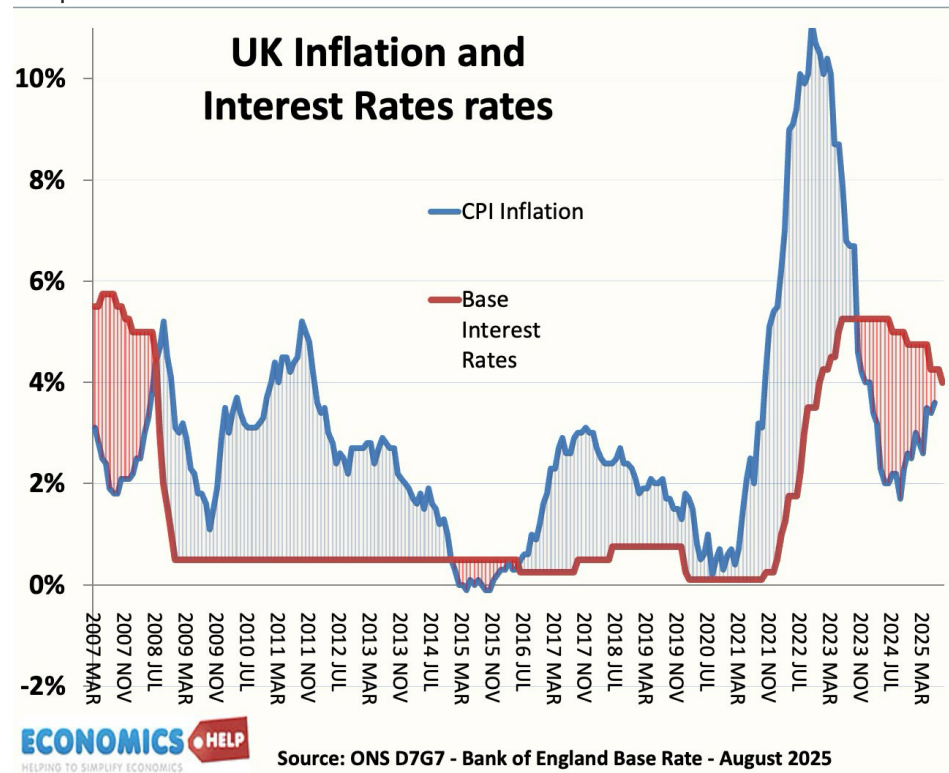
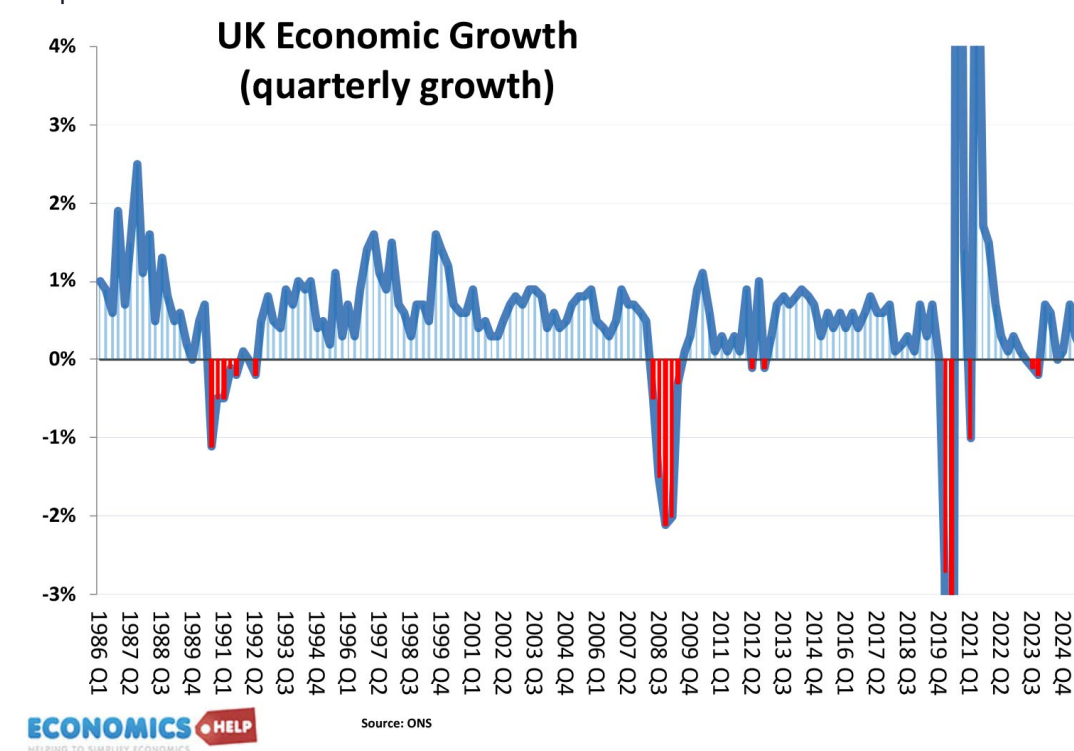


Using the data and your own knowledge, evaluate the effectiveness of monetary policy in achieving macroeconomic stability in the UK. (25)

