

# **Question 1**

## **Part A: Base and Bank Money**

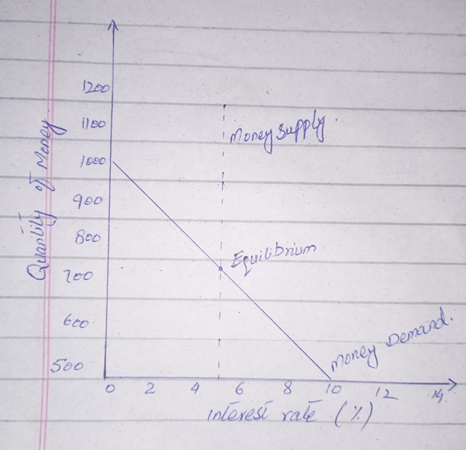
Base money (or central bank money) refers to the money created without delay by means of the central bank, together with bodily foreign money and reserves held by using business banks at the central bank. Bank money (also referred to as credit score money) is created by business banks when they difficulty loans, which provides to the money supply as deposits in bank accounts. Essentially, banks create money by the procedure of deposit creation (Mankiw, 2021).

Banks create bank money through issuing loans, which will increase the deposits accessible to households and firms. The relative significance of every kind of money in a contemporary economic system is notable: whilst base money is fundamental for liquidity and for making sure steadiness in the banking system, the bulk of the money supply in a current economic system is bank money. Bank money a long way exceeds base money due to the multiplier impact of lending (Mankiw, 2021).

The demand for money (Md) can be modeled the use of the function:

𝑀𝑑 = 𝐿(𝑌,𝑟)

Y is earnings and 𝑟 is the interest rate. Individuals maintain money for transactions, precaution, and speculative reasons, with liquidity choice growing when the interest price decreases.



Diagrams illustrating the money market can exhibit the money provide (MS) as vertical (since it is decided by using the central bank) and the demand for money (L) as a downward-sloping curve representing liquidity preference. The money market equilibrium is accomplished the place the money grant meets the demand for money (Krugman & Wells, 2018).

Commercial banks face risk like savings risk, market risk, and liquidity threat (Carlin & Soskice, 2015). These risk spotlight the fragility of the banking system, the place over-lending can lead to liquidity shortages and, ultimately, banking crises.

## **Part B: Central Bank's Role in Controlling Inflation**

When the central bank expects inflation, it restricts financial recreation through elevating interest rates. The central bank implements economic coverage the use of equipment such as open market operations, the cut price rate, and reserve requirements. By elevating activity rates, it reduces the money supply, growing borrowing prices for households and firms, which in flip curtails consumption and investment. This procedure is mirrored in diagrams of the funding function, where greater interest prices shift the funding curve downward, decreasing funding degrees (Carlin & Soskice, 2015). Additionally, the Phillips Curve can be used to exhibit the relationship between inflation and unemployment, displaying that greater interest fees can decrease inflationary pressures by growing unemployment in the brief run.

Households, firms, and banks react to rising interest quotes by means of lowering their borrowing and spending. Higher activity costs additionally appeal to overseas investment, main to foreign money appreciation, which can further limit inflation by way of making imports cheaper. However, greater interest prices can additionally limit home investment, probably stifling growth (Krugman & Wells, 2018).

## **Part C: Fiscal Policy During COVID-19**

To counteract the financial downturn induced riskCOVID-19, governments can use fiscal policy, both by way of growing taxes or the usage of bond financing. Each approach has implications for combination demand and authority’s debt.

* **Tax Increases:** Raising taxes reduces disposable earnings for households, dampening consumption and combination demand. This coverage can counteract inflation however may additionally sluggish down monetary restoration (Carlin & Soskice, 2015).
* **Bond Financing**: The authorities can trouble bonds to finance spending, which will increase combination demand in the quick run. However, in the long run, greater debt tiers can lead to greater activity prices as the authorities competes for money in the money market. This can crowd out non-public funding and sluggish long-term increase (The Core Team, 2017).

The Keynesian move graph can illustrate how authorities spending (G) influences mixture demand, transferring the equilibrium output upward. The IS curve demonstrates how bond financing may additionally at the beginning make bigger output however lead to greater interest rate in the long run.

# **Question 2**

## **Part A: Impact of Expected Promotion on Long-Run Consumption**

The everlasting earnings speculation suggests that household’s easy consumption over time, based totally on their predicted lifetime profits alternatively than present day profits (The Core Team, 2017). When an earner expects a promotion, they assume greater future income, so they may additionally amplify present day consumption, even earlier than the merchandising occurs, particularly if they have get entry to credit. If the merchandising is unexpected, the family may additionally react greater cautiously, adjusting consumption after the fact. For credit-constrained households, the potential to easy consumption is limited, and they may additionally solely enlarge consumption after the promotion. Diagrams displaying consumption smoothing with and barring credit score constraints can illustrate these eventualities (Carlin & Soskice, 2015).

## **Part B: Role of Banks in Lending**

Households do now not lend without delay to different households due to the fact of the hazard of default and the mismatch of time horizons between savers and borrowers. Banks intermediate by using remodeling private deposits into long-term loans, managing liquidity and deposit risks. Banks pool financial savings and diversify loans, lowering character default risk (Carlin & Soskice, 2015). Banks mitigate risk by practices such as collateral necessities and credit score assessments. By keeping reserves and diversifying loans, banks limit the threat of defaults impacting their solvency.

## **Part C: Deflation and the Phillips Curve**

Deflation takes place when expenditures limit over time, main to decrease combination demand and rising unemployment. The Phillips Curve illustrates the inverse relationship between inflation and unemployment. As mixture demand falls, unemployment increases, developing a poor bargaining hole in the labor market, the place workers' actual wages reduce due to deflation, exacerbating unemployment (The Core Team, 2017). Deflation is tough to reverse due to the fact falling expenses lead to greater real interest rates, discouraging funding and consumption. This is mirrored in a downward shift in the combination demand curve, main to a deflationary spiral that can be difficult to spoil (Carlin & Soskice, 2015). A key undertaking in overcoming deflation is reigniting demand whilst dealing with the poor comments loops induced through falling prices.

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