

Cambridge AS & A Level · Economics 9708 · Notes

Monetary policy AS

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What you need to know

By the end of this topic you should be able to:

1. **Define monetary policy:** action by the central bank (or the government through it) to change interest rates, the money supply and the availability of credit in order to influence aggregate demand and so reach macroeconomic objectives.
2. **Describe its three tools:** interest rates, the money supply and credit regulations.
3. **Tell expansionary monetary policy from contractionary monetary policy.**
4. **Use AD/AS diagrams** to show how expansionary and contractionary monetary policy change the equilibrium level of national income and real output, the price level and employment.

Understand it

What monetary policy is

Monetary policy is the use of **interest rates**, the **money supply** and **credit regulations** to influence spending in the economy. In most countries it is run by the **central bank** (the Federal Reserve in the US, the Bank of England, the Reserve Bank of India), often with an **inflation target** set by the government, such as 2% a year.

Keep it apart from the other policies:

Policy	Its tools
Monetary	Interest rates, the money supply, credit regulations (and, in many questions, the exchange rate)
Fiscal	Government spending, taxes, the budget deficit or surplus, subsidies
Supply-side	Training, deregulation, privatisation, incentives that raise productive capacity
Trade	Tariffs and quotas

Some things are not in the central bank's hands at all: it cannot set wages in the private and public sectors, change taxes or impose tariffs.

Tool 1: interest rates

The central bank sets its own **policy rate** (the rate at which it lends to commercial banks). Commercial banks then change the rates they charge on loans and pay on savings. The interest rate is the **price of borrowing** and the **reward for saving**.

A rise in interest rates works through several channels:

- **Borrowing costs more.** A household with a \$150 000 variable-rate mortgage pays \$4500 a year in interest at 3%, but \$9000 at 6%: \$4500 a year less to spend on other things. Loans for cars, furniture and other consumer durables become dearer too, so **consumption (C) falls**.
- **Saving pays more.** \$20 000 in a savings account earns \$400 a year at 2% but \$1000 at 5%, so households save more and spend less: **consumption falls**.
- **Investment is less profitable.** A firm considering a project that returns 7% a year will go ahead if it can borrow at 5%, but not at 8%. So **investment (I) falls**.
- **The exchange rate rises.** Higher interest rates attract savings ("hot money") from abroad, raising demand for the currency, so it **appreciates**. Exports become dearer abroad and imports cheaper at home, so **net exports ($X - M$) fall**, and cheaper imported raw materials lower firms' costs.
- **Confidence and wealth fall.** House and share prices tend to fall, so people feel poorer and spend less.

A cut in interest rates does the opposite: borrowing is cheaper, saving pays less, investment rises, the currency **depreciates** (so export prices fall and import prices rise) and C , I and $(X - M)$ all rise.

The **real interest rate** is what borrowing really costs once inflation is taken off:

$$\text{real interest rate} = \text{nominal interest rate} - \text{inflation rate}$$

At 5% interest and 3% inflation the real rate is $5 - 3 = 2\%$. At 4% interest and 7% inflation it is $4 - 7 = -3\%$: savers lose purchasing power and borrowers gain, so a negative real rate encourages spending even though the nominal rate looks high.

Tool 2: the money supply

The **money supply** is the amount of money in the economy: notes and coins plus bank deposits. The central bank can increase it, for example by issuing more notes and coins or by buying government bonds from banks (which gives the banks more money to lend; this is often called **quantitative easing**). It can reduce it by selling bonds (**quantitative tightening**).

More money in the banks means more money to lend, so banks lend more cheaply: **an increase in the money supply lowers interest rates** and raises spending, so **AD shifts right**. A cut in the money supply raises interest rates and shifts AD left.

Tool 3: credit regulations

Credit regulations are rules that limit how much commercial banks can lend and to whom, for example:

- a higher **reserve requirement** (the share of deposits banks must keep and not lend);
- limits on how much people can borrow compared with the value of a house, or with their income;
- a minimum deposit on goods bought on credit (hire purchase), or limits on credit-card lending.

Tighter credit rules mean fewer loans, so less spending (contractionary). **Looser** credit rules, or the central bank helping banks to lend more, mean more borrowing and spending (expansionary). Credit rules act quickly on borrowing because they limit loans directly instead of waiting for people to react to a price.

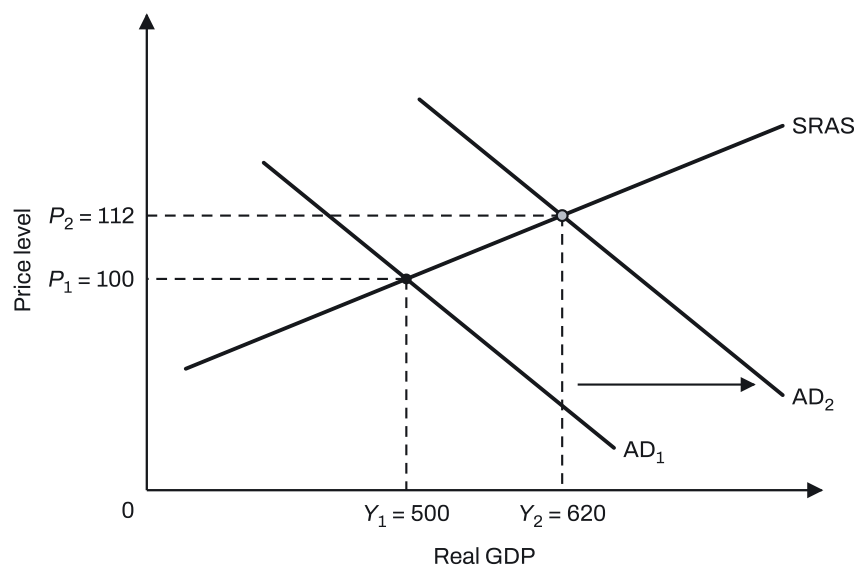
Expansionary and contractionary monetary policy

	Expansionary (loose)	Contractionary (tight)
Interest rates	Cut	Raised
Money supply	Increased	Reduced
Credit regulations	Loosened	Tightened
Exchange rate (if managed)	Lowered (depreciation)	Raised (appreciation)
Aggregate demand	Rises (AD shifts right)	Falls (AD shifts left)
Used for	Recession, high unemployment, deflation	High demand-pull inflation, an overheating economy

Monetary policy on an AD/AS diagram

Aggregate demand is $AD = C + I + G + (X - M)$. Monetary policy works on C , I and $(X - M)$ through the channels above. This chain from the central bank's decision to spending is called the **transmission mechanism**:

interest rate $\downarrow \Rightarrow$ borrowing cheaper, saving less rewarding $\Rightarrow C \uparrow, I \uparrow \Rightarrow AD \uparrow \Rightarrow$ output, jobs, prices $\uparrow$

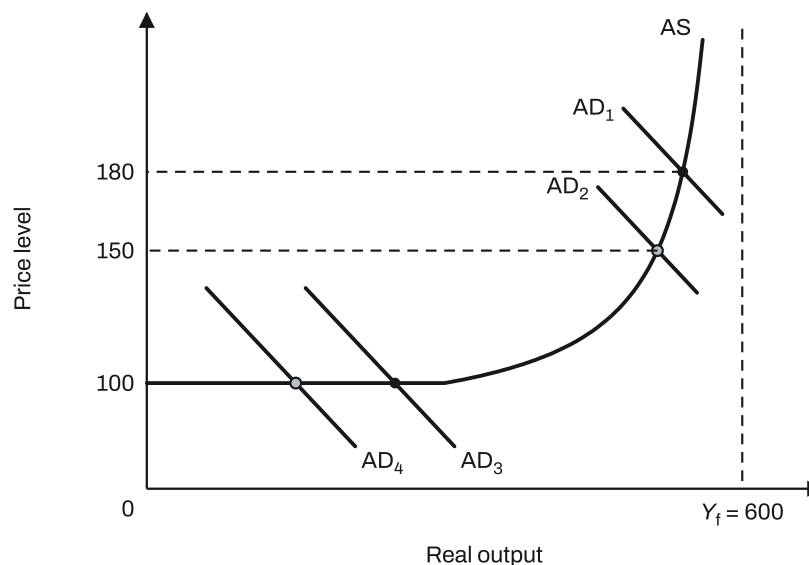


Expansionary monetary policy. The central bank cuts interest rates (or raises the money supply, or loosens credit), so consumption and investment rise and AD shifts right from AD_1 to AD_2 . Firms sell more, so **real output and national income rise** (500 to 620). To produce more they hire more workers, so **employment rises** and unemployment falls. As output grows, costs rise, so the **price level rises** too (100 to 112). This is **economic growth** in the short run: a rise in real GDP. If the extra investment adds to the stock of machines and buildings, it also raises productive capacity in the long run.

Contractionary monetary policy does the reverse: higher interest rates shift AD left from AD_2 to AD_1 . The **price level falls** (in practice, inflation slows: prices rise more slowly), but **real output falls** (620 to 500) and **unemployment rises**. This is the trade-off: lower inflation is bought with slower growth and fewer jobs.

How much output and how much inflation?

How much a change in AD moves prices rather than output depends on how much **spare capacity** the economy has.



- **Near full capacity** (AD_1 to AD_2 , an economy on its production possibility curve): a rise in interest rates lowers the price level a lot (180 to 150) for a small loss of output (540 to 515). This is when contractionary monetary policy works best against inflation.
- **With lots of spare capacity** (AD_3 to AD_4): the same fall in AD cuts output a lot (250 to 150) and the price level not at all. Here contractionary policy only costs jobs.
- Read the other way, **expansionary policy** raises output and jobs most when there is spare capacity; near full capacity it mostly raises prices. A rate cut cannot cut unemployment if there is **no spare productive capacity**.

When monetary policy works well, and when it does not

These are the evaluation points examiners reward:

- **Interest elasticity of spending.** If borrowing and spending respond strongly to interest rates (much spending is on credit, many mortgages are on variable rates), the policy is powerful. If households and firms barely react, it is weak.
- **Confidence and expectations.** In a deep recession or deflation, firms may not invest and households may not borrow however low rates go, because they expect falling sales or falling prices. Once rates are near zero they **cannot be cut much further**. And if people expect prices to rise even faster, they buy now and demand pay rises, so a rate rise has less effect.
- **The cause of inflation.** Higher rates reduce AD, so they suit **demand-pull** inflation. Against **cost-push** inflation (dearer oil, food or imported materials) they only reduce output and jobs, and can even raise firms' costs of borrowing.

- **Time lags.** A change in interest rates takes many months (often a year or more) to have its full effect on spending and prices.
- **Side effects on other objectives.** Higher rates slow growth and raise unemployment; can push the economy into **recession**; appreciate the currency, which makes exports less competitive and worsens the current account; raise the cost of the government's debt; and can reduce investment and so **aggregate supply** in the long run.
- **The exchange rate can help.** With a **floating exchange rate**, a rate rise that **appreciates** the currency makes imports cheaper, which pulls inflation down further.
- **Independence and targets.** A central bank that is independent of the government and has a clear inflation target is more believable: if people trust it to keep inflation near the target, wage and price expectations stay low and a **wage-price spiral** is less likely. But a target does not stop shocks, and the bank may hesitate to raise rates if it fears a recession.

Monetary policy compared with other policies

	Monetary policy	Fiscal policy	Supply-side policy
Works through	$C, I, (X - M)$ via interest rates and credit	G directly and C, I via taxes	Aggregate supply: productivity, costs, capacity
Speed of decision	Fast: a committee meeting each month or so	Slow: a budget must be agreed	Slow to agree and very slow to work
Strengths	Flexible, small steps, no extra government debt, run by an independent bank	Direct; can target groups or regions; works when rates are already near zero	Lowers costs and raises capacity, so cuts inflation and raises output; suits cost-push inflation and structural unemployment
Weaknesses	Blunt (hits all borrowers), time lags, weak if confidence is low or inflation is cost-push, exchange-rate effects	Deficit and national debt, political pressure, time lags	Takes years, can be expensive, results not guaranteed, cannot stop imported inflation

Key facts and formulas

There is no formula list in the 9708 exam, so everything here is "Learn it".

Formula	Status
Real interest rate = nominal interest rate – inflation rate	Learn it
Interest paid in a year = amount borrowed $\times$ interest rate	Learn it
$AD = C + I + G + (X - M)$	Learn it
Expansionary: interest rates down, money supply up, credit loosened; AD shifts right	Learn it
Contractionary: interest rates up, money supply down, credit tightened; AD shifts left	Learn it
Money supply up $\Rightarrow$ interest rate down $\Rightarrow C$ and I up $\Rightarrow$ AD right	Learn it

How to do it

We tagged 55 questions for this topic (2021–2025): 37 Paper 1 multiple choice and 18 Paper 2 essays or data responses. For Paper 2 we count only the parts about monetary policy; 4 of those questions have parts of more than one type, so the counts add up to 60.

Question type	Questions
Multiple choice: identify monetary tools; expansionary or contractionary	14
Trace a monetary policy change to AD, output, prices and jobs	11
Multiple choice: choose the right monetary policy (or fiscal–monetary mix)	10
Essay or data: will monetary policy control inflation or correct deflation?	8
12-mark essay: compare monetary policy with fiscal or supply-side policy	8
Multiple choice: conditions that make monetary policy more or less effective	5
Data response: assess a monetary stance in context	2
Data response: real interest rate, or compare rate and inflation changes	2

1. Multiple choice: identify monetary tools; expansionary or contractionary (14 questions)

1. **Sort each measure:** interest rates, the money supply, credit regulations (and issuing notes and coins) are **monetary**; taxes, spending, the budget balance and subsidies are **fiscal**; tariffs are trade policy; training is supply-side.
2. **Give it a direction:** lower rates, more money, looser credit and a lower exchange rate are expansionary; the opposite is contractionary.
3. **Match every column** in a table question. One wrong column rules an option out.

Variations you will meet:

- **"Which is not monetary policy?"** The odd one out is a fiscal or trade measure: higher subsidies, a rise in import tariffs ([9708/11/M/J/25 Q21](#)).
- **"Which is not directly in the central bank's control?"** Wage limits in the public and private sectors; the bank controls interest rates, the money supply and credit rules ([9708/12/O/N/25 Q19](#)).
- **"Which would the government increase for tighter monetary policy?"** The interest rate. An increase in the budget surplus or taxes is tighter **fiscal** policy.
- **Exchange rate options.** A **fall** in the exchange rate is counted as expansionary monetary policy ([9708/12/M/J/25 Q21](#)); a rise (appreciation) is contractionary.
- **"Most expansionary set":** credit availability increased, interest rates down, money supply increased, all three at once ([9708/11/O/N/23 Q29](#)).
- **Reducing credit regulation** is expansionary monetary policy.
- **Two policies together.** Higher interest rates with higher taxes on spending are both contractionary, so they **reinforce** each other.

2. Trace a monetary policy change to AD, output, prices and jobs (11 questions)

1. **Start with the interest rate.** More money supply or looser credit lowers it; less money or tighter credit raises it.
2. **Follow the chain:** borrowing cost and reward for saving $\rightarrow C$ and I (and the exchange rate $\rightarrow X - M$) $\rightarrow$ AD shifts.
3. **Read the outcome:** AD right means real GDP up, employment up (unemployment down), price level up; AD left means the reverse.

Variations you will meet:

- **"Effect of more money supply on the interest rate and AD?"** Interest rate falls, AD shifts right (9708/12/O/N/25 Q22).
- **Expansionary policy over several years:** real GDP rising, price level rising, unemployment falling.
- **Contractionary policy:** investment falls and inflation falls; consumers save more because saving pays more.
- **Rate cut and trade:** the currency depreciates, so **export prices fall** (in foreign currency) and import prices rise. Borrowing by firms and consumer spending rise.
- **Diagram questions:** find the new equilibrium where the shifted AD meets AS. Less money supply moves AD **left**; to move along an LRAS diagram to a point with more output, the policy must be expansionary (more money, lower rate).
- **8-mark (a) part**, such as "with an AD/AS diagram, explain how a cut in interest rates could cause economic growth and consider whether growth always brings inflation":
 1. **Knowledge (3):** define economic growth (a rise in real GDP), inflation (a sustained rise in the general price level) and the interest rate (the cost of borrowing and reward for saving), and draw an accurate diagram (axes price level and real GDP, AD_1 , AD_2 , AS, both equilibria).
 2. **Analysis (3):** lower rates $\rightarrow$ cheaper borrowing, less reward for saving (1) $\rightarrow$ more consumption, investment (and net exports via a depreciation) (1) $\rightarrow$ AD shifts right, real GDP rises: growth (1).
 3. **Evaluation (2):** growth brings inflation only if the economy is near full capacity; with spare capacity output rises with little price rise (diagram 2), and if the extra investment raises long-run capacity, AS shifts right too, so growth need not be inflationary (1). End with a justified conclusion (1).
- **Data parts** may ask for an exchange-rate diagram: low interest rates reduce the demand for the currency (savers move money abroad), so it depreciates.

3. Multiple choice: choose the right monetary policy (or fiscal–monetary mix) (10 questions)

1. **Name the problem:** inflation above target (often with very low unemployment) needs AD to fall; deflation, a falling CPI or a recession need AD to rise.
2. **Pick the policy that moves AD that way**, and check every column of a mix.
3. **Check any extra condition** in the stem ("without adding to the national debt", "in the short run", "most immediate").

Variations you will meet:

- **Inflation of 6% against a 2.5% target, very low unemployment:** raise interest rates.
- **Deflation or a negative CPI change:** reduce interest rates, increase the money supply; a fiscal partner is more government spending or a bigger deficit (9708/11/M/J/24 Q23).

- **A CPI table** (100, 103, 101, 97): prices are falling, so increase the money supply.
- **"Deflation, but the national debt is already very large"**: reduce the budget deficit (so no new debt) and increase the money supply ([9708/13/O/N/22 Q29](#)).
- **To cut inflation**: a higher exchange rate, a higher interest rate and a lower money supply, all together.
- **Global recession**: keep interest rates very low and increase the money supply.
- **"Most immediate effect in a downturn"**: helping banks lend more acts faster than long-term transport projects.
- **Inflation-target graph**: rates are cut only where inflation is **below** the target (the minimum) and raised where it is above it.

4. Essay or data: will monetary policy control inflation or correct deflation? (8 questions)

Data-response parts (4 or 6 marks) and essay parts (8 or 12 marks), such as "Assess the extent to which keeping interest rates high is the best way to control inflation" or "Discuss whether expansionary monetary policy will correct deflation".

1. **Define** monetary policy and the problem (inflation or deflation: a sustained fall in the general price level).
2. **Explain the chain in full** for at least two components of AD: higher rates $\rightarrow$ dearer borrowing and more reward for saving $\rightarrow C$ falls; dearer borrowing $\rightarrow I$ falls; appreciation $\rightarrow (X - M)$ falls and imports cheaper $\rightarrow$ AD shifts left $\rightarrow$ the price level rises less (lower demand-pull inflation). Use diagram 1.
3. **Explain why it may not work** (at least two reasons): cost-push inflation, low interest elasticity, time lags, expectations, damage to growth and jobs, appreciation hurting exporters, rates already very high or near zero, low confidence in deflation.
4. **Evaluate in the context of the case**. Use the data: is the inflation caused by rising AD (then rates suit it) or rising costs (then they do not)? How high are rates already? How long will it take? Is there an alternative (fiscal, supply-side) that does less damage?
5. **Conclude**: answer the question directly ("high rates are the best policy in the short run because the inflation is demand-led, but...").

In 6-mark data parts: up to 3 marks for each side (4 at most for both together), then 2 for evaluation, 1 kept for a justified conclusion.

5. 12-mark essay: compare monetary policy with fiscal or supply-side policy (8 questions)

Marked by levels: 8 for knowledge and analysis, 4 for evaluation. For example "Assess whether supply-side policy or demand-side policy is the better way of reducing inflation", "Discuss whether you would use monetary or fiscal policy to correct deflation", or "Assess which expansionary policy would best achieve low unemployment".

1. **Define** both policies and the aim.
2. **Analyse policy 1** for **this** aim: its mechanism as a full chain (with a diagram) and its drawbacks.
3. **Analyse policy 2** the same way. Use the comparison table above.
4. **Tie each one to the cause**: demand-pull inflation suits demand-side policy (higher rates or taxes); cost-push inflation suits supply-side policy (training, technology and infrastructure raise productivity and lower costs, shifting AS right) but this takes years, and supply-side policy cannot stop imported inflation from dearer oil; deflation from weak demand suits expansionary fiscal policy if confidence is too low for rate cuts to work.

5. **Judge which is better** for the stated aim and say what it depends on (the cause, the time scale, how high rates or debt already are, spare capacity). Often the best answer is a mix: rates for a quick effect on demand, supply-side policy for the long run.

A general description of the two policies, not linked to the aim, stays in Level 2. A one-sided answer gets no evaluation marks. With "Excluding interest rate changes, what else could reduce inflation?", use the other monetary tools (less money supply, tighter credit) and fiscal policy (higher taxes, lower spending), one advantage and one drawback each.

6. Multiple choice: conditions that make monetary policy more or less effective (5 questions)

1. **Ask what the policy must change:** a rate rise must cut spending, so it works best when spending is **interest-elastic** and the economy is at **full capacity**.
2. **Look for something that helps or blocks the chain.**

Variations you will meet:

- **"When is a rate rise most likely to succeed?"** When a floating exchange rate **appreciates** (imports cheaper, exports dearer) ([9708/11/O/N/25 Q23](#)). Not when spending is interest-inelastic, the budget deficit is growing or unions push up wages.
- **"Biggest impact on the price level?"** The economy is **on** its production possibility curve (full capacity) and AD is **highly** responsive to interest rates.
- **"What limits a rate cut in reducing unemployment?"** A lack of productive capacity.
- **"Why might a government not raise rates to cut inflation?"** Aggregate supply may fall (dearer borrowing cuts investment and capacity). A fall in AD is the aim, not the drawback.
- **"What makes a rate rise less effective?"** Consumers expect prices to rise even faster. (Spending mostly on credit makes it **more** effective.)

7. Data response: assess a monetary stance in context (2 questions)

6-mark parts, such as "Assess whether rises in the interest rate make a recession inevitable" or "Assess whether an inflation target helps the economy".

1. **Quote the data:** the rates and inflation figures over time.
2. **Analyse one side** (up to 3): for example, rising rates make borrowing dearer for consumers and firms, so AD (and, through investment, AS) falls, output falls and unemployment rises: a recession.
3. **Analyse the other side** (up to 3): for example, spending may be interest-inelastic, other things (government spending, exports, confidence) may keep AD up, and the rise may be small or brief.
4. **Evaluate** (2): weigh the two in this country's case and end with a justified conclusion.

For an **inflation target**: helpful because it anchors expectations, builds confidence and limits a wage-price spiral; less helpful because the bank may not act firmly for fear of recession, and shocks such as dearer energy are beyond its control. For **cutting rates while inflation is high**: the currency depreciates, making exports cheaper but imports dearer, which adds to inflation and can lead savers to move money abroad.

8. Data response: real interest rate, or compare rate and inflation changes (2 questions)

1. **Real interest rate** = nominal rate – inflation rate. Keep the sign: with a 14% interest rate and 48.7% inflation the real rate is $14 - 48.7 = -34.7\%$ (9708/23/M/J/24 Q1). Leaving off the minus sign loses a mark.
2. **"Compare changes in the inflation rate and the interest rate"**: make a direct comparison across both series (for example "inflation rose then fell, while the interest rate rose throughout"; "the interest rate changed by proportionately more"), not a description of each in turn.

Worked examples

Example 1

Which combination is the most expansionary monetary policy?

	interest rate	money supply	reserve requirement for banks
A	down	up	up
B	up	down	up
C	down	up	down
D	up	up	down

[1]

A lower interest rate, a larger money supply and a lower reserve requirement (banks can lend more of their deposits) all make borrowing cheaper or easier, so all three raise AD. The answer is **C**. (1)

A tightens credit, so one tool works against the others; B is contractionary in every column; D raises the interest rate.

Example 2

The table shows a country's central bank interest rate and its inflation rate in two years.

	year 1	year 2
interest rate (%)	5.5	6.0
inflation rate (%)	8.0	3.2

Calculate the real interest rate in each year and explain what the change means for borrowers. [3]

Real interest rate = nominal rate – inflation rate. Year 1: $5.5 - 8.0 = -2.5\%$ (1). Year 2: $6.0 - 3.2 = 2.8\%$ (1).

The real interest rate rose by $2.8 - (-2.5) = 5.3$ percentage points although the nominal rate rose by only 0.5, so the real cost of borrowing went from negative (inflation more than wiped out the interest) to positive, discouraging borrowing and spending (1).

Example 3

With the help of an AD/AS diagram, explain how a rise in interest rates could reduce demand-pull inflation, and consider whether it will always reduce inflation. [8]

Monetary policy is the use of interest rates, the money supply and credit regulations by the central bank to influence aggregate demand (1, AO1). Demand-pull inflation is a sustained rise in the general price level caused by aggregate demand growing faster than the economy's capacity to supply (1, AO1). [Diagram 1 read from AD_2 to AD_1 ; axes labelled price level and real GDP, SRAS, AD shifting left, the price level falling from 112 to 100 and real GDP from 620 to 500] (1, AO1).

A rise in interest rates makes borrowing dearer and saving more rewarding, so households take out fewer loans for cars and houses and save more (1, AO2). Firms find fewer investment projects profitable at the higher cost of borrowing, so investment falls, and the higher rate attracts money from abroad, appreciating the currency and cutting net exports (1, AO2). With consumption, investment and net exports lower, AD shifts left, so the price level rises more slowly than before: demand-pull inflation falls, though real output and employment fall too (1, AO2).

It will not always work: if the inflation is cost-push, caused by dearer energy or imported materials, cutting AD lowers output and jobs while costs keep rising, and if households and firms are not sensitive to interest rates, or expect inflation to stay high, spending falls little (1, AO3). So a rise in interest rates is likely to reduce inflation when it is caused by excess demand and the economy is near full capacity, but it is a weak and costly tool against cost-push inflation (1, AO3, a justified conclusion).

(Knowledge 3, analysis 3, evaluation 2: 8/8.)

Example 4

Assess whether cutting interest rates or raising government spending is the better way to end a recession in an economy whose national debt is already high. [12]

Model answer (outline of each paragraph):

1. **Terms.** A recession is a fall in real GDP over at least two quarters in a row, with rising unemployment. Cutting interest rates is expansionary monetary policy, run by the central bank; raising government spending is expansionary fiscal policy, run by the government through its budget. Both aim to raise aggregate demand. *(Accurate knowledge.)*
2. **How a rate cut works.** Lower rates make borrowing cheaper and saving less rewarding, so households spend more on credit and firms find more investment projects profitable; the currency depreciates, so exports rise and imports fall. C , I and $(X - M)$ rise, AD shifts right (diagram 1, AD_1 to AD_2), and real output and employment rise. With spare capacity in a recession, prices rise little (diagram 2). Crucially here, it adds nothing to the national debt and lowers the interest the government pays on what it already owes. *(Developed chain with a labelled diagram, more than one component of AD, tied to the high debt.)*
3. **Limits of a rate cut.** In a recession confidence is low: firms expecting falling sales may not invest and worried households may save however cheap borrowing is. Rates may already be low, leaving little room to cut. The full effect takes a year or more, and a weaker currency raises import prices. *(The other side: Level 3 needs both.)*
4. **How more government spending works.** Spending on roads, schools or hospitals raises G directly, creating jobs and incomes, which are then spent again; it does not depend on anyone choosing to borrow, and spending on infrastructure can also raise capacity later. But with debt already high it means a bigger deficit and more debt,

higher interest payments that take money from future spending, possibly higher rates demanded by lenders (which cuts private investment), and future tax rises that people may save for now. It is also slow to agree and start. (*Alternative analysed with strengths and limits, in the context of high debt.*)

5. **Evaluation.** The answer depends on how deep the recession is, how low rates already are and how high the debt is. A rate cut suits a mild recession where rates have room to fall and confidence is reasonable; government spending suits a deep slump with rates near zero, but high debt makes it costly and risky. (*Weighs the conditions.*)
6. **Conclusion.** Because the national debt is already high, cutting interest rates is the better first step: it is quick, cheap for the government and lowers its debt interest. Higher spending should be kept for a deep recession where rate cuts fail, and then targeted at projects that raise future capacity. (*Justified conclusion: full evaluation marks.*)

Common mistakes

- **Mixing up monetary and fiscal policy.** Taxes, government spending, subsidies and the budget deficit are fiscal; interest rates, the money supply and credit rules are monetary. An answer that swaps them throughout earns almost nothing, however well argued.
- **Asserting the result.** "Higher interest rates reduce AD, so inflation falls" is the most common weak answer. Examiners keep asking for the reason: borrowing becomes more expensive **and** saving more rewarding, **so** C and I fall. Without the link, marks stop at about half.
- **Only one component of AD.** Explain the effect on at least two of consumption, investment and net exports; mark schemes cap answers that cover only one.
- **No reasons why it might fail.** Many answers explain how monetary policy works but never say why it might not: cost-push inflation, low interest elasticity, low confidence, time lags.
- **Describing instead of comparing.** When asked which policy is better, a description of each policy, not tied to the aim, stays in Level 2. Supply-side policy is often explained too thinly to compare.
- **Diagrams.** Use an AD/AS diagram, not a demand and supply diagram for one market. Label the axes price level and real GDP (or real output), the curves AD_1 , AD_2 and AS, and both equilibria.
- **Disinflation is not deflation.** A rate rise that brings inflation down from 6% to 3% is disinflation: prices still rise, just more slowly.
- **Losing the minus sign.** A real interest rate with inflation above the nominal rate is negative.
- **No conclusion.** "Assess" and "discuss" need a final judgement that answers the question; summing up the analysis again is not evaluation.