Graph 1

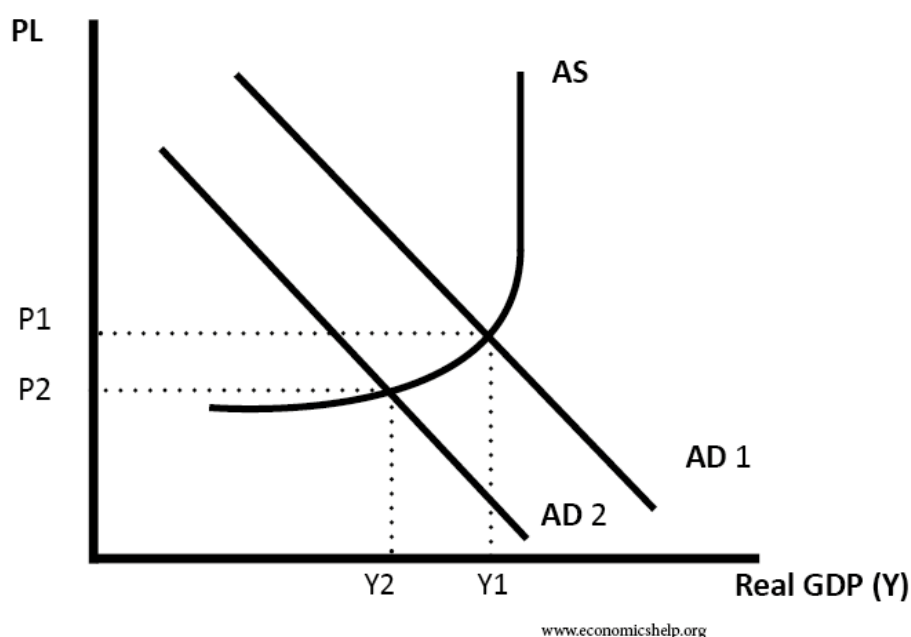


Graph 2.



Monetary policy refers to the use of interest rates and unconventional tools such as quantitative easing (QE) to influence aggregate demand and economic activity. In the UK, monetary policy is conducted by the Bank of England, whose primary objective is price stability, defined as an inflation target of 2% CPI ($\pm 1\%$). Broader macroeconomic stability also includes sustainable economic growth, low unemployment, and a stable external position, such as a manageable current account deficit.

When inflation rises above the target, the Bank of England can increase interest rates to reduce inflationary pressure. Higher interest rates increase the cost of borrowing for firms, discouraging investment, and raise mortgage and loan repayments for households, reducing disposable income. As a result, consumer spending falls, aggregate demand (AD) slows, and demand-pull inflationary pressures are reduced.



This shows how a fall in aggregate demand can lead to a lower price level.

However, the data in Graph 1 suggest that monetary policy is not always immediately effective in achieving price stability. In 2022, inflation rose sharply, peaking at around 11%, despite the Bank of England increasing interest rates. This indicates that monetary policy failed to prevent inflation rising far above the government's 2% target. One explanation is that the Bank faced imperfect information and forecasting uncertainty, meaning interest rates were raised too late. Monetary policy also operates with significant time lags, as shown by the fall in inflation during 2023 following earlier interest rate rises. This suggests that while monetary policy can eventually reduce inflation, it may not be effective in responding quickly to sudden inflationary shocks.

A further limitation is that some types of inflation are harder to control. Graph 2 shows several periods when inflation exceeded the target, such as in 2011 and 2017. These episodes were largely caused by cost-push factors, including rising oil prices, increases in indirect taxes, and depreciation of the exchange rate raising import prices. In such circumstances, raising interest rates may reduce inflation, but at the cost of lower economic growth and higher unemployment. This creates a policy trade-off. Monetary

policy struggles to deal with cost-push inflation while simultaneously maintaining economic growth. However, allowing temporary above-target inflation may be the best option for maintaining overall macroeconomic stability, as aggressively tightening policy could risk recession.

Another key objective of macroeconomic stability is avoiding recession and maintaining growth close to the long-run trend rate of around 2.5%. Graph 1 shows that between 1992 and 2007, UK economic growth was relatively stable, averaging about 0.75% per quarter (approximately 2.5% per year). This suggests that monetary policy was effective in smoothing the economic cycle during this period. However, during the 2008–09 financial crisis, the UK experienced a deep recession despite a sharp cut in interest rates to 0.5%.

In theory, lower interest rates should reduce the cost of borrowing and stimulate aggregate demand by encouraging investment, and consumption. But in practice, the recovery was weak. Banks were unwilling to lend due to the credit crunch, while households and firms lacked confidence and were reluctant to borrow, even at very low interest rates. This highlights weaknesses in the transmission mechanism of monetary policy. Furthermore, fiscal austerity from 2010 onwards reduced government spending, offsetting the expansionary impact of monetary policy. This suggests that monetary policy alone may be insufficient to ensure stable economic growth, particularly during severe downturns.

Overall, the effectiveness of monetary policy in achieving macroeconomic stability depends crucially on the nature of inflation and the state of the financial system: it is most effective against demand-pull inflation in normal conditions. But far less effective during supply-side shocks (2022) or financial crises (2008), when other policies like fiscal, regulatory and supply-side policies are needed.