Edexcel (A) Economics A-level

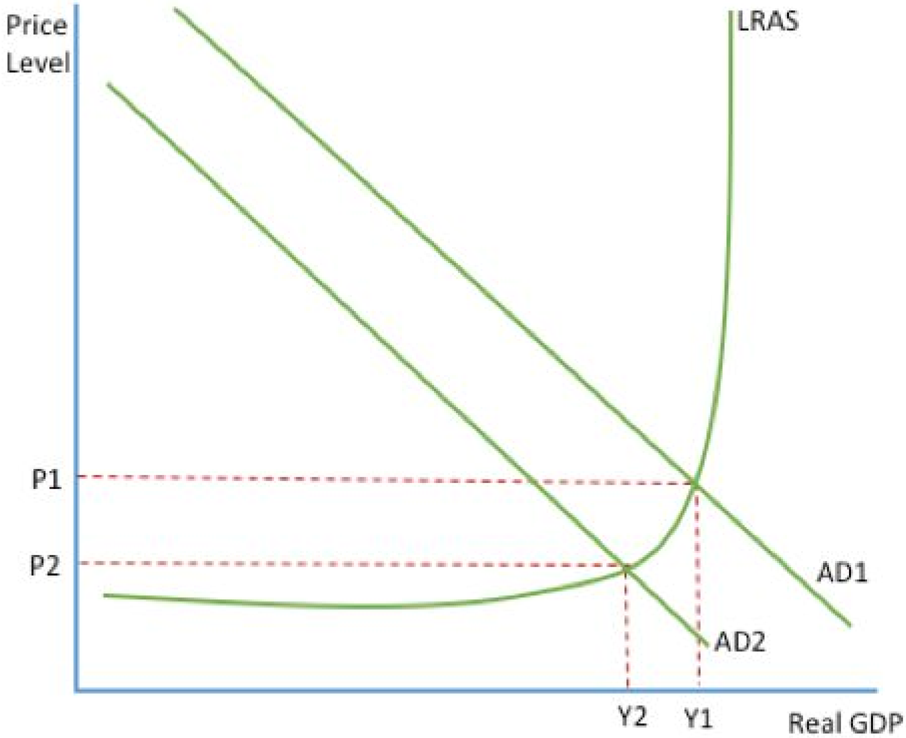
A-level Paper 2: National and Global Economy

Example answers

To what extent might monetary policy help the UK government achieve its macroeconomic objectives.

Monetary policy is the use of control over money supply and interest rates in order to manage demand. There are a range of macroeconomic objectives, including stable inflation, high employment, economic growth, neutral balance of payments, equality and protecting the environment. Monetary policy can only be used to fix some of these.

Firstly, interest rates can be increased when demand is too high. An increase in interest rates will make borrowing more expensive as more has to be paid back in loans. This will decrease consumption, particularly on durables which are often bought on credit and investment, as businesses will have to be more confident in their investments to invest as there is higher risk as loans become more expensive. Borrowing has become more expensive as banks will raise their interest rates as they know that if they have to borrow money from the central bank, they will need to pay higher rates. Moreover, it will encourage people to save which will decrease consumption and will increase the value of the pound due to increased demand for sterling for foreigners who want to invest. Therefore, exports will become expensive and imports cheap as there may be a current account deficit and a fall in net trade. The fall in consumption, investment and net trade will cause AD1 to fall to AD2, causing prices to fall from P1 to P2, helping to achieve stable inflation. On the other hand, real national income falls from Y1 to Y2 and so therefore it doesn't achieve high employment or economic growth. If the economy was producing on the inelastic section of the curve, then an increase in interest rates would not affect output, just prices.



On the other hand, interest rates can be decreased to increase AD. If AD2 was increased to AD1 then prices would rise from P2 to P1 but economic growth and employment would rise. This is likely to also make imports more expensive so increase net trade and improve the current account. Overall, the effect of a change in interest rates depends how big the impact is- small change in rates will have little impact, and on whether they are up or down.

Moreover, quantitative easing can be used to affect money supply. The central bank can inject money into the economy by buying assets from private firms. This encourages firms to spend more, as they have more money, and pushes prices up as demand for goods rises. This can also lead to a positive wealth effect as if the price of people's assets rise, they are likely to increase consumption. Moreover, banks may be more willing to lend money if they have more money, which will increase consumption and investment. On the whole, AD will increase from AD2 to AD1. This is usually done when the economy is at very low output so the LRAS is elastic. As a result, it increases employment and economic growth without having a negative effect on inflation. If it was done at a different time, it may push inflation up without increasing economic growth/employment at all- this would be when the economy is at full output. The increased AD could cause a balance of payments deficit if consumers needs cannot be met by the country ,so imports are increased.

Overall, monetary policy is usually used to tackle inflation. An increase in interest rates tackles inflation but this is usually at the expense of other goals such as growth and employment. It does nothing to tackle environmental issues or inequality. When used at the right time, monetary policy can be successful in tackling inflation or increasing growth/employment but never at the same time.

Teacher's comments: 20/25
Key is it is a powerful tool but generally needs to be used alongside other things! You cover major points effectively and quickly which is good for an exam. You could however be a little clearer in your evaluation about the importance of elasticity: it is there but could be stressed. Also talk about time it takes for the impact to be fully seen.