2.16 The Monetary Policy Transmission Mechanism and Its Evaluation: Test Pack

AQA 7136 · Calculators not allowed · about 15 minutes

Total Marks

Name: _____ Date: ____ / ____ / _____

Answer all questions. Show working for calculations where required. You have 15 minutes in total.

1 Multiple choice on the monetary transmission channels in the UK context: which channel directly reduces the cost of servicing variable-rate mortgages and new consumer loans following a Bank Rate cut?

- ☐ A, the exchange rate channel
- ☐ B, the interest rate channel
- ☐ C, the asset price channel
- ☐ D, the expectations channel

(Total for Question 1 is 1 mark)

2 Define the term 'liquidity trap' in the context of ECO.MAC14 and explain why it is relevant to monetary policy effectiveness.

(Total for Question 2 is 2 marks)

3 Define the 'asset price channel' of monetary policy transmission, in the context of ECO.MAC14 and how monetary stimulus affects aggregate demand via asset markets.

(Total for Question 3 is 2 marks)

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4 Explain briefly how a Bank Rate cut can affect business investment via the cost of capital channel. Give the three-step causal chain specific to investment and state the end effect on AD.

(Total for Question 4 is 3 marks)

5 Explain the expectations or confidence channel: how can a change in Bank Rate alter household or business confidence and thereby affect aggregate demand? Give the key causal links.

(Total for Question 5 is 3 marks)

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Question 1

selecting B, the interest rate channel, which directly reduces market interest rates on mortgages and consumer loans when Bank Rate is cut **B1**

Answer: B

Question 2

a liquidity trap occurs when interest rates are at or near zero and households and firms prefer to hold cash rather than invest or spend, making conventional monetary policy ineffective **B1**

relevance: in a liquidity trap, cuts in Bank Rate have little effect on spending because the demand for money is highly elastic and the normal channels of interest-rate transmission are impaired **B1**

Answer: A liquidity trap is when interest rates are at or near zero and people prefer holding cash, reducing the effectiveness of Bank Rate cuts because monetary transmission into spending and investment is weak.

Question 3

a monetary policy action that raises asset prices such as equities, bonds and house prices **B1**

higher asset prices increase household wealth and collateral values, encouraging consumption and enabling more lending for investment, thereby raising aggregate demand **B1**

Answer: Higher monetary stimulus raises asset prices, which increases wealth and collateral values and so boosts consumption and investment, increasing AD.

Question 4

Bank Rate cut reduces the cost of borrowing and lowers yields on safe assets, reducing firms' cost of capital **M1**

a lower cost of capital makes more investment projects have expected returns exceeding financing costs, so firms undertake more investment **A1**

higher investment increases aggregate demand directly and also raises future productive capacity **A1**

Answer: A Bank Rate cut lowers borrowing costs and yields, reducing firms' cost of capital. More investment projects become profitable, so firms increase investment spending, raising AD now and increasing future capacity.

Question 5

a Bank Rate cut can raise consumer and business confidence by signalling easier financial conditions and by reducing the chance of unemployment rising **M1**

higher confidence increases the propensity to spend now rather than save, and encourages firms to invest and hire **A1**

this behavioural response amplifies the impact of the interest rate cut on AD beyond the mechanical effect of lower borrowing costs **A1**

Answer: A cut in Bank Rate can boost consumer and business confidence, making households more willing to spend and firms more willing to invest, which amplifies the rightward shift in AD beyond purely mechanical interest-rate effects.

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