2.16 The Monetary Policy Transmission Mechanism and Its Evaluation: 30-minute Pack

AQA 7136 · Calculators not allowed · about 30 minutes

Total Marks

Name: _____ Date: ____ / ____ / _____

Answer all questions. Question 3 (the essay) requires extended full-sentence answers and a supported judgement. Show working for calculations where required. You have 30 minutes in total. At least Question 3 requires full-sentence responses.

1 Explain how weak household or business balance sheets can reduce the responsiveness of consumption and investment to lower interest rates, giving the mechanism and consequence for monetary policy.

(Total for Question 1 is 3 marks)

2 Explain how a Bank Rate cut can affect the exchange rate and then net exports, specifying the intermediate steps and the likely sign of the effect on aggregate demand.

(Total for Question 2 is 3 marks)

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3 Evaluate how effective monetary policy is likely to be in closing a negative output gap. In your answer, consider the different transmission channels (consumption, investment, exchange rate, asset prices, expectations), the role of quantitative easing at low rates, and the key limits such as time lags, liquidity traps, and balance-sheet constraints. Use an AD/AS framework where relevant and reach a supported judgement.

(Total for Question 3 is 15 marks)

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Mark scheme · 2.16 The Monetary Policy Transmission Mechanism and Its Evaluation: 30-minute Pack

Question 1

identifies that households or firms with high debt or low collateral may be unwilling or unable to borrow even when rates fall — **M1**

explains that lenders may be unwilling to extend credit to weak-balance-sheet borrowers, so lower rates do not translate into higher lending and spending — **A1**

consequence: monetary policy stimulus is blunted, reducing its capacity to raise AD and close a negative output gap — **A1**

Answer: If households or firms are highly indebted or lack collateral, they may not borrow more when rates fall, and banks may restrict credit; this weakens the link from rate cuts to consumption and investment so monetary policy has smaller effects on AD.

Question 2

lower interest rates tend to reduce inflows of capital seeking higher returns and can make sterling less attractive, causing a depreciation of the exchange rate — **M1**

a depreciation makes exports cheaper to foreign buyers and imports more expensive to domestic buyers, tending to increase export volumes and reduce import volumes — **A1**

the net exports component (X-M) improves, raising aggregate demand — **A1**

Answer: A Bank Rate cut often depreciates the exchange rate by reducing capital inflows, making exports cheaper and imports more expensive; this tends to raise net exports and so increases AD.

Question 3

Level 1 Basic statements about how monetary policy can affect demand, with limited linkage between channels and the negative output gap and little or no evaluation or use of AD/AS. Points are fragmentary or descriptive. — **1-5**

Level 2 Clear explanation of several transmission channels and how they can work to close a negative output gap, with some use of AD/AS. Some evaluation of limits such as lags, liquidity traps and balance-sheet issues, but analysis may be partially developed or unbalanced. — **6-10**

Level 3 Detailed, well-balanced analysis weighing strengths and weaknesses of monetary policy in closing a negative output gap. Considers multiple channels, the role and limits of QE at low rates, time lags, confidence effects and distributional or supply-side considerations. Uses AD/AS to show short-run effects and discusses secondary effects and real-world constraints, leading to a supported and nuanced judgement. — **11-15**

Indicative content:

- Explanation of how Bank Rate cuts affect consumption via lower mortgage and loan payments and cheaper borrowing, shifting AD right; use AD/AS to show higher Y and higher PL in short run.
- Discussion of investment channel via lower cost of capital, higher profitability of projects, and impact on AD and future LRAS.
- Exchange rate channel: rate cuts can depreciate the currency, improving net exports and shifting AD right, but effects depend on elasticities and openness.
- Asset price channel and portfolio balance: lower yields raise equity and house prices, boosting wealth and collateral and supporting consumption and investment; QE amplifies this at low rates.
- Expectations channel: policy can influence confidence, which can magnify or mute mechanical effects; credibility of the central bank matters.
- Evaluation of QE at low rates: can lower long-term yields and raise asset prices, but effectiveness depends on banks lending, investors rebalancing and households spending; may have diminishing returns and distributional consequences.
- Limits due to liquidity trap: when rates near zero, conventional cuts are ineffective; QE may help but is uncertain.
- Time lags: recognition, implementation and transmission lags can mean policy is too late or causes inflation later; variable lags complicate calibration.
- Balance-sheet constraints: high household or corporate debt and weak collateral reduce the pass-through to spending.
- Other limits: supply-side constraints, global factors, and fiscal policy interactions; monetary policy may be less effective when the negative gap is due to structural problems.
- Consideration of when monetary policy is relatively more effective, e.g. when confidence is responsive, banks lend freely, and the economy has spare capacity, versus when it is less effective, e.g. deep liquidity traps or severe balance-sheet recessions.
- Supported judgement weighing the above, for example that monetary policy is an important and often rapid tool to reduce a modest negative output gap but is unlikely to fully close a deep, balance-sheet driven gap on its own and works best in combination with fiscal or supply-side measures.

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