, and a described diagram that clarifies the argument.
- **Level 4** (16-20): Comprehensive and well structured evaluation with multiple developed arguments on both sides, explicit institutional examples, and careful consideration of when independence might fail or need complements such as transparency and legislative accountability. A clear, balanced judgement is given and diagrams are used effectively in the explanation.
- **Level 5** (21-25): Outstanding evaluation showing deep understanding of the trade-offs. Arguments include time inconsistency and credibility, democratic legitimacy and accountability, interaction with fiscal policy and the financial stability remit, and how forward guidance and macroprudential tools interact with independence. Provides a clear, well supported judgement and refers to an appropriate diagram described in words that illuminates mechanisms discussed.
- **Indicative content:**
    - Arguments for independence: reduces political cycle pressure to stimulate the economy before elections, helps anchor inflation expectations improving credibility, allows decisions to be made on technical economic grounds and forecasts, reduces time inconsistency by committing to rules-based behaviour, supports lower average inflation and lower output volatility over the long run
    - Arguments against independence: democratic legitimacy concerns since policymakers are not directly elected, possible misalignment with fiscal policy or living standards goals, limited accountability if transparency mechanisms are weak, distributional consequences of monetary policy that elected governments may wish to consider
    - Institutional considerations: internal MPC voting procedures, fixed terms of committee members, statutory inflation targets, reporting requirements to parliament, and published minutes and inflation reports as accountability mechanisms
    - Political and practical constraints: when nominal rates are at or near the lower bound, independence alone cannot achieve target without fiscal support; independence may be less effective if fiscal policy is highly procyclical or debt dynamics are bad
    - Complementary measures: forward guidance, clear remit and target, macroprudential regulation led by financial oversight bodies, coordination protocols with the Treasury, and publicity and transparency to maintain legitimacy
    - Diagrams described: an expectations-anchoring diagram could be described showing how credible independence shifts inflation expectations downward, or a simple AD/AS sketch described in words to show how monetary policy affects price level under different capacity conditions. Explain labelling: vertical axis price level, horizontal axis real GDP, initial equilibrium and effect of tightening credibility reducing AD volatility
    - Judgement guidance: conclude that independence is a powerful tool to meet an inflation target when paired with accountability and clear remit, but it is not a panacea and can be undermined by poor fiscal choices or weak transparency; a balanced view recognising conditional effectiveness scores highly