



Skoolumy

**CAMBRIDGE A LEVEL ECONOMICS TOPICAL ESSAY
QUESTIONS**

MONEY AND BANKING

PAST QUESTIONS

1. Explain and critically evaluate the quantity theory of money. [12]

2. (a) Explain the reasons why people demand money according to the liquidity preference theory.

Consider which reason is the most important. [12]

(b) In 2015, after a period of low inflation and low interest rates a commentator wrote, 'If inflation suddenly increases it could result in a faster than expected rise in interest rates. The consumer spending boom will end.' (Source: London Evening Standard, 26 January 2015)

Discuss the possible reasons behind this suggested result. [13]

3. (a) In a time of recession some people fear that their continued employment is uncertain. Explain how, according to liquidity preference theory, this might affect their demand for money. [12]

(b) Discuss how, in a closed economy, a fall in interest rates might affect consumers and producers. [13]

4. Discuss, with reference to liquidity preference theory, whether interest rates are the main determinant of consumers' demand for money. [13]

5. (a) For what purposes do people demand money? [10]

(b) Discuss the effect of an increase in the supply of money on interest rates and national income. [15]

6. Discuss the role and importance of the commercial banks in a developed economy. [13]

7. Privatisation is often required by the International Monetary Fund (IMF) and the World Bank before they are prepared to offer support to countries requiring loans, grants, debt relief and debt cancellation programs.

Evaluate the view that privatisation will always improve the allocation of resources in a country. [20]

8. Between 2010 and 2020, very low interest rates encouraged low-income countries to borrow money from foreign investors and governments to finance long-term economic growth.

Evaluate this approach to promoting long-term economic growth. [20]

9. Central banks can control the money supply. An increase in the money supply will cause inflation, therefore central banks can control inflation.

Evaluate this statement. [20]

MARK SCHEME

1. The quantity theory of money is based on the assumption that there is a direct relationship between a change in the money supply and the rate of inflation. The theory uses the equation $MV = PT$. This assumes that V is constant and T is constant (i.e. consistent with the full employment level of transactions). On this basis, any change in M (the money supply) will have a direct effect on P (the price level).

Critics question both of these assumptions and also point out that it is extremely difficult to measure the money supply and also difficult to effectively control the money supply.

L4 (9–12 marks) For a clear explanation of the quantity theory of money and the assumptions upon which this theory is based. At least two critical evaluation points should be raised which question the assumptions and the ability to measure/control some of the variables in the equation.

L3 (7–8 marks) For detailed analysis of the quantity theory and how it is supposed to work in practice. This should be supported by some critical comment based on the assumptions of the theory.

L2 (5–6 marks) For some knowledge of the quantity theory of money and how it might be used to support the monetarist explanation of the cause of inflation. Key assumptions relating to this theory might not be considered and critical comment will be brief and undeveloped.

L1 (1–4 marks) For an answer that shows some knowledge but does not indicate that the question has been fully grasped or where the answer is mostly irrelevant.

2. (a) Description of transactions, precautionary and speculative with a suggestion as to the most important. It is likely that transactions would be the most important, but expect a reason for the choice.

Level 4 (9–12 marks): for a sound description and a clear understanding of the principles involved together with a reasoned conclusion for the choice of most important.

Level 3 (7–8 marks): for a competent comment with limited development of 3 reasons – up to 7. Competent comment with a choice of most important but no explanation of why – 8.

Level 2 (5–6 marks): for a correct description but undeveloped comment with no attempt to decide on the most important.

Level 1 (1–4 marks): for an answer that has some basic correct facts but includes irrelevancies and errors of theory.

(b) Discussion of the theory that low interest rates encourages borrowing and spending, production and employment, higher interest rates deter borrowing, Higher than expected inflation could result in a rise in interest rates to stop prices rising further because of pressure from demand.

Level 4 (9–13 marks): for a sound discussion and a clear understanding of the principles involved and a reasoned conclusion.

Level 3 (7–8 marks): for a competent comment with limited development, probably a brief mention of the possible link between inflation and interest rates. max 7 without a conclusion.

Level 2 (5–6 marks): for a limited but acceptable attempt to consider the links.

Level 1 (1–4 marks): for an answer that has some basic correct facts but includes irrelevancies and errors of theory.

3. (a) Expect transactions, precautionary and speculative explanations. Potential reductions in income might: reduce transactions, increase precautionary, or might reduce the wish to speculate with balance. It depends on individual perceptions, and the result is uncertain. Up to 6 marks for transactions and precautionary, 6 marks for speculative. [12]

(b) Candidates should analyse how the lowering of interest rates might encourage borrowing by firms/consumers, and might not encourage saving. It might help increase national income through increased investment or increased spending. [13]

L4 (9–13) For a sound discussion with good explanation of the analysis of interest rate changes and the effect on producers and consumers.

L3 (7–8) For a competent comment but with limited development of the analysis or a concentration on one group (producer/consumer), and a weaker discussion of the other group.

L2 (5–6) For a brief discussion of interest rate change and a weak application to both groups (producer/consumer).

L1 (1–4) For an answer which has some basic correct facts but includes irrelevancies. Errors of theory or omissions of analysis will be substantial.

4. Discussion of the analytical reasons why consumers demand money according to liquidity preference; transactions, precautionary, speculative motives. Interest may only affect transactions and precautionary marginally – high rates may encourage some temporary saving in ‘on-demand’ accounts. Precautionary demand has been weakened by use of credit cards – expenditure on credit cards may be influenced by interest charges. Interest rates do affect speculative demand. There is an inverse relationship – except where there is a ‘liquidity trap’.

L4 For a sound discussion with good application and a clear understanding of the principles involved. (9–13)

L3 For an accurate reference to the question but with a more limited discussion and minor errors in the analysis. (7–8)

L2 For a correct discussion but undeveloped comment, not necessarily logically presented. (5–6)

L1 For an answer which has some basic correct facts but includes irrelevancies and errors of theory. (1–4)

5. (a) Explanation of the demand for money.

L4) For a sound explanation with clear understanding of the principles involved for the different types of demand. (8–10)

L3) For a competent explanation but with limited development. (6–7)

L2) For a more general explanation which presents quite a simplistic approach. (4–5)

L1) For an answer which has some basic correct facts but includes irrelevancies. Errors of theory or omissions of analysis will be substantial. (1–3)

(b) Increase in the money supply will lead interest rates to fall, fall in interest rates lead to rise in investment and borrowing, rise in investment will lead through the multiplier to a rise in national income.

L4) For a structured discussion of each of the steps, a clearly structured answer together with a reasoned conclusion. (12–15)

L3) For a discussion, but without such a clear analysis of the steps or development and with weaker or missing conclusion. (9–11)

L2) For a limited but acceptable attempt to discuss the links but in a much more general way and without any conclusion. (6–8)

L1) For an answer which has some basic correct facts but includes irrelevancies. Errors of theory or omissions of analysis will be substantial. (1–5)

6. Key roles associated with commercial banks include: to allow the safekeeping of funds; to provide loans to consumers and producers; to act as financial intermediaries and make it easier for payments to be made within and between persons and firms.

Each of these roles can be linked to growth and development in a developed economy. Savings can be used to allow firms to borrow for investment purposes thus promoting long term economic growth. Loans can be also provided to consumers to promote an increase in consumer expenditure, increased aggregate demand and an increase in output and employment. Financial intermediation and easier methods of payment should promote specialisation and exchange thus further encouraging economic growth.

However it should also be noted that profitability is one of the main aims of a commercial bank and in some circumstances it is not clear that the needs of would-be investors are not consistent with the aims of a commercial bank. Banks have to maintain liquidity and security as well as profitability. Hence much needed loans to the private sector are not always available. In addition commercial bank loans create new bank deposits which automatically increase the money supply in an economy. In some situations this does not help a government to maintain an appropriate monetary policy. For example, a rapid increase in bank lending would be unwise when an economy is experiencing rising rates of inflation. A conclusion should summarise the preceding discussion.

L4 (9–13 marks): For a description of three key functions of a commercial bank. Responses should then discuss the importance of at least two of these roles in relation to a developed economy. Each role should be analysed and at least one evaluative comment provided in relation to each role discussed. A conclusion should attempt to assess the importance of commercial banks in relation to the preceding analysis/discussion.

L3 (7–8 marks): For a description of at least two functions of a commercial bank and an attempt to analyse the importance of these functions in a developed economy. Some attempt should be made to evaluate the importance of one of these roles.

L2 (5–6 marks): For a competent comment with the emphasis on describing how commercial banks function and supporting this with some limited comment. There will be a very limited attempt to examine why commercial banks might be important in a developed economy.

L1 (1–4 marks): For an answer that has some basic correct facts but includes irrelevancies and errors of theory.

7. AO1 and AO2 out of 14 marks. AO3 out of 6 marks.

Indicative content

Responses may include:

AO1 Knowledge and understanding and AO2 Analysis

- Definition/explanation of privatisation: the selling of state-owned corporations (the meaning of the term can include the provision of services and goods by private firms).
- Explanation of productive/allocative efficiency. X-inefficiency.
- A model of monopolistic competition/oligopoly/monopoly is used to analyse the effects on efficiency of shifting to privatised economy
- Definition/explanation of a market economy.
- Development of benefits of privatisation:
 - Greater competition in the market if an industry is privatised as competing firms.
 - Greater scrutiny of operation by shareholders should hold the company to account and increase efficiency.
 - Wider access to funds - not dependent on a government's wider economic concerns.

- Analysis may be in terms of comparing the monopoly model with one which is more competitive e.g. monopolistic competition or oligopoly and drawing the relevant inferences.
- Relevant diagrams correctly drawn and labelled with accurate reference to them in the text.
- Reduction in the need for the government to finance the activity and the implications for fiscal policy.
- A further source of funds for the government that can be used to repay government debt and reduce the burden of interest payments. The funds can be devoted to education/health services improving economic development.
- The cost of a loss-making state industry is no longer borne by the general taxpayer.

AO3 Evaluation

- Evaluation against productive, allocative and/or dynamic efficiency.
- Privatisation may lead to the break-up of a natural monopoly e.g. railways/water pipelines. The problem of the 'final mile delivery'.
- A state monopoly may simply be replaced with a private monopoly. Competition may be unrealistic due to high barriers to entry (BTE).
- Many privatisations are accompanied by an industry regulator which suggests that the privatisation needs policing. The amount and direction of investment, and the pricing strategy are reviewed to maintain the industry's efficiency.
- Equity the transfer of profitable state-owned assets to private individuals means the contribution they might make to the state funds are lost.
- Often there is a loss of employment in the industry and the burden of unemployment pay falls on the government raising the fiscal deficit or requiring more borrowing.
- Private firms are only concerned with private costs and benefits, they ignore negative externalities and their consequences.

Accept all valid responses.

8. Indicative content

Responses may include:

AO1 Knowledge and understanding and AO2 Analysis

- Definition and explanation of long-term economic growth as a function of more inputs such as labour, land, and equipment creating an outwards shift of the productive possibility curve. Economic growth is measurable in terms of increases in real GDP.
- Many developing countries are characterised by low incomes which prevent savings and the funds needed to finance investment and economic growth. Funding is needed to finance the investment and technological aspects of economic growth which comes from internal sources (savings) or from foreign lending/investment.
- Foreign investment may be from governments (e.g. China's Belt and Roads initiative), international agencies (e.g. International Bank for Reconstruction and Development (IBRD)) or sovereign wealth funds.

Governments borrow from other governments and international agencies to invest in infrastructure and other development projects which under lie economic growth.

- Private capital investment via multinational corporations (e.g. Toyota, Intel). MNC investment is usually in factories, plant and machinery which increase output directly.
- Candidates may analyse the effects of the increase in investment through aggregate supply and demand analysis.
- Successful investment requires a return (marginal efficiency of capital (MEC)) which exceeds the rate of interest that has been relatively easy to obtain.
- The effects of rising interest rates on developing countries: Many developing countries will suffer from falling exchange rates, especially if US\$ interest rates rise

this will increase the US\$ funding cost of borrowings. The balance of payments (X-M) will deteriorate.

- Accept references to IMF and World Bank lending investment funds.

AO3 Evaluation

- Impact depends on the proportion of funding which comes from abroad and how much is locally sourced. If domestic funds are not available, then how else will the growth be funded.
- The quality of the investment projects and the likelihood of realising a profit will affect the ability to cover the increase in interest rates. In some cases 'vanity projects' with little long-term economic benefit are funded (Roads to Nowhere) which enhance the standing of the government amongst its supporters but have no economic benefit.
- The short-term effects of the project in terms of raising aggregate demand may be of limited benefit to the borrower if the lender requires much of the construction and materials to be sourced from them. This will have a negative effect on the current account of the balance of payments.
- Higher interest rates in high income countries will raise the cost of borrowing by the low-income country. This means the cost of financing projects has risen representing an opportunity cost for borrowing. The balance of payments current account will deteriorate as the higher interest is paid.
- Many low-income countries may be affected by a commodity price slump which reduces export earnings and depreciates a floating exchange rate making interest rate and capital repayment more expensive.

9. AO1 and AO2 out of 14 marks. AO3 out of 6 marks.

Indicative content

Responses may include:

AO1 Knowledge and understanding and AO2 Analysis

- A definition of what is meant by inflation.
- An explanation of what constitutes the key components of the money supply. This should primarily consist of commercial bank balances held at the central bank plus all bank deposits held in the commercial banks.
- Examples of the instruments available to use by the central bank to control the money supply. Reference to and explanation of Open Market operations/Quantitative Easing, plus the use of changes in interest rates should be made and explained.
- The potential link between changes in the money supply and/or changes in the rate of interest rate and inflation should be examined.
- Analysis of the use of specific monetary policy instruments and their impact on reducing the money supply should be provided. For example, examining the links between the sale of long-term government securities and changes in the level of bank deposits.
- Analysis of how changes in interest rates/money supply might impact upon the level of aggregate demand and inflation.

AO3 Evaluation

- The money supply is very difficult to measure, thus there are many different definitions of what might constitute the money supply.
- The link between changes in the money and changes in the price level is not altogether clear.
- The link between changes in the rate of interest and changes in the money supply are not always clear. For example, an increase in the rate of interest might lead to

an increase in savings. This would cause bank deposits and therefore, the money supply to rise.

- The effectiveness of the use of monetary policy to control inflation will also depend upon the cause of inflation. For example, demand pull inflation might be controlled more effectively by the use of contractionary fiscal policy.
- A conclusion should use the preceding discussion to decide the extent to which this type of monetary is likely to be used effectively to control inflation.

Accept all valid responses

AO1 Knowledge and understanding and AO2 Analysis 14

AO3 Evaluation 6