2.16 The Monetary Policy Transmission Mechanism and Its Evaluation

Total Marks

AQA 7136 · Calculators not allowed · about 65 minutes · Write-in edition

Name: _____ Date: ____ / ____ / _____

Answer all questions. Question 6 (the essay) requires extended full-sentence answers and a supported judgement. Show working for calculations where required. You have 65 minutes in total. At least Question 6 requires full-sentence responses.

1 Explain how long and variable time lags in monetary policy transmission limit the policy's ability to close a negative output gap. Give two linked points about the nature and consequences of lags.

(Total for Question 1 is 3 marks)

2 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 2 is 3 marks)

3 Explain, in the context of ECO.MAC14, how a cut in Bank Rate can lead to higher consumer spending via the consumption channel. Set out the causal steps briefly.

(Total for Question 3 is 3 marks)

4 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 4 is 3 marks)

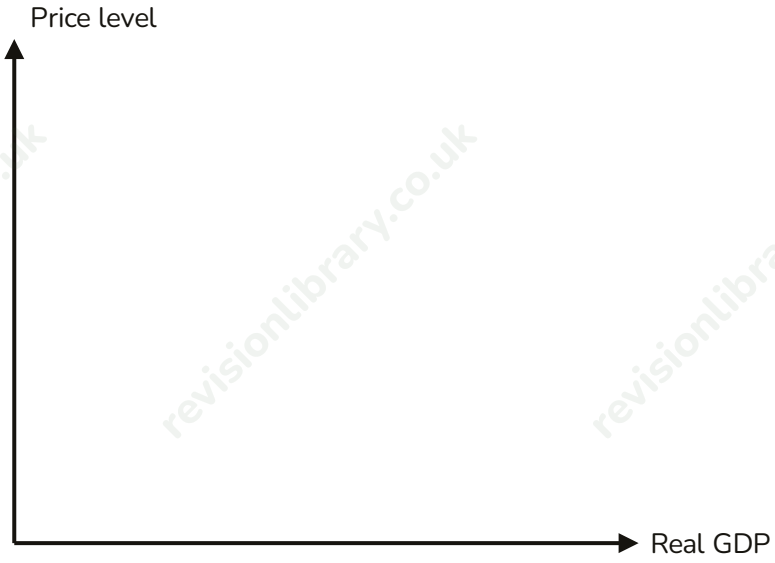
5 Explain how quantitative easing (QE) can stimulate aggregate demand via the portfolio balance and bank lending channels. Give two linked steps and the expected direction of AD.

(Total for Question 5 is 3 marks)

6 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 6 is 15 marks)

7 Diagram task: Draw an AD/AS diagram for the UK economy showing the effect of a Bank Rate cut on aggregate demand and the price level. On the axes, draw and label AD1 and SRAS, then show AD2 after the change. Mark and label the initial equilibrium E1 and the new equilibrium E2, with their corresponding price levels and real GDP levels. Explain briefly the transmission steps shown (consumption, investment, asset prices and exchange rate where relevant).



(Total for Question 7 is 8 marks)

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8 Assess briefly whether quantitative easing is likely to be effective at the zero lower bound (the point where Bank Rate is at or near zero). Give two linked evaluative points and a short judgement.

(Total for Question 8 is 4 marks)

Mark scheme · 2.16 The Monetary Policy Transmission Mechanism and Its Evaluation

Question 1

identifies that there are recognition, decision and implementation lags plus long transmission and impact lags before policy affects output — **M1**

explains that because lags are long and uncertain, monetary policy may take effect after the output gap has partly or fully closed, potentially destabilising the economy or causing inflation later — **A1**

adds that variable lag length makes it hard to calibrate policy size and timing, weakening confidence that policy will reliably close a given negative output gap — **A1**

Answer: Monetary policy faces long recognition, decision and transmission lags so its effects on output are delayed and uncertain; this means policy may act too late or overshoot, limiting its reliability in closing a negative output gap.

Question 2

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 3

Bank Rate cut puts downward pressure on market interest rates for mortgages, credit cards and personal loans — **M1**

lower interest payments increase disposable income for households with variable-rate debt and reduce the cost of new borrowing — **A1**

higher disposable income and cheaper credit raise consumption, shifting aggregate demand to the right — **A1**

Answer: A lower Bank Rate reduces market interest rates, lowering mortgage and loan payments and making borrowing cheaper; households therefore have higher effective disposable income and face cheaper credit, which increases consumption and shifts AD rightwards.

Question 4

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 5

QE involves central bank purchases of long-term assets which raises their prices and lowers yields, prompting investors to rebalance into riskier assets and equities — **M1**

higher asset prices boost wealth and collateral, and lower yields reduce firms' and households' cost of borrowing, increasing consumption and investment and thus shifting AD to the right — **A1**

additionally, by increasing bank reserves QE can encourage banks to expand lending if they choose to, further supporting AD — **A1**

Answer: QE raises asset prices and lowers long-term yields, causing portfolio rebalancing into riskier assets, increasing wealth and lowering financing costs, which boosts consumption and investment and so increases AD. QE may also raise bank reserves and support lending if banks expand credit.

Question 6

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.

Question 7

axes are correctly labelled Price level (vertical) and Real GDP (horizontal)	**B1**
initial equilibrium labelled E1 with an intersection of AD1 and SRAS at PL1 and Y1	**B1**
AD curve is drawn shifted to the right and labelled AD2	**B1**
new equilibrium labelled E2 with PL2 and Y2 clearly shown	**B1**
states that a Bank Rate cut reduces interest rates, encouraging C and I, can raise asset prices and may depreciate the exchange rate	**M1**
links the rise in C and I (and possibly net exports and asset-driven consumption) to a rightward shift of AD (AD1 to AD2)	**A1**
identifies the result: higher real GDP (Y2>Y1) and a higher price level (PL2>PL1) given SRAS unchanged	**A1**
diagram and explanation are coherent, showing the causal chain from interest rate cut to AD shift and higher price level	**B1**

Question 8

identifies a reason QE can work at the zero lower bound, e.g. by lowering long-term yields and raising asset prices when short rates cannot be cut further	**M1**
develops this point: lower long yields and higher asset prices can raise consumption and investment and support AD even when Bank Rate is at zero	**A1**
identifies a limitation, e.g. if banks hoard reserves or if the portfolio rebalancing effect is weak, the pass-through to lending, asset prices and real activity may be muted	**M1**
brief judgement: QE can be a useful tool at the zero lower bound but its effectiveness depends on behavioural responses by banks, investors and households and so is not guaranteed	**A1**

Answer: QE can be effective at the zero lower bound by lowering long-term yields and raising asset prices, supporting AD; however its impact is uncertain if banks do not lend or investors do not rebalance, so it is a useful but not foolproof tool.