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Answers

Exam-style questions

Questions on inflation and the bank rate

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This resource provides answers to the questions posed in the Exam-Style Questions column, in the April 2023 issue of ECONOMIC REVIEW.

Question 1

Using Table 1, calculate the mean rate of CPI inflation over the period shown. Give your answer to one decimal place. (2 marks)

Answer

$$(-0.1 + 1.0 + 3.0 + 2.4 + 1.7 + 1.4 + 3.1 + 10.1) / 8 = 22.6 / 8 = 2.825$$

- Answer = 2.8 to 1dp
- 1 mark for correct answers not rounded to 1dp
- 1 mark for correct method but incorrect final answer

Question 2

With the help of a diagram, explain how the transmission mechanism of monetary policy works when the bank rate is increased. (9 marks)

Answer

Relevant points include:

- Definitions, e.g. of transmission mechanism, monetary policy, interest rate
- Increased bank rate leads to increased market interest rates, increasing reward/incentive for saving, reducing consumption, reducing AD
- Explanations of reduced business investment, reduced exports
- Use of relevant diagram, e.g. AD decrease
- Possible multiplier effects

Question 3

Explain how the data in Table 1 may show that incentives for saving in the UK have changed between 2015 and 2022. (25 marks)

Answer

Relevant points include:

- Incentives to save include reward for saving (interest rate)
- Bank rate rose by 1.75% over the whole of the period
- In September 2015, the bank rate was greater than inflation which suggests that the real interest rate, and therefore the real reward for saving, was positive
- In every other period in the table, inflation was greater than the bank rate, which suggests that the real interest rate, and therefore the real reward for saving, was negative
- Maximum difference was in September 2022

Question 4

Evaluate the view that governments should target low inflation even in a recession. (25 marks)

Answer

Issues for consideration:

- Understanding of low inflation
- Nature of inflation targeting and monetary policy framework
- Understanding of recession/economic cycle
- Justification for/benefits of low inflation, e.g. increased international competitiveness
- Avoiding problems of high inflation, e.g. reduced certainty/confidence of economic agents
- Issues with targeting low inflation when growth is low/negative, e.g. 'tight' monetary policy may reduce economic activity further, worsening recession, cyclical unemployment etc.

Issues for evaluation:

- Low inflation should be maintained irrespective of the stage in the economic (business) cycle as it helps to achieve other macroeconomic objectives as it is associated with macroeconomic stability
- Low inflation should not be maintained as it makes the problem of recession worse if macroeconomic policy is tightened
- Scope for use of supply-side policies
- Scope for relaxing the target in a recession
- Scope for targeting alternative objectives, e.g. strong, stable growth, or low unemployment