How to get the marks

- **Multiple choice:** write "M / F / S" (monetary, fiscal, supply-side) and "exp / con" beside each measure; for "most" or "least" questions read all four options before choosing.
- **Define first.** Knowledge (AO1) marks go to precise definitions: monetary policy, interest rate, money supply, credit regulations, inflation, deflation, economic growth.
- **"Explain"** means the full transmission mechanism: tool $\rightarrow$ interest rate $\rightarrow$ borrowing and saving $\rightarrow C, I, (X - M) \rightarrow$ AD $\rightarrow$ output, employment and the price level. Each link is an analysis (AO2) mark.

- **Diagrams:** an accurate, labelled AD/AS diagram earns a knowledge mark and makes analysis clearer. Show the shift and both equilibria.
- **"Consider", "assess", "discuss", "to what extent":** both sides, then a judgement that says what the answer **depends on** (the cause of inflation, spare capacity, confidence, the time scale), then a sentence that answers the question. One-sided answers get no evaluation marks.
- **8-mark (a) parts:** point-marked, up to 3 knowledge, 3 analysis, 2 evaluation (one kept for a justified conclusion).
- **12-mark (b) parts:** level-marked, 8 for knowledge and analysis, 4 for evaluation. Level 3 needs balanced analysis tied to the question's aim; "the best way" needs at least one alternative policy.
- **Data responses:** use the case. If the data shows the inflation is caused by rising demand, say rates suit it; quote the figures; evaluation not in the country's context gets no credit.
- **Calculations:** show the formula and the answer with its sign and unit (%).

Quick check

1. Classify each as monetary, fiscal or supply-side policy, and as expansionary or contractionary: (a) the central bank cuts its interest rate; (b) banks must keep a larger share of deposits in reserve; (c) income tax is raised; (d) the government cuts its spending on roads.
2. The interest rate is 4% and inflation is 6.5%. Next year the interest rate is 7.5% and inflation is 3%. Calculate the real interest rate in each year and the change.
3. A firm has a \$12 000 loan. Calculate its yearly interest at 8% and at 5%, and explain how a cut in interest rates from 8% to 5% might affect its investment.
4. Explain how a cut in interest rates affects the exchange rate, export prices and aggregate demand.
5. Explain why raising interest rates may be a poor way to reduce inflation caused by a rise in world oil prices. **[2]**

Answers

1. (a) monetary, expansionary; (b) monetary (credit regulation), contractionary; (c) fiscal, contractionary; (d) fiscal, contractionary (lower G reduces AD).
2. Year 1: $4 - 6.5 = -2.5\%$. Year 2: $7.5 - 3 = 4.5\%$. The real rate rose by $4.5 - (-2.5) = 7$ percentage points, a big tightening of monetary conditions.
3. At 8%: $12\,000 \times 0.08 = 960$, so \$960 a year; at 5%: $12\,000 \times 0.05 = 600$, so \$600. The cut saves the firm \$360 a year, so more projects become profitable and it is more likely to borrow and invest, which raises AD (and, later, capacity), especially if it is confident sales will grow.
4. Lower interest rates make saving in the country less attractive, so savers move money abroad and demand for the currency falls: it depreciates. Exports become cheaper in foreign currency and imports dearer, so net exports rise, adding to the rise in consumption and investment from cheaper borrowing: AD shifts right.
5. Dearer oil is cost-push inflation: it raises firms' costs and shifts AS left, which higher interest rates do not reverse (1). Cutting AD then lowers output and raises unemployment, while prices are still pushed up by costs, so the economy gets less growth with little fall in inflation (1).

Past questions to try

- [9708/13/O/N/22 Q29](#): the fiscal–monetary mix for deflation when the national debt is large.
- [9708/11/O/N/23 Q29](#): the most expansionary combination of monetary tools.
- [9708/23/M/J/24 Q1](#): a real interest rate calculation and a country cutting rates during high inflation.
- [9708/23/M/J/22 Q3](#): whether contractionary monetary policy is the best way to reduce inflation